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United Kingdom: Financial Sector Assessment Program Technical Notes and Detailed Standards Assessments

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FINANCIAL SECTOR ASSESSMENT PROGRAM

UNITED KINGDOM

TECHNICAL NOTE: PUBLIC DEBT MANAGEMENT IN THE UNITED KINGDOM

MAY 2003

Contents **Page**

I. Introduction 3

II. Objectives and Scope of Debt Management 6

III. Transparency and Accountability 9

IV. Institutional Framework..10

V. Debt Strategy..14

VI. Risk Management Framework..16

VII. Developing and Maintaining an Efficient Market for Government Securities 18

VIII. Overall Assessment..34

Text Tables
1. Public Sector Net Debt..3
2. General Government Net Financial Liabilities for G-7 Countries...4
3. Distribution of Nominal Central Government Gross Debt by Instrument............................4
4. Distribution of Gilt Holdings as of December 2001 5
5. Sterling Capital Markets 18
6. Secondary Market Turnover in Selected Sterling...19
7. 1997 Cross-Country Comparison of Government Bond Market Trading Volumes............20
8. Yield Curve Slopes in G-7 Countries 29
9. April 2002 PBR forecasts for the CGNCR..29

Figures
1. Par Gilt Curves..28

I. INTRODUCTION[1]

1. **The amount of public sector debt outstanding in the U.K. is low.** Public sector net debt totaled £303 billion in nominal terms or 30 percent of GDP as of February 2002 (Table 1), the lowest ratio since 1992, and also the lowest among all the G-7 countries (Table 2). Total public sector gross debt (i.e., public sector net debt before short-term financial assets are deducted) consists almost entirely of central government gross debt, since the vast majority of local government and public corporations' gross debt is borrowed from the central government and is thus netted out when calculating the consolidated figure. In addition, although more than £4 billion of local government debt is not held by the central government, this is offset in the public sector net debt figures by a similar amount of central government debt held by public corporations, such as the Post Office.

Table 1. Public Sector Net Debt
(£ billions, percentages in italics)

End-March 1/	1997	1998	1999	2000	2001	2002
Central government gross debt	**391.9**	**393.9**	**392.3**	**387.7**	**376.7**	**372.0**
Local government gross debt	51.6	51.9	52.7	53.4	52.3	52.5
Less holdings of other public sector debt:						
Central gov't holdings of local gov't debt	42.5	43.4	45.3	46.8	48.0	47.9
Local gov't holdings of central gov't debt	0.2	0.2	0.3	0.3	0.0	0.0
General government consolidated gross debt	**400.8**	**402.2**	**399.5**	**394.1**	**381.0**	**376.5**
As a percent of GDP	*50.6*	*47.8*	*45.5*	*42.2*	*38.9*	*37.2*
Public corporations gross debt	26.6	26.0	26.8	26.8	27.7	26.8
Less holdings of other public sector debt:						
Central gov't holdings of public corp. debt	25.7	25.7	26.4	26.5	27.3	26.7
Local gov't holdings of public corp. debt	0.0	0.0	0.0	0.0	0.0	0.0
Public corp. holdings of central gov't debt	7.1	7.4	6.5	7.1	6.5	6.7
Public corp. holdings of local gov't debt	0.8	0.8	0.8	0.0	0.0	0.0
Public sector consolidated gross debt	**393.4**	**394.3**	**392.5**	**387.3**	**375.0**	**369.9**
As a percent of GDP	*49.7*	*46.8*	*44.7*	*41.4*	*38.3*	*36.5*
Less public sector liquid assets	44.9	41.4	43.9	47.2	69.0	66.8
Public sector net debt	**348.5**	**352.9**	**348.6**	**340.1**	**305.9**	**303.2**
As a percent of GDP	*44.0*	*41.9*	*39.7*	*36.4*	*31.2*	*29.9*

Source: Office for National Statistics.
1/ 2002 data are as of end-February.

[1] This paper was prepared by the FSAP mission team as part of the background work for the U.K. FSAP in the summer-fall of 2002. The primary contributor to this paper was Mark Zelmer of the IMF's Monetary and Financial Systems Department.

Table 2. General Government Net Financial Liabilities for G-7 Countries
(As a percent of GDP)

					Estimates and projections			
Year	1985	1990	1995	2000	2001	2002	2003	
Canada		52.5	61.2	88.0	65.0	59.7	56.1	51.0
France		10.6	16.1	35.9	42.2	42.2	42.6	42.2
Germany		18.7	17.8	39.4	41.5	41.5	43.2	43.3
Italy	79.6	83.7	108.7	98.7	95.5	93.0	89.8	
Japan		35.0	12.4	16.9	51.1	58.7	66.8	74.0
United Kingdom		**30.8**	**15.1**	**36.9**	**33.1**	**30.5**	**29.2**	**28.5**
United States	41.9	49.9	59.2	43.4	41.1	41.4	40.0	
Memo items:								
European Union Countries		34.3	33.0	54.1	50.0	48.3	47.7	46.5
20 OECD Countries	36.4	35.0	48.2	44.2	43.4	44.3	44.1	

Source: OECD Economic Outlook No. 70, Government Debt Statistics: Fiscal Balances & Public Indebtedness

2. **Gilts (government bonds) are the main component of the stock of central government debt** (Table 3). Most consist of conventional instruments, although there is a significant stock of inflation-indexed (index-linked) bonds outstanding. National Savings instruments issued to U.K. households represent the largest non-gilt segment. There is also a small amount of Treasury bills outstanding, which are issued for government cash management purposes. Foreign currency debt is very small, and is hedged by matching foreign currency reserves.

Table 3. Distribution of Nominal Central Government Gross Debt by Instrument
(£ billions, percentages in italics)

End-February 2002		
British Government Gilt Stocks	269.7	*72.5*
Of which: Conventional	198.8	*53.4*
Index-linked 1/	70.9	*19.1*
Sterling Treasury bills	7.9	*2.1*
National Savings & Investment	62.5	*16.8*
Certificates of tax deposits	0.5	*0.1*
Other sterling debt	27.9	*7.5*
Central government sterling gross debt	**368.4**	***99.0***
US$ debt	2.1	*0.6*
Euro Treasury notes	1.2	*0.3*
North American government war loans	0.2	*0.1*
Central government foreign currency gross debt	**3.6**	***1.0***
Total central government gross debt	**372.0**	***100.0***

1/ The nominal value of index-linked gilts has been raised by the amount of accrued capital uplift.
Source: Office for National Statistics.

3. **The stock of gilts is mainly held by institutional investors.** U.K. insurance companies and pension funds hold most of the gilts outstanding (Table 4). The rest is mainly held by other domestic financial institutions and nonresidents.

Table 4. Distribution of Gilt Holdings as of December 2001
(market values)
(£ billions, percentages in italics)

Public sector 1/	4.4	*1.3*
Banks and building societies	3.1	*1.0*
Insurance companies and pension funds	183.7	*62.7*
Other domestic financial institutions	29.6	*10.3*
Households	18.8	*6.4*
Nonresidents	53.4	*18.2*
Total	**292.9**	***100.0***

Source: Office for National Statistics
1/ Net of central government holdings.

4. **The U.K. government follows a sustainable investment rule, which states that public sector net debt as a proportion of GDP will be held at a stable and prudent level over the economic cycle.** Other things being equal, policy is for net debt to be maintained below 40 percent of GDP over the economic cycle. The government also has a second fiscal rule known as the golden rule, which states that, over the economic cycle, the government will borrow only to invest, and not to fund current spending. The low level of government indebtedness in recent years has enabled the government to respect these rules with comfortable margins to spare.

5. **The rest of this chapter examines the UK's public debt management practices using the IMF-World Bank Guidelines for Public Debt Management as a framework.** The focus is on the management of the central government's domestic wholesale market obligations by the Debt Management Office (DMO), since these account for most of the debt outstanding and are the most relevant from the standpoint of the stability of the U.K. financial system. In light of the low level of borrowing by the U.K. government in recent years, special attention is placed on the measures taken by the authorities to maintain a well-functioning gilt market. The coordination of debt and cash management with monetary policy is also examined given the transfer of sterling cash management from the Bank of England to the DMO in 2000. Section A examines the objectives of debt management; transparency issues are discussed in Section B; and the institutional framework is outlined in Section C. The debt strategy followed by U.K. authorities is reviewed in Section D; the risk management framework in Section E; and the functioning of the gilt market in Section F. An overall assessment of U.K. public debt management practices is provided in Section G.

II. OBJECTIVES AND SCOPE OF DEBT MANAGEMENT

6. **The current objective for debt management was set in 1995**. It is as follows:

> To manage over the long-term the cost of meeting the Government's financing needs, taking into account risk, whilst ensuring that debt management is consistent with the objectives of monetary policy.

7. **This objective is to be achieved through the following strategies**:

- Pursuing an issuance policy that is open, predictable, and transparent;
- Issuing conventional gilts that achieve a benchmark premium;
- Adjusting the maturity and nature of the government debt portfolio, by means of the maturity and composition of debt issuance and other market operations, including switch auctions, conversion offers, and buy-backs;
- Developing a liquid and efficient gilts market; and
- Offering cost-effective retail savings instruments.

8. **The objective explicitly takes account of risk and focuses on managing debt service costs over the long-term.** The authorities seek to ensure that expected debt service costs are robust against a variety of economic outturns. The main way of doing this is by considering the effect of issuance on the ensuing government debt portfolio. They do not believe that they are able to predict which security will prove to be cheaper than any other, since they do not believe that they are any better informed than the market on key macroeconomic variables. Instead, they prefer to select a debt portfolio that protects the government from as wide a range of shocks as possible.

9. **In terms of the operational delivery of the objective, the 1995 review of debt management heralded a move away from a highly discretionary debt management policy.** It rejected the thesis that discretion benefited the government in that it could sell appropriate amounts of debt at advantageous prices. It concluded that under such arrangements the government would pay an unnecessary premium, since it would be systematically attempting to beat the market and there would be no certainty or transparency in the path of issuance policy. As a result, the government has shifted in favor of a policy that promotes a more efficient, liquid and informationally more complete market. This includes adhering to a policy of annual published remits, which set out in advance issuance in terms of type and maturity of gilt, a pre-announced auction calendar, and a move from gilt sales by tap to an auction-based issuance system.

Coordinating debt management with fiscal and monetary policy

10. Responsibility for debt and cash management has been formally separated from monetary policy, and there are mechanisms in place to ensure that the conduct of these policies is appropriately coordinated. The DMO officially became operational as an executive agency of HM Treasury in April 1998 and took over responsibility for debt management from the Bank of England as of that date. Full responsibility for cash management was assumed in April 2000. Prior to April 1998, the Bank of England acted as the government's agent in debt and cash markets. The transfer of debt management responsibilities to HM Treasury helped to mitigate any perception that the Government's debt and cash operations benefited from inside knowledge over the future path of interest rates. It has also helped to avoid a potential conflict of interest, or perception of a conflict, between the objectives guiding debt management and monetary policy operations. And, it appears to have aligned incentives within HM Treasury to improve cash forecasting, as evidenced by the significant improvement in mean absolute forecasting errors documented in the chapter on systemic liquidity arrangements.

11. **The separation of responsibilities allows for the setting of clear and separate objectives for monetary policy and debt management with benefits in terms of reduced market uncertainty and hence lower interest rates.** The Bank of England's Monetary Policy Committee (MPC) is able to raise any issues about the implications of debt management for monetary policy with HM Treasury's representative at MPC meetings. However, in order to avoid creating any external perceptions that the DMO is privy to monetary deliberations, it has no contact with the MPC (including the non-voting HM Treasury representative) with regard to interest rate decisions or its thinking.

12. **The debt management objective still has a reference to monetary policy.** It ensures that the Bank of England's monetary policy responsibilities will not be undermined by the DMO or by the Treasury (e.g., "printing money" to meet the government's cash requirements, or DMO cash management operations interfering with the Bank's monetary policy operations).

13. **At the operational level, the framework for cash management developed by HM Treasury and the DMO in discussion with the Bank of England is designed to ensure that DMO operations do not cut across the Bank's monetary policy operations.** The DMO avoids holding tenders at times when the Bank is conducting money market operations, and does not hold reverse repo tenders at the 14-day maturity range. It also does not conduct ad hoc tenders on MPC decision days. These restrictions do not apply to bilateral operations conducted by the DMO owing to their relatively low market profile compared to auctions. However, the DMO acts as a price-taker in its market operations.

14. **The DMO may also issue Treasury bills to assist the Bank of England in its management of the sterling money market.** If so requested by the Bank, the DMO would add an additional amount of bills to a tender and deposit the proceeds at the Bank at an interest rate equal to the average yield at the tender. If the DMO were to do this, it would

identify, in its usual announcements, any amounts being issued for the Bank. This facility has not been used.

15. **On occasion, sizeable unanticipated cash inflows and outflows may occur too late in the day for their impact to be smoothed by the DMO in the money market.** To take account of this, arrangements have been put in place with the Bank of England and settlement banks to cope with late changes to the forecast without disadvantage to the market. In circumstances where there is an Exchequer cash surplus, the surplus is taken into the Bank of England's 4:20 p.m. overnight repo facility and is allocated at a non-penal interest rate (i.e., the additional refinancing is provided by the Bank to the settlement banks at its two-week repo rate). An Exchequer cash deficit can also be offset by bilateral borrowing from a number of settlement banks through a special end-of-day transfer arrangement.

16. **The DMO targets a balance of £200 million at the Bank of England in order to manage the rare circumstances where unanticipated changes to the forecast are not fully accommodated in the usual end of day arrangements.** The current structure replaces the previous arrangements through which late changes were absorbed by fluctuations in the size of the government's Ways and Means advance from the Bank of England. Since the transfer of cash management to the DMO, the £200 million target has, as expected, covered all but two daily cash shortfalls. The two exceptions both occurred in the 2000–01 fiscal year, and only required modest (around £20 million) fluctuations in the size of the Ways and Means advance (which normally stands at £13.4 billion). Both were reversed the following business day.

17. **Debt management is coordinated with fiscal policy in that the annual borrowing program is set by HM Treasury on the basis of the fiscal plans contained in the government's budget.** The borrowing program is updated in line with the update to the government's cash forecast, issued at the time of the Pre-Budget Report.

18. **The DMO operates as much as possible on a commercial basis and distances itself from a role in supervising financial markets.** For example, it sets its own terms and conditions when managing the risks associated with its operations, such as rules governing eligible collateral in its market operations.[2] However, it tries to promote well-functioning markets by operating as a "good market citizen"—e.g., by setting a good example in the conduct of its market operations and responding to requests for information from the Bank of England and the FSA on market developments. It also plays an active role in the market

[2] The range of collateral accepted by the DMO in its market operations is set without recourse to prudential information from the Bank of England or the FSA. It consists of all gilts, Treasury bills, and foreign currency issues of HM Treasury; selected European government €-denominated sovereign issues; selected highest-rated supranational £- and €-denominated debt; selected bank bills, and other high quality short-term debt issued by supranationals and foreign governments. Consistent with market practice, the DMO does not publish specific details regarding the collateral it will accept, but does publish broad outlines of the collateral accepted in repo and reverse repo trades. This enables it to set rules that are free of public policy considerations and devoid of signaling content. Its market counterparties learn the details through experience.

committees that discuss the functioning of the markets in which it operates, and works closely with market participants to introduce new innovations such as electronic trading systems to the interdealer gilt market. It is also prepared to serve as an instrument of the Treasury should there be a need for public intervention to support the markets, provided that such an operation would be conducted in a transparent fashion and in a way that clearly separates it from the DMO's normal market operations.

III. Transparency and Accountability

19. **Public debt management in the U.K. is conducted in an open and transparent fashion in accordance with the government's *Code for Fiscal Stability*.** Indeed, market participants effusively praised the authorities for the major improvements in transparency that have been introduced since 1997. The DMO and HM Treasury maintain websites that contain a comprehensive set of information and publications that provide data on, and explanations of: the objectives guiding debt and cash management activities; the debt/cash management governance and institutional framework; the government's finances; and debt/cash management operations. Under statute, the government must publish details of its borrowing activities during the fiscal year, and its plans for the year ahead before the end of the fiscal year. These are contained in the *Debt and Reserves Management Report* (DRMR) published by the Treasury. The DRMR also explains the debt and foreign exchange reserves management operations of the fiscal year just ended, and for the coming fiscal year, details the financing requirement, the forecast sales of gilts, their breakdown by maturity and instrument type, and the gilt auction calendar, along with planned short-term debt sales including Treasury bills.

20. **An auction calendar is issued at the end of each quarter by the DMO, which confirms auction dates for the coming quarter and states which gilts are to be issued on which date.** Normally eight calendar days before an auction, the amount of stock to be auctioned is announced (and if it is a new stock, the coupon). At this point, the stock is listed on the London Stock Exchange and 'when-issued' trading commences. A quarterly auction calendar is also issued for Treasury bill tenders.

21. **Market-makers and end-investor groups are consulted regularly through meetings with DMO staff during the formulation of these plans (and also quarterly before the DMO announces specific auction stocks for the quarter ahead).** They are also regularly consulted ahead of time whenever the authorities are considering changes to debt management practices or initiatives to enhance the functioning of the market. Minutes of the consultation meetings are published within a few hours of the meetings.

22. **Gilts are now issued by auction.** The DMO retains the ability to buy-back or issue gilts in smaller quantities (by tap) and conduct special repos at short notice for market management reasons—i.e., to ensure that the functioning of the market is not severely impaired by technical pricing distortions associated with excess demand for a specific

security and the like. Operational transparency is enhanced through regular close consultation with market participants.[3]

23. **The National Audit Office (NAO) annually audits the government's Debt Management Account (DMA), the account through which all financial transactions entered into by the DMO in pursuit of its debt and cash management objectives pass, and the National Loans Fund (NLF), through which all gilt issuance is recorded.** It also audits the administrative (or agency) accounts of the DMO. The results of these audits are published each year. In addition, the DMO's annual report reports its performance in meeting the objectives set forth in its business plan. This report and the DMO's annual business plan are published each year on the DMO's website. Like all U.K. government executive agencies, the DMO's activities are to be regularly reviewed by the parent department, the results of which are reported to Parliament.

24. **One area where there continues to be some opaqueness in the process is the lack of information on the considerations that lie behind the cost-risk trade-offs implicit in the annual remit provided to the DMO.** The authorities expect to publish work shortly that examines the linkages between fiscal policy and the debt portfolio. It includes the development of a comprehensive asset and liability risk monitor to aid the quantification of risks faced by the central government in its balance sheet. A preliminary version of the risk monitor was published in the 2002-03 DRMR as a precursor to the publication of the *Whole of Government Accounts* in 2005-06.

IV. Institutional Framework

25. **The institutional framework for debt management is well specified with a clear articulation of roles and responsibilities.** Government debt management is principally handled by two executive agencies. The DMO manage the government's domestic wholesale market borrowings and its domestic cash balances. National Savings and Investments (NS&I) oversees the government's savings instrument program, which raises funds directly from U.K. households. Foreign currency debt management and the management of the government's foreign currency reserves are still conducted by the Bank of England as agent for HM Treasury under a formal remit between the two institutions.[4] The annual remits provided to the DMO and NS&I and the MOU between the Bank and HM Treasury are published in the DRMR.

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[3] Full details of all these instruments and operations are available in the Gilt Operational Notice and Cash Operational Notice on the DMO website.

[4] The Exchange Equalization Accounts (the government's repository for its foreign currency reserves) are published each year. There is also a formal monthly requirement to publish the level of reserves and indicate whether (and if so, the amount) the authorities have intervened in the foreign exchange market.

26. **As with all U.K. government executive agencies, the DMO's relationship with HM Treasury is outlined in a framework document that sets out the roles and responsibilities for each of the parties involved in debt management.**[5] The basic structure for debt management is that Treasury Ministers, advised by officials in HM Treasury's Debt and Reserves Management Team, set the policy framework within which the DMO takes operational decisions within the terms of the annual remit provided to it by Treasury Ministers. The DMO's business objectives include a requirement for the DMO to advise the Treasury about the appropriate policy framework, but strategic decisions rest with Ministers. The Bank of England acts as the DMO's agent for gilt settlement and retains responsibility for gilt registration.

Legal framework for borrowing

27. **The legal framework underpinning debt management provides HM Treasury with wide discretion as to how to raise money by borrowing.** It does so through two statutory funds, the National Loans Fund, and its sub-account for wholesale market borrowings, the Debt Management Account. Its main power to borrow for the National Loans Fund is conferred by section 12 of the National Loans Act 1968. This provides that the Treasury can raise any money that it considers expedient to raise for the purpose of promoting sound monetary conditions in the U.K., and this money may be raised in such manner and on such terms and conditions as the Treasury think fit. Section 12(3) of the same Act makes it clear that the Treasury's power to raise money extends to raising money either within or outside the U.K., and in other currencies. There are no set limits on the extent to which the Treasury may borrow from outside the United Kingdom.

28. **The Treasury's power to borrow for the Debt Management Account is conferred by paragraph 4 of Schedule 5A of the National Loans Act 1968, and this paragraph, like section 12 of the Act, gives the Treasury a wide discretion as to how to raise money.** Paragraph 4(3) is similar in terms to section 12(3) of the Act, and it provides that the Treasury's power to raise money under paragraph 4 extends to raising money either within or outside the United Kingdom, and in other currencies. Again, there is nothing in Schedule 5 of the Act to limit the amount of money the Treasury may borrow from outside the United Kingdom. In practice, Treasury borrowing takes a wide range of forms and ranges from the issuing of long-term securities (gilts) to the issuing of short-term Treasury Bills (12 months maximum) under the Treasury Bills Act 1877.

Organizational structure within the DMO

29. **The DMO's own organizational framework is clear and well-specified.** The Chancellor of the Exchequer, with advice from Treasury officials, determines the policy and

[5] A full description of all the DMO's responsibilities, objectives and lines of accountability is set out in the current version of its Framework Document (July 2001). It and other relevant documents can be found on the DMO's website.

financial framework within which the DMO operates, and delegates to its Chief Executive operational decisions on debt and cash management and day-to-day administrative issues. The Chief Executive is appointed by HM Treasury, and variously reports to the Permanent Secretary (on expenditure and related issues), to Treasury Ministers (on policy issues), and to Parliament (in the formal presentation of accounts). In particular, the Chief Executive is responsible to Treasury Ministers for the overall operation of the DMO, and for delivering the remit in a way that he/she judges will involve the least long run cost to the Exchequer, subject to being compatible with other policy considerations.

30. **The DMO employs approximately 80 people organized around ten business units, and has a structure of corporate governance in place to assist the Chief Executive in carrying out his responsibilities.** There is an informal high-level Advisory Board, advising the Managing Committee, which is the senior decision making body for the office.[6] The Managing Committee is in turn supported by a Credit and Risk Committee and strategy groups for each key business area (Debt, Cash, Investment). There are currently two external non-Executive Directors on the Advisory Board, both of whom are also on the office's Audit Committee, together with a member of HM Treasury. And, there is an appropriate separation of front, middle, and back office activities. **If the Advisory Board is expected to become a permanent fixture in the DMO, the authorities may wish to consider formalizing it in the DMO's governance framework, and introduce some selection criteria to guide its membership.**

31. **The DMO is financed as part of HM Treasury and operates under arrangements that control its administrative expenses.** It is subject to an internal audit function that reviews the systems of internal control, including financial controls, and to external audit by the National Audit Office. The Chief Executive is the Accounting Officer for both the office's administrative accounts, and the accounts of the Debt Management Account (DMA) through which all its market transactions pass.

32. **Appropriate human resource policies and systems are in place.** The Chief Executive of the DMO is responsible for setting the DMO's personnel policies and managing staff. The Office has delegated authority for pay, pay bargaining, training and setting terms and conditions in order to recruit, retain and motivate staff. Nonetheless, personnel policies must be consistent with wider public sector pay policy and the Civil Service Management Code. In practice, this means that while the DMO has some discretion with respect to the setting of staff compensation levels, the overall compensation policy must be approved by the government. The DMO achieved *Investors in People* accreditation in June 2000—an internationally-recognized ISO accreditation that recognizes the DMO's commitment to staff

[6] The Advisory Board does not have any formal standing in the governance framework and its proceedings are not published. The two members were appointed by the Chief Executive Officer through an informal selection process. They provide the DMO's management team with access to external expertise in audit issues and the formulation of investment management guidelines—the latter has taken on added importance now that the DMO has cash management responsibilities.

training and development, and its efforts to foster a "learning" environment in the organization. DMO staff are bound by conflict-of-interest guidelines and the code-of-conduct applicable to the U.K. civil service.

33. **Policies and procedures have been adopted to control operational risk.** The Statement of Internal Controls (SIC) in the DMO's Annual Report & Accounts (ARA) 2000-2001 describes the DMO's approach to managing its operational risk. The adequacy of the DMO's management of risk and internal controls is regularly reviewed by the DMO's Audit Committee, which is chaired by an external non-executive director. In addition, the DMO has established a Business Continuity Plan. This Plan includes a capability that would enable it to conduct its business at its Disaster Recovery Site in the event of its main offices becoming unavailable (see the SIC).[7] In the event that the DMO had to invoke this plan, it would post a notice on its web site notifying market counterparties of the event and of further information relevant to the continued operation of its business. A business continuity plan is also being developed in conjunction with key market participants under the stewardship of the Bank of England to mitigate the effect of a severe dislocation to the infrastructure supporting the U.K. markets.

34. **The lack of an automated bidding process for Treasury bill and gilt auctions is one area where the DMO is currently exposed to more operational risk than debt managers in some other industrial countries.** Bids are submitted by auction participants to the DMO by telephone, and DMO staff call the bidders back to confirm the details of each bid before the auction is processed. While a telephone system is very resilient, such an approach can potentially result in human errors, and may also slow the processing of the auction. As a result, government debt managers in several industrial countries have automated the bid-capture process using Bloomberg or customized systems, and have cut the amount of time spent processing the auction to 15 minutes, compared 30 minutes for gilt auctions. The DMO would also like to automate its bid-capture process, and expects to consult the market later this fiscal year. One hurdle to overcome in developing such a system will be to ensure that it can handle bidding limits for dealers and end-investors; however, some countries have been able to develop systems with such a feature. Inasmuch as this would represent a transfer of operational risk from the DMO to the market, such a proposal may not necessarily be enthusiastically endorsed by the DMO's counterparties. **Nonetheless, the DMO is encouraged to follow through with its desire to automate the bid-capture process for gilt and Treasury bill auctions** (although the latter should wait until these instruments are dematerialized). Once these systems are installed, the telephone bidding system could be used as a fall-back, for use in cases where the electronic systems are not available for some reason.

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[7] For example, under one of the arrangements the DMO and the Bank of England can use each other's trading room as a backup facility in the event of an emergency. This arrangement has been successfully tested in practice. For example, on one occasion the processing of a T-bill tender was successfully transferred from the DMO to the Bank in the middle of an auction.

V. Debt Strategy

35. **HM Treasury, with input from the DMO, determines the desired structure of new issuance for the year ahead taking into account the financing requirement and the costs and risks associated with various instruments.** This remit is published in the annual DRMR, and is expressed in terms of the percentage issuance across each class of gilt and overall financing to be raised through the issuance of Treasury bills.[8] After consulting HM Treasury and market participants, the DMO takes further tactical decisions about the features of new debt issues, and the precise timing of new borrowings during the year in line with the overall target. Significant changes to projected borrowing requirements may result in revisions to the remit. The Chancellor's Pre-Budget Report (typically published in October or November) provides an opportunity to revise the remit, if necessary, in light of changes to HM Treasury's economic outlook.

36. **The risks associated with the government's debt are prudently managed.** The government's policy has been to issue debt **across** a variety of instruments with a definite preference in favor of longer-term securities. At 7.5 years (at end-March 2002) the average duration of the gilt stock is longer than that of most OECD governments. This partly reflects a desire to minimize rollover risks, which in the past were significant when indebtedness levels were high. In addition, by issuing longer-term conventional debt, the government has been able to profit from the high institutional demand for long maturity debt from U.K. insurance companies and pension funds, which contributed to an inverted yield curve in recent years (see Section F). Along with a relatively smooth redemption profile, this helps to provide additional certainty to projections of future nominal debt servicing costs. Long duration debt also helps to limit the effect of any supply-side shock on the government's fiscal position.

37. **If the yield curve distortions should recede at some point in the future, the authorities may wish to consider shortening the average duration of the gilt portfolio.** In an upwardly sloping yield curve environment, this would result in debt service cost savings at the expense of some added risk to the debt portfolio—risk that the U.K. government should be well-placed to tolerate given its low level of indebtedness. To be fair, the authorities have already begun taking steps along this path. The 2002–03 remit provides for a more balanced distribution of gilt sales across the short, medium, and long tenors compared to the one in 2001–02, which called for the majority of gilt issuance to take place in the long (15+ year) tenor.

38. **Almost a quarter of the government's marketable debt portfolio consists of index-linked gilts and Treasury bills, and the debt issued by NS&I is also short-**

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[8] The amount of money to be raised in the wholesale market each year is set after taking into account projections of the net amount of funds that the NS&I expects to raise directly from U.K. households. NS&I projections are based on experience in previous years, and its own sales targets set in consultation with HM Treasury.

duration in nature. In the event of a demand shock this should allow the changes in the debt servicing cost relating to these parts of the national debt to mitigate the resulting effect on the government's fiscal balance. Index-linked securities also provide protection against a "nominal" shock. The expected cost advantages of issuing these securities have declined over time as the spread between nominal and real yields has settled just above the 2 ½ percent inflation target for monetary policy. The authorities noted that there remains strong demand in the market for them with limited substitutes available from private sector issuers.

39. **U.K. governments have not used foreign currency debt to finance domestic borrowing requirements in peacetime, reflecting the belief that foreign currency risk to the government's balance sheet is neither desirable nor cost-effective.** Instead, the issuance of such debt in recent years has been to augment the foreign currency reserves. Issuing liabilities in the currency in which the government wishes to hold foreign currency assets helps to hedge its foreign currency reserves against unexpected exchange rate fluctuations.

40. **The development of an active currency swap market has meant that the currency debt is issued in, and the currency in which assets are held, do not necessarily have to be the same.** Consequently, the authorities have **recently** issued additional amounts of domestic currency debt, and swapped the proceeds into another currency, in order to augment the government's foreign currency reserves and maintain issuance volumes in the domestic market. Value for money is the primary concern when deciding whether to fund the foreign currency reserves from debt issued in sterling swapped into foreign currency, or from the issuance of foreign currency denominated debt, with the comparison being made on a swapped basis. Stringent controls are in place to limit the amount of basis risk and credit risk associated with these swap transactions. Approximately £10 billion of such swaps were outstanding at the end of March 2002.

Cash management

41. **The DMO's management of the government's cash balances is highly respected by the market.** The DMO manages the government's domestic cash balances primarily through a combination of Treasury bill tenders conducted on a competitive bidding basis and repo or reverse repo transactions. Treasury bill tenders tend to be used to manage longer-term swings in cash flows within the fiscal year, while repo operations with market participants are used to manage shorter-term swings of less than one month. Market participants praised the DMO for its professionalism in executing its cash management transactions. They especially applauded its smooth investment of the much larger than expected receipts from the third generation mobile phone license auction (3G) in fiscal year 2000–01.

42. **Although the cash management process is working well with much smaller forecast errors than in past decades, U.K. authorities conceded that the quality of information received from government departments on the magnitude and timing of cash flows could be improved, and that the timing of these flows could be better synchronized so as to minimize the volatility of cash balances.** HM Treasury's Exchequer

Funds & Accounts team coordinates the cash forecasting process across government departments and agencies, and a system of financial rewards and penalties has been established to encourage good forecasting behavior at the department/agency level. Although this system is helping to encourage departments and agencies to provide better cash forecasts at the margin, the authorities may wish to consider larger rewards/penalties in order to motivate better performance. They could also consider providing financial managers in government departments/agencies with more information on the timing and magnitude of aggregate government revenues and expenditures, and introduce a system of rewards/penalties to encourage them to try and achieve a better synchronization of the timing of their expenditures with government cash receipts.

VI. Risk Management Framework

43. **Work is underway on managing risk in the debt portfolio by assessing the resilience of cost and tax smoothing properties for different debt structures to a range of economic conditions and shocks.** HM Treasury and the DMO will consider the "cost-at-risk" and robustness of different issuance strategies to different possible economic outcomes generated using Monte Carlo simulations within a reduced form macroeconomic model. These results will be further subjected to a range of stress tests to allow for the possibility of particular shocks, for example supply shocks.

44. **This should help to quantify an optimal debt portfolio against which an issuance strategy and long-term performance could be assessed, and thus could facilitate the identification of a counterfactual portfolio**. The two institutions believe that this counterfactual portfolio will provide a useful analytical tool when setting the terms of the DMO's annual financing remit. This counterfactual would help articulate, in the form of some simple indicators, the government's preferences for the appropriate structure of the debt. This might help the public understand better the government's cost-risk preferences, and would help separate accountability for the choice of the optimal debt portfolio (a policy decision) from accountability for the realization of the remit (DMO's tactical mandate).[9] It would also help address comments made by the Treasury Select Committee, which noted that portfolio benchmarks could "help produce a clear published assessment of the costs and risks faced by the DMO."[10]

45. **However, HM Treasury and the DMO would have significant concerns if this approach led to an explicit performance benchmark for the DMO.** The absence of such a

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[9] Recent monetary history offers a useful parallel in this regard. In an inflation targeting framework, one cannot say with precision what the target rate of inflation should be—it is ultimately a question of judgment. However, the adoption of inflation targeting helps to separate accountability for the choice of target (a strategic decision) from accountability for tactical decisions related to the implementation of monetary policy

[10] "Government's Cash and Debt Management" (HC 154) was published on May 22, 2000. It provides a comprehensive review of the Government's cash and debt management arrangements, as well as records of the oral evidence provided by officials and expert witnesses.

target is a deliberate choice that has been made for a number of reasons. They believe that such an approach would encourage short-term opportunistic behavior (or the perceptions of such behavior) on the part of debt managers as they strive to meet the performance benchmark to the detriment of the long-run cost minimization objective. First, there is no expectation that the DMO can predict movements in the gilt yield curve more accurately that the market as a whole, other than by exploiting inside information about future gilt supply or other relevant policy announcements. As a result, such a target might lead to a market perception that HM Treasury and the DMO would seek to outperform the benchmark target, either by taking views on the future course of interest rates or by having access to privileged information, to the detriment of the separation of debt and cash management from monetary policy. Secondly, in an environment where the government debt manager is the dominant issuer in the domestic currency, it is not possible to derive an objective benchmark that would not be affected by the very actions of the debt manager it is designed to assess. Third, a benchmark approach would curtail the ability of HM Treasury and the DMO to pursue wider debt management objectives, for example to maintain liquidity or build benchmarks at particular tenors. The DMO believes that this conflict could not simply be resolved through the use of interest rate swaps, since the swap counterparties would purchase gilts at the tenor the government was swapping out of to hedge their exposures. This would negate the effect of the initial strategic motivated issuance.

46. **Introducing some indicators that simply articulate the cost-risk preferences underpinning the remit would not necessarily induce opportunistic behavior on the part of the DMO.** The latter could still be governed by the structure of the current remit, which sets strict guidelines for the amount and tenor of new borrowings. There would not be any changes to the incentives it currently faces. The risk of opportunistic behavior would only arise if the DMO was given a more flexible remit that gave it additional discretion to set issuance strategy or use derivatives to actively manage the risk profile of the debt stock in pursuit of an optimal debt structure. Several countries in the European Monetary Union have given their public debt managers such discretion, which is understandable as these countries are no longer sovereign borrowers and compete against one another in the deep Euro-area bond market. **However, there is no need to change the structure of the DMO's remit at this time.**

Scope for active management

47. **Since almost all government borrowing is conducted in domestic markets, U.K. authorities do not seek to actively manage the debt portfolio to profit from movements in interest rates and exchange rates.** The authorities believe that this would risk financial loss, as well as potentially send adverse signals to the markets and conflict with monetary and fiscal policies. It could also add to market uncertainty, which in turn could be passed on to the government in the form of higher borrowing costs.

Contingent liabilities

48. **The government's contingent liabilities are managed separately from the debt program.** Generally, the government tries to avoid taking on such liabilities, but the decision on whether to finance commitments through debt or through guarantees is one that is made at the political level after taking account of information provided by HM Treasury and the DMO on the opportunity cost of financing the commitments in the market. Details of the government's contingent liabilities are published each year in the Supplementary Statements accompanying the publication of the Consolidated Fund and National Loan Fund accounts. A list of contingent liabilities and their maximum potential loss is produced. (They mainly consist of the cost of nuclear waste cleanup, export credits, and guarantees provided for the construction of the Channel Tunnel.) Additional work is planned to quantify and assess the risks of these liabilities so that their estimated values can be calculated within a probabilistic framework.

VII. Developing and Maintaining an Efficient Market for Government Securities

49. **The gilt market is the smallest segment of the sterling capital market, although the gilt repo market is becoming an increasingly important component of the sterling money market.** Table 5 compares the size of the gilt market with the sterling money market and markets for other fixed income securities and equities. The relatively small size of the gilt market reflects the government's modest borrowing requirements in recent years. Although the gilt market is small, these securities are actively traded in the secondary market, while other sterling-denominated bonds are not (Table 6). Gilt trading volumes have held fairly steady despite the shrinking size of the market in recent years. A 1997 BIS study suggests that the secondary market in gilts is less active than comparable markets in France and North America, but compares favorably with many government bond markets in Continental Europe and Japan (Table 7).

Table 5. Sterling Capital Markets
Amounts outstanding (£ billions, end of period)

	1990	**1995**	**1998**	**1999**	**2000**	**2001**
Money market1/	183	195	434	475	504	541
Gilts	**125**	**233**	**301**	**294**	**294**	**275**
Non-gilt bonds	60	117	203	255	314	379
UK equities 2/	486	849	1,334	1,893	1,715	1,498
Interest rate swaps 3/	167	541	1,979	2,194	2,651	3,456
Total	**1,021**	**1,935**	**4,251**	**5,111**	**5,478**	**6,149**

Source: Bank of England.
1/ Defined here as amounts outstanding in the interbank, certificate of deposit, gilt repo and stock lending, bill, and commercial paper market.
2/ Measured as market capitalization of the FTSE All-Share index; 1990 data are estimated.
3/ Single currency interest rate swaps, notional principal outstanding. 1990 data are not available so the table uses 1992 data; 2000 data are end-June.

Table 6. Secondary Market Turnover in Selected Sterling Markets
Average daily amount (£ billions)

		1998	1999	2000	2001
Gilts	Conventional	7.4	5.2	6.1	7.7
	Indexed-linked	0.3	0.2	0.3	0.3
Gilt futures		4.9	3.3	2.1	2.6
Non-gilt bonds		0.4	0.3	0.4	0.5
UK equities		4.1	5.6	7.5	7.5
International equities 1/		8.7	9.6	14.0	14.5

Source: London Stock Exchange and London International Futures and Options Exchange
1/ Foreign firms listed for trading on the London Stock Exchange.

50. **Most of the trading in gilts consists of over-the-counter trading between market makers and their customers.** Market participants suggested that the gilt interdealer market is less active than comparable markets in Europe and North America. Institutional clients expect to be able to transact £25 to £100 million with tight spreads, while trades of £5 million are more common in the interdealer market. Market participants reported that the market is dominated by about 25 insurance and pension fund clients that deal primarily through the five most active gilt-edged market makers (GEMMs). The GEMMs prefer whenever possible to intermediate transactions through their client base, rather than trade with each other, in order to retain as much of the bid-offer spread as possible. The limited number of large investors that are regularly present in the market has helped to limit search costs and increase the viability of such a strategy. Institutional clients are reportedly becoming more adept at trading off immediacy versus price when negotiating trades with the GEMMs; in the past, they tended to insist on immediacy at the expense of price. GEMMs have reportedly become more cautious since 1997 about quoting tight spreads for large orders as their risk management practices tightened up.

Table 7. 1997 Cross-Country Comparison of Government Bond Market Trading Volumes

	Bid-offer Spreads 1/	Annual Trading Volume (US$ billions)	Stock Turnover Ratio 3/
Belgium	…	947	4.1
Canada	2-10	6.243	21.9
France	4-24	18.634	33.8
Germany	4-10	...	...
Italy	3-6	8.419	7.7
Japan	5-16	13.282	6.9
Netherlands	...	450 2/	2.6
Sweden	4-27	3.626	32.7
Switzerland	10-25	125 2/	3.6
UK	**3-8**	**3.222**	**7.0**
US	1.6-3.1	75.901	22.0

Source: Bank for International Settlements, Committee on the Global Financial System. 1999. "Market Liquidity: Research Findings and Selected Policy Implications" BIS-CGFS Study No. 11. May.
1/ The range of interdealer bid-offer spreads for benchmark securities, expressed in 1/100 of a currency unit for the face value of 100 currency units. Spreads tend to be narrower for shorter-term securities, and wider for longer-term ones.
2/ Data may include trading other than outright transactions, such as repos or buy/sellbacks.
3/ Annual trading volume divided by the stock of debt outstanding.

Structure of the Gilt Market

Gilt-edged Market Makers (GEMMs)

51. **The U.K. Government bond market operates as a primary dealer system.** There are 16 firms recognized as primary dealers (GEMMs) by the DMO. Each GEMM is authorized by the Financial Services Authority (FSA), and must be a member of the London Stock Exchange so that its trading practices are subject to supervision by the Exchange. The GEMMs undertake a number of market-making obligations, in return for certain benefits.

52. **The obligations of a GEMM are to participate actively in the DMO's gilt issuance program; to make effective two-way prices on demand in almost all gilts (those issues that have very small amounts outstanding are excluded); and to provide information to the DMO on market conditions.** 10 of the 16 recognized GEMMs are also recognized as Index-linked Gilt-edged Market Makers (IG GEMMs), and their market-making obligations extend to cover inflation-indexed gilts.

53. **Beginning in 2002, GEMMs are also required to provide firm two-way quotes to other GEMMs in a small set of benchmark gilts.**[11] The purpose of this new obligation is to ensure there is a minimum amount of liquidity in the intra-GEMM market for the benefit of the entire secondary market for gilts. These quotes are to be made for at least 5 hours during the eight hour London trading day on any of the three recognized interdealer broker (IDB) screens. They ensure that at least £28 million of liquidity is available across the yield curve to any GEMM needing to lay-off an undesired position. Although non-GEMM market participants do not have access to these screens, the transparency of the market is aided by the prices that GEMMs voluntarily make available through various wire services, and by the fact that the DMO publishes a real-time indicative mid-prices for a selection of benchmark gilts, drawing on GEMM prices as published on the wire services. At the retail level, the transparency of the market is enhanced by the fact that all trades of less than £50 thousand (par-value) are published on a real-time basis by the London Stock Exchange on its ticker tape.

54. **Although the GEMMs were consulted by the DMO on several occasions prior to the introduction of the mandatory price quoting rules, some of them now regret their introduction.** They view the mandatory quoting rules as an annoyance that causes them, at the margin, to pay more attention to servicing the IDB market than they would otherwise prefer. While recognizing that these rules should help to make the IDB market more accessible to potential new market entrants, which could add liquidity to the overall market, they fear that the rules may simply serve to generate artificial trading between themselves, to the distraction of servicing their client base. Smaller GEMMs are reportedly the most active users of the IDB market, since the larger ones are better able to intermediate through their own customer base. **On balance, the new rules should prove to be a useful step in developing a deep and liquid interdealer market—a market that could become more important if the underlying investor base broadens out over time and search costs for GEMMs increase accordingly.** Although the maximum bid-offer spreads are wider than the typical spreads seen in this market, there is no need to narrow them in. They currently serve a useful backstop function, and the future growth of the IDB market would be best served by leaving it to the participants to determine appropriate spread margins.

55. **GEMMs receive a number of benefits in return for their obligations.** These include: exclusive rights to competitive telephone bidding at gilt auctions and taps, either for

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[11] Mandatory bid-offer spreads on inter-GEMM quotes are to be 3 basis points or less, and the two-way quotes are expected to be good for dealing amounts of up to £5 million in the case of short and medium-term gilts, and £2 million in the case of long-term gilts. Most IDB trades take place at prices well within these bid-offer spreads. Thus, the maximum allowable spreads are not normally binding in practice. Moreover, in the event of a severe crisis in the gilts market, the DMO would be prepared to consider relaxing the maximum spread obligation, since it may not provide adequate cover for the risk being undertaken. This should ensure that this obligation does not have any significant negative effects on the resiliency of the gilt market in periods of market stress.

the GEMM's own account or on behalf of clients;[12] exclusive access to a non-competitive bidding facility at outright auctions; the exclusive facility to trade or switch stocks from the DMO's dealing screens; exclusive facilities to strip and reconstitute gilts; an invitation to a quarterly consultation meeting with the DMO (allowing the GEMMs to advise on the stock(s) to be scheduled for auction in the following quarter, and to discuss other market-related issues);[13] and exclusive access to gilt IDB screens. In addition, any transactions undertaken by the DMO for market management purposes are only carried out with or through the GEMMs.

Gilt Inter-Dealer Brokers (IDBs)

56. **There are three IDBs operating in the gilt market.** Their main purpose is to support liquidity in the secondary markets by enabling the GEMMs to unwind on an anonymous basis any unwanted gilt positions acquired in the course of their market-making activities. Almost all inter-GEMM trades are executed through an IDB. Non index-linked GEMMs do not have access to index-linked screens.

57. **IDBs are registered with the London Stock Exchange (LSE) and endorsed by the DMO.** The DMO monitors this segment of the market on an ongoing basis to ensure that the IDBs' services are available to all GEMMs on an equitable basis, and that the market maker structure is effectively supported by the IDB arrangements. The IDBs are also subject to specific conduct of business rules promulgated by the LSE. For example, they are prohibited from taking proprietary positions or from disseminating any market information beyond the GEMM community.

58. **Although IDBs cannot take proprietary positions, they serve as the counterparty between the GEMMs involved in a transaction going through them.** This is done in order to protect the anonymity of the GEMMs, who only see the name of the IDB when they transact through it. While no IDB has reportedly ever failed to honor its transactions, their central counterparty role in the inter-GEMM market could, in theory, be a source of risk. However, in that event the London Stock Exchange's default rules would come into effect. Under Rule 15.18 a Stock Exchange official (default official) would determine any payments due to or by the IDB to its counterparties on the transactions in default (on the basis of the current market or "hammer" prices of the bonds in question). Under Rule 15.24 (b) the default official would put the counterparties to unsettled trades in direct contact with one another, and the counterparties is required to complete the trade at the price at which the

[12] In order to prevent undue market concentration, GEMMs and their customers are each subject to allocation limits at the auctions. The limits are 25 percent of the amount of securities being auctioned (40 percent in the case of index-linked auctions).

[13] The DMO also holds quarterly meetings with the representatives of end investors. Minutes of these meetings are published shortly afterwards on the DMO's website. Additionally, there are annual meetings with the relevant Treasury Minister for both groups in January as part of the preparations for the annual remit, generally published in March.

original order was submitted. In the second half of 2002, the London Clearing House introduced a central counterparty clearing service for cash and gilt repo transactions. This service is currently restricted to conventional gilt transactions.

59. **Most IDB transactions are executed through the voice broking systems of the IDBs, rather than through their recently introduced electronic trading platforms.** However, the popularity of the latter is growing quickly, especially for straightforward transactions involving benchmark securities. Voice brokers are very useful for other trades, which tend to be more complex involving hedges against futures or links to other transactions, where the price and amounts need to be negotiated with the help of a broker. That said, the number of IDBs is expected to shrink as market preferences settle in favor of one or two electronic dealing systems.

Mechanisms used to issue gilts

60. **The DMO uses market-based mechanisms to issue debt and manage the stock of debt outstanding in a transparent and predictable fashion.** Auctions are the exclusive means by which the DMO issues gilts as part of its scheduled funding operations. Two different auction formats are used to issue gilts:

- conventional gilts are issued through a multiple price auction; and
- index-linked gilts are auctioned on a uniform price basis.

61. **Different auction formats are employed because of the different nature of the risks involved to the bidder for the different securities.** Conventional gilts are thought to have less primary issuance risk. There are often similar gilts already in the market to allow ease of pricing (or if more of an existing gilt is being issued, there is price information from the existing parent stock); auction positions can be hedged using gilt futures; and the secondary market is relatively liquid. This suggests that participation is not significantly deterred by bidders not knowing the rest of the market's valuation of the gilts on offer. A multiple price auction format also reduces the risk to the Government of implicit collusion by strategic bidding at auctions.

62. **In contrast, a uniform price format is used for index-linked gilt auctions.** Positions in index-linked gilts cannot be hedged as easily as conventional gilts. The secondary market for these gilts is also not as liquid as for conventional gilts. Both of these factors increase the uncertainty of index-linked auctions and increase the "Winner's Curse" for successful bidders—that is the cost of bidding high when the rest of the market bids low. Uniform price auctions reduce this uncertainty for auction participants and encourage participation. In addition there are fewer index-linked bonds than conventionals on issue, so pricing a new index-linked security might be harder than for a new conventional one.

63. **GEMMs have access to a non-competitive bidding facility under both formats.** They can submit a non-competitive bid for up to 0.5 percent of the amount of stock on offer in a conventional gilt auction. In an indexed-link auction, the proportion of stock available to

each IG GEMM is tied to their performance in the previous three auctions and an aggregate ceiling of 10 percent of the total amount of stock on offer.

64. **The DMO allots securities at its sole discretion.** Consistent with practices in other major industrialized countries, in exceptional circumstances it may choose not to allot all securities of offer—e.g., where the auction would only be covered at a level unacceptably below the prevailing market yield. In addition, in order to protect the integrity of the auction process, it may decline to allot securities to a bidder if it appears that to do so would likely lead to a market distortion. As a guideline, successful bidders, GEMMs or end-investors, should not expect to acquire at auction for their own account more than 25 percent of the amount on offer (net of the GEMM's own short position in the when-issued market or parent stock) for conventional gilts and 40 percent for index-linked securities. In addition to minimizing the risk that an investor, or group of investors, could exert undue influence over the prices of individual securities, these limits also help to promote a diversified investor base for the government' securities.

Tap issues

65. **The DMO only uses taps of both conventional and index-linked gilts for market management reasons, in conditions of temporary excess demand for a particular stock or sector.** The last one was in August 1999.

Conversion offers and switch auctions

66. **Market-based mechanisms have also been used to minimize debt stock fragmentation and promote a well-functioning secondary market for gilts.** In addition to the above operations, the DMO will occasionally issue stock through a conversion offer or a switch auction, where debt holders are offered the opportunity to convert or switch their holding of one gilt into another at a rate of conversion related to the market prices of each stock. In both cases, the main purposes of these operations are to:

- build up the size of new benchmark gilts more quickly than can be achieved through auctions alone. This is particularly important in a period of low issuance; and

- concentrate liquidity across the gilt yield curve by reducing the number of small, high coupon gilts and converting them into larger, current coupon gilts of broadly similar maturity.

67. **Conversion candidates will normally have around five years or more to maturity and less than £5.5bn nominal outstanding.** In addition, conversion offers will not be made for a stock that is cheapest-to-deliver, or has a reasonable likelihood of becoming cheapest-to-deliver, for any gilt futures contracts (with any outstanding open interest).

68. **The price terms of any conversion offer are decided by the DMO, using its own yield curve model to provide a benchmark ratio for the offer.** It then adjusts this ratio to take some account of the observed cheap/dear characteristics of the source and destination

stocks. Conversion offers remain open for a period of three weeks from the date of the initial announcement of the fixed price ratio in order to allow retail investors to participate. The appropriate amount of accrued interest on both gilts is incorporated into the calculation of the dirty price ratio, for forward settlement. The conversion itself involves no exchange of cash flows. When conducting these operations, the DMO chooses stocks with similar durations in order to limit its exposure to yield curve fluctuations that may arise during the three week life of the conversion offer.

69. **Acceptance of such offers is voluntary and debt holders are free to retain their existing stock although this is likely to become less liquid (i.e., traded less widely, with a possible adverse impact on price) if the bulk of the other holders of the gilt choose to convert their holdings.** Should the amount outstanding of a gilt be too small to expect a two-way market to exist, the DMO is prepared, when asked by a GEMM, to bid a price of its own choosing for the gilt. In addition, the DMO would relax market-making obligations on GEMMs in this "rump" gilt. The DMO would announce if a gilt took on this "rump" status.

70. **In addition to the main purposes identified for conversion offers, switch auctions were introduced in 2000 in order to:**

- facilitate switching by index-tracking funds as a particular stock is about to fall out of a significant maturity bracket, thus contributing to market stability; and
- allow the DMO to minimize rollover risk by smoothing the maturing gilt redemption profile by offering switches out of large maturing issues into the current 5-year benchmark (or other short-term instruments).

71. **Switch auctions are held only for a proportion of a larger stock that is too large to be considered for an outright conversion offer.** The DMO ensures that a sufficient amount of the source stock remains for a viable, liquid market to exist following a switch auction. Hence, it will not hold a switch auction for a conventional stock that would reduce the amount in issue to below £4.5 billion (nominal) and are only held where both the respective stocks are within the same maturity bracket, although here the maturity brackets overlap (short and ultra-short 0-7 years; medium 5-15 years; longs 14 years and over). In addition, it will not hold a switch auction out of a stock that is cheapest-to-deliver, or has a reasonable likelihood of becoming cheapest-to-deliver, into any of the 'active' gilt futures contracts. It may, however, switch into such a stock.

72. **Switch auctions are open to all holders of the source stock, although non-GEMMs must route their bids through a GEMM.** They are conducted on a competitive bid price basis, where successful competitive bidders are allotted stock at the prices which they bid. There is no non-competitive facility and the DMO does not set a minimum price.

73. **The same principles apply to index-linked switch auctions with the following exceptions.** First, these switches will only be held where both the respective stocks have longer than 4½ years to maturity, and where the source stock has not been auctioned in the

previous six months. Second, the (nominal) size of any single switch auction is limited to £250 million to £750 million of the source stock, and the DMO will not hold a switch auction that would leave an index-linked stock with a resultant amount outstanding of less than £1.5 billion nominal. Third, the auctions are conducted on a uniform bid price basis, whereby all successful bidders will receive stock at the same price. Where a GEMM's bids are above this price it will be allotted in the full amount bid, but allotments for bids at the striking price may be scaled. Published results will include the common allotment price; the pro rata rate at this price; the real yield equivalent to that price (and the inflation assumption used in that calculation), and the ratio of bids received to the amount on offer (the cover). Only one index-linked switch auction has been held to date.

Gilt Repo

74. **The DMO has the ability to create and repo specific stocks to market-makers, or other counterparties, under a special repo facility if, for example, a particular stock is in exceptionally short supply and distorting the orderly functioning of the market.** In response to a previous consultation exercise, the DMO introduced a non-discretionary standing repo facility in June 2000 for the purpose of managing actual or potential dislocations in the gilt market. Any GEMM, or other counterparty, may request the temporary creation of any non-rump stock for repo purposes. The DMO charges an overnight penal rate; and the returned stock is cancelled.[14] The facility is cash-neutral, since the operations involve the creation of additional stock in exchange for general collateral securities.

Gilt Strips

75. **The U.K. gilt strip market was launched on 8 December 1997.** Not all gilts are strippable (see below). The strip market was introduced to permit investors to:

- closely match the cash flows of their assets (strips) to those of their liabilities (e.g., annuities);
- to enable different types of investment risk to be taken; and
- to bring the range of products offered in the U.K. market in line with other large markets, such as the United States, Japan, Germany and France.

76. **From the issuer's perspective, a strips market can result in slightly lower financing costs if the market is willing to pay a premium for strippable bonds.** As of

[14] The penal rate of interest is ten percent of the prevailing Bank of England two-week repo rate. For example, if the Bank of England's two-week repo rate is 4 percent, then the institution borrowing the stock from the DMO would receive an annualized rate-of-return of 0.40 percent on the funds lodged with the DMO in exchange for the stock.

March 28, 2002, there were 13 strippable gilts in issue totaling £133.94 billion (nominal). Of these, £1.4 billion of stock was held in stripped form. All issues have aligned coupon payment dates. This means that coupons from different strippable bonds are fungible when traded as strips. However, coupon and principal strips paid on the same day are not fungible in order to protect the overall size of an issue and maintain the integrity of various benchmark bond indices. The first series of strippable stocks were issued with June 7/December 7 coupon dates; however, in 2001, the DMO issued two new conventional stocks with coupon dates aligned on March 7/September 7. These stocks became strippable in April 2002. The second series of coupon dates was introduced to avoid cash-flows becoming too concentrated on just two days in the year.

77. **Although anyone can trade or hold strips, only a GEMM, the DMO or the Bank of England can access the service provided by CREST to strip (or reconstitute) a strippable gilt.** GEMMs are obliged to make a market for strips. Thus, consistent with practices in other major industrialized countries, end-investors must deal through a GEMM.

78. **The market in gilt strips has grown slowly since its inception.** Factors that have contributed to this slow take-off have been the need for pension fund trustees to give appropriate authority to fund managers to invest in strips and the inversion of the yield curve over the period since the inception of strips, which makes strips appear expensive relative to conventional gilts. Retail demand for strips has also been hampered by the necessary tax treatment, whereby securities are taxed each year on their accrued capital gain or loss even though no income payment has been made. However, the ability to hold strips within some tax exempt savings products should reduce the tax disincentives to personal investment in strips.

Recent factors shaping the U.K. Gilt Market

79. **As indicated above, there have been a number of advances in issuance techniques since the 1995 debt management review.** The range of debt instruments has been refined and expanded, and numerous structural changes have taken place in the U.K. government debt markets. The overall aim of the reforms has been to help lower the cost of public financing over the long-term, responding to both endogenous and exogenous factors that have influenced the U.K. debt market during the period. In recent years these factors have included budget surpluses, the rapid rise of the U.K. corporate bond sector, institutional changes (particularly those relating to insurance companies and pension funds), and increasing technological and other advancements, which have enhanced systems, market structures and debt instruments around the world.

Declining levels of government debt

80. **As in other currencies, the sterling debt market has seen increased annual private issuance at a time when the U.K. has been running a budget surplus.** Thus, the government's percentage of the overall outstanding sterling debt has been steadily declining (Table 5). Falling government funding requirements have resulted in gilts acquiring a

scarcity premium, especially the longer-dated bonds, which in turn led to a reduction in yields and an inverted yield curve that was pronounced in both absolute terms and relative to those observed in other G-7 countries (Figure 1 and Table 8). At the same time, the U.K. has enjoyed a low inflation/low interest rate environment, so the need to enhance returns has led investors to increase their appetite for (credit) risk.

81. **As the U.K. Government's budgetary position improved, gross issuance of gilts declined from a peak of £55 billion in financial year 1993–94 to a trough of £8 billion in 1998–99.** However, given that the government's borrowing needs are cyclical, there is a benefit in maintaining a minimum level of issuance so that market infrastructure is sustained and the market remains sufficiently liquid and retains the capability to absorb future larger gross issuance. Table 9 summarizes the government's forecast for the Central Government Net Cash Requirement (CGNCR) over the next few years. The medium term forecasts point to an increasing level of net borrowing in response to planned investments in public services that is fully consistent with the fiscal rules.

Figure 1. Par Gilt Curves

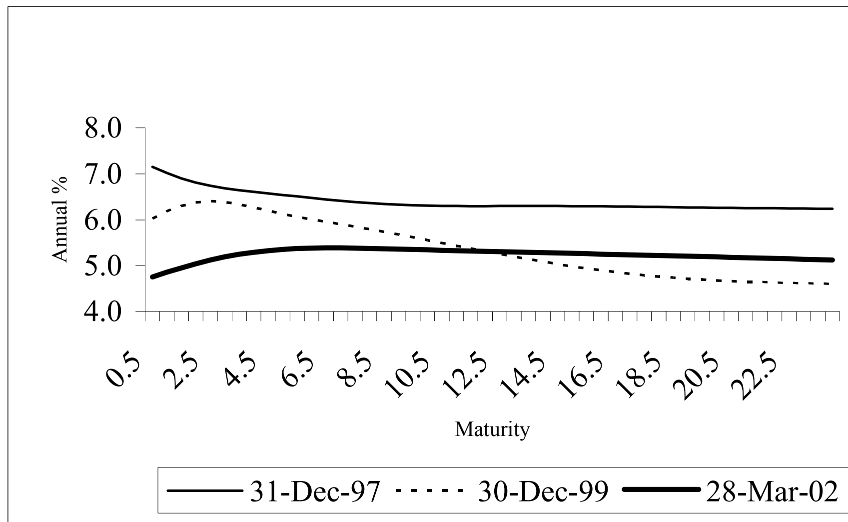

Table 8. Yield Curve Slopes in G-7 Countries 1/

	1996 Dec. 2/	1997	1998	1999	2000	2001	2002 Mar.
Canada	+234	+133	+22	+32	+2	+136	+130
France	+227	+165	+76	+136	+50	+106	+105
Germany	+227	+180	+72	+127	+41	+101	+92
Italy	+98	+59	+65	+145	+59	+128	+109
Japan	+205	+156	+105	+142	+123	+121	+134
UK	**+71**	**-5**	**-78**	**-48**	**-76**	**+5**	**+20**
US	+55	+33	+8	+26	-24	+142	+169

Source: Bloomberg Financial Services.
1/ Yields on 10-year benchmark bonds minus yields on 2-year benchmark bonds expressed in basis points.
2/ End of period for December 1996 and March 2002. All other years represent averages of end of quarters.

Table 9. April 2002 PBR forecasts for the CGNCR

(£ billion):

2001-02 projection	2002-03	2003-04	2004-05	2005-06	2006-07
6	14	18	16	21	24

82. **In view of the limited amount of gilt issuance in recent years, the DMO adopted a number of strategies to concentrate debt issuance into larger benchmark issues, currently at three maturity points, with a 5-, 10-, and long terms to maturity.** These larger issues enable the government to capture a liquidity premium across the yield curve. Examples of some of the initiatives include: running down the stock of NS&I securities, postponing the ramping up of the Treasury bill program, introducing buyback swaps and secondary market purchases of existing stock, and increased holdings of financial assets (such as running larger cash balances). The DMO has also used conversion and switch auctions (see above) to build benchmark issues.

83. **The authorities decided to launch a structured gilt buy-back program in FY2000–01 in order to add to gross issuance and thus help to maintain liquidity in the market during a time of strong demand.** Following market consultations, reverse auctions were reintroduced in FY2000–01 while the DMO acquired from the secondary market, short-dated index-linked gilts and double-dated gilts. It also purchases near-maturity gilts (with less than six months residual maturity) as part of its regular operations to smooth the cash flow effects of redemptions.

84. **The authorities have been pleased with these operations.** There was more than 90 percent take-up of the conversion offers, apart from the one conducted in November 1998. The switch auctions have all been covered with a comfortable margin, and the three longer-dated switches have secured very attractive forward-dated funding rates. The rates at which the DMO has repurchased stock in the program of reverse auctions were at yields that were considered "cheap" relative to the DMO's fitted yield curve.

Effects of pension fund and accounting rule changes

85. **In recent years, the pricing of gilts and other sterling-denominated bonds has also been significantly affected by the rules governing pension funds, notably the Minimum Funding Requirement (MFR) and Financial Reporting Standard 17 (FRS 17).** The conventional gilt market is especially exposed to the effects of such rule changes because U.K. pension funds and insurance companies are the principal investors in the gilt market.

86. **The MFR test was introduced in 1997 as part of the 1995 Pensions Act, and is applied to the assets of defined benefit occupational pension schemes.** The MFR test seeks to ensure that a defined benefit pension fund holds enough assets to balance its long-term pension liabilities, discounted over time. In the late 1990s, there was some concern that the MFR had significantly influenced pension funds' investment decisions. In particular, pension funds may have held more gilts as a hedge against short-term fluctuations in the MFR discount rate (which is based on the prevailing market yield on a basket of gilts with a maturity of 15 years) than would otherwise be the case. Furthermore, this increase in the demand for gilts appeared to have been relatively price-insensitive. Together with the decline in the net issuance of gilts, this excess demand may have contributed to the inversion of the gilt yield curve.

87. **Reflecting these concerns, the authorities initiated a review of the MFR.** In the March 2001 Budget the Chancellor of the Exchequer announced the Government's intention to repeal the MFR, and in February 2002 application of the MFR test was relaxed. While there remains some uncertainty as to what will take its pace, institutional investors have begun shifting their demand for fixed-income investments away from gilts in favor of non-gilt bonds in anticipation of the demise of the MFR, and the gilt yield curve has significantly disinverted. However, this relief could be short-lived. U.K. authorities and market participants noted that there is some uncertainty surrounding new European Community pension rules that are in the process of being developed. Some fear that these could prove to be more stringent than the MFR if they require pension funds to be fully funded on a continuous basis. If so, this would add to the incentives for pension funds to prefer fixed-income securities over equities in order to achieve a better matching of their assets and liabilities.

88. **Pension funds' demand for bonds is also being whetted by the introduction of FRS 17, and over time by an aging population, which is leading many pension funds to shift their investments from equities to bonds as their liabilities shorten in duration.**

Details of FRS 17 and how it compares to International Accounting **Standards** (IAS) can be found in the chapter dealing with accounting, disclosure, and corporate governance issues. Briefly, it requires that companies' defined benefit pension assets be measured at fair value, and that liabilities be discounted to present value using the prevailing yield on AA-rated corporate bonds with a similar tenor to the scheme's liabilities. The net surplus or deficit is recorded in the balance sheet and ongoing service costs (including the basic cost of pension provision) are recorded in the profit and loss statement. Other surpluses and deficits arising from fluctuating market values of fund assets will be recognized in the statement of total recognized gains and losses (STRGL). There is a transition period prior to full adoption of the standard for accounting periods ending on or after June 22, 2003.

89. **This accounting change has not had any material effects on the gilt market.** However, many pension funds are sharply increasing their holdings of *non-government* bonds in anticipation of the full implementation of the standard, so that they can achieve a better matching of reported values for pension fund assets and liabilities and limit the effects of changing market values on the sponsor's financial statements. The Bank of England's "Markets and Operations" article in the Spring 2002 *Bank of England Quarterly Bulletin* noted that non-gilt holdings as a proportion of insurance companies' and pension funds' asset portfolios have doubled since 1997 to16 percent of total assets, while equity holdings declined by more than 6 percentage points to 61 percent. In mid-2002, the Accounting Standards Board announced that it would delay the full implementation of FRS 17 in order to bring it in line with IAS and EU directives.

90. **An obvious puzzle that emerges is why did U.K. insurance companies and pension funds continue to invest in long-term gilt securities when the yield curve became inverted, rather than invest in other sterling debt instruments or offshore on a hedged basis, and why did U.K. companies and foreign borrowers not move more aggressively to tap the sterling market for long-term funding.** A couple of reasons were offered by market participants and U.K. authorities.

91. **First, it does appear that over time U.K. corporate and nonresident borrowers have in fact sought to access the sterling bond market for funds.** In an environment of modest government borrowing requirements, corporate and international issuance of sterling debt has grown rapidly to the point that they now outstrip U.K. government borrowing (Table 5). At times, the European Investment Bank has been a larger borrower in sterling than the DMO. This stands in marked contrast to 1995 when the amount of gilts outstanding was double that of non-gilt sterling bonds. However, U.K. corporate borrowers' appetite for long-term funds is reportedly very price sensitive. Thus, they appear to be only willing to enter the market when long-term gilt yields are less than 5½ percent. Similarly, foreign borrowers' willingness to enter the sterling market is very sensitive to currency swap rates. The latter are not always attractive after one takes account of transaction costs and counterparty risk, even though long-term sterling yields may appear low on an unhedged basis.

92. **As for U.K. insurance companies and pension funds, they traditionally have not had much of an appetite for non-gilt debt.** One reason they have not invested in government bonds in other countries is that it is almost impossible for them to implement the necessary exchange rate hedge because a foreign exchange swap market does not exist for long term investment horizons—three years appears to be the longest tenor available—whereas they would want to hold an investment with a tenor exceeding 15 years. Second, it takes time to change trustee rules and other governance clauses that have limited the discretion of portfolio managers when it came to investing in private debt securities. Pension fund trustees are reportedly unsophisticated and conservative—they have been reluctant to obtain the necessary expertise to supervise more complicated investment strategies. Moreover, a strong equity market in the late 1990s enabled their plans to achieve returns that more than satisfied their actuarial requirements. Thus, they had no incentive to pursue more sophisticated investment strategies because any gains at the margin would have accrued to the plan sponsors, not to the beneficiaries to whom they are accountable. That said, given the weakness in equity markets over the last couple of years, some insurance companies and pension fund portfolio managers have begun taking steps to hire staff that are experienced in investing in corporate debt.

93. **The effects of the MFR and FRS 17 on the sterling bond markets illustrate how rules and regulations designed to address public policy concerns can have unexpected consequences on the functioning of financial markets.** Authorities need to be especially vigilant of such effects in circumstances where markets, such as the sterling fixed income market, are dominated by a narrow group of investors. However, it is also important to note that these effects are often transitory. The distortions in the gilt yield curve are now beginning to fade as insurance companies and pension funds become more adept at investing in non-gilt bonds, and as other bond issuers enter the sterling bond market to exploit the favorable borrowing opportunities.

Emergence of alternative trading systems

94. **Another significant challenge confronting U.K. authorities is the growing popularity of alternative trading systems.** Many GEMMs have been active supporters of a number of fixed-income electronic trading systems, including inter-dealer platforms, such as BrokerTec and Euro MTS, and multiple dealer to client systems, such as TradeWeb and BondClick (now part of EuroMTS and BondVision).[15] In addition, GEMMs have considered adding gilts to their single dealer to customer platforms, where they exist for other **government** bonds.

95. **As part of its continuing commitment to encourage liquidity and transparency of the gilts market, the DMO consulted widely in 2000 about the possible impact of**

[15] Discussion of this issue draws heavily from A. Holland, 2001, "The Development of Alternative Trading Systems in the U.K. Gilt Market: Lessons and Implications." This paper was prepared for the Financial Market Structure and Dynamics Conference organized by the Bank of Canada in November 2001.

electronic trading systems on the secondary market for gilts and how the DMO's relationship with the GEMMs might change as a consequence. That work continued **during** 2001, and led to the introduction in 2002 of an inter-GEMMs electronic market with mandatory quote obligations in the more liquid gilts.

96. **This approach is similar to the mandatory liquidity provision common in most European government bond markets.** Although this poses an extra burden on the GEMMs, a central committed market should benefit the entire market (including the GEMMs), especially in times of limited issuance. It ensures that the GEMMs have access to a minimum depth of liquidity in certain bonds and that prices in that market are fully efficient, allowing the GEMMs to carry on their wider market-making activities in confidence. This could be particularly valuable in an environment where a number of trading venues exist. The DMO hopes that this model will make it more likely that entry barriers facing prospective GEMMs remain at acceptable levels, maintaining a high degree of competition in market-making services.

97. **The DMO sees little need to extend the model to the full electronic dealership model, where the centralized primary dealer core is augmented through direct participation of other financial institutions.** However, this model may evolve naturally from the inter-GEMM model.

98. **The issue of who should supply the necessary trading systems was delegated to a group of elected representatives of the GEMMs and a representative of the DMO.** This group has concluded that the best way is to allow each GEMM to supply their prices to any recognized IDB. Adopting this approach preserves competition in the provision of IDB services, and ensures that brokers will have a continuing incentive to develop their services and encourage further technological innovation. While liquidity would not be concentrated with just one broker, there should not be any market fragmentation, since all GEMMs will have equal access to all recognized IDBs.

99. **At the retail level, three of the GEMMs that specialize in servicing retail clients have launched a multiple dealer to client electronic trading service, BondScape, for sterling-denominated fixed income products.** This platform provides some basic bond analytics, in addition to supplying firm prices in bonds in small size, adding to the **prospective** investors' information set. The service is also provided to the network of retail brokers that deal directly with individuals.

100. **Electronic trading systems also open the way for primary auctions to be held electronically.** In addition to alleviating operational risk and facilitating faster auction processing (as discussed previously), it would open the possibility for more direct access to auctions by a wider set of market participants. Some settlement safeguards would need to be introduced, however, to protect the government against settlement risk in case some of the new participants failed to honor their auction obligations. That said, it is not clear whether major investors would choose to participate directly in the auction. Some prefer to avoid execution risk by dealing in the when-issued market, while others, especially index-trackers,

would likely wait to trade until after the auction so that they can execute at a price close to the one used in the calculation of gilt indices.

VIII. Overall Assessment

101. **The management of public debt is not a source of vulnerability for the financial system given the low level of government indebtedness and the conservative approach to managing the risks associated with the debt.** The UK's practices are fully consistent with the *IMF/World Bank Guidelines for Public Debt Management*. Indeed, the authorities deserve to be commended for the smooth transfer of cash management responsibilities from the Bank of England to the DMO in 2000, which has contributed to a highly efficient process for managing cash balances, and the large number of innovative initiatives undertaken to minimize the fragmentation of the debt stock and maintain issuance volumes in a period of modest borrowing requirements. Going forward, consideration could be given to some minor technical innovations, such as: (i) introducing some indicators to explicitly articulate the government's preferred cost-risk tradeoff in order to increase public understanding of the decisions underpinning the debt management remit, and reinforce the separation of accountability for debt policy strategy (a policy decision) from accountability for the tactics used to implement the strategy (the DMO's tactical mandate); (ii) automating the bid-capture process used in debt auctions in order to reduce operational risk and improve auction-processing times; and (iii) formalizing the role of the advisory board in the DMO's governance framework and introducing some selection criteria for members if this body is expected to become a permanent fixture in the DMO.

102. **Despite the U.K. authorities having undertaken a number of steps to maintain the depth and liquidity of the gilt market in an environment of modest borrowing requirements, the gilt market has been distorted by changes to accounting and pension rules.** It is important to note that these distortions are gradually being resolved by market participants themselves as insurance companies and pension funds become more adept at investing in non-gilt securities, and as other borrowers enter the market to take advantage of the high demand for sterling-denominated debt securities. Thus, there does not appear to be a need for public intervention beyond the steps already taken by the DMO to maintain gilt issuance volumes and minimize fragmentation in the debt stock. The main lesson to be drawn is that policymakers need to be cognizant of the unexpected consequences for financial markets of public policy actions in other domains. This is especially true for markets such as the gilt market, that are dominated by a narrow group of market participants.

103. **Finally, some market makers expressed concern about the new mandatory quotation rules in the interdealer gilt market.** While conceding that typical bid-offer spreads in this market are well within the maximum permissible limits, they believe that the need to be seen quoting prices in this market distracts them, at the margin, from focusing their efforts on serving their underlying customer base. In contrast to government bond markets in the U.S. and the largest Continental European countries, most of the trading activity in the U.K. consists of transactions with customers rather than interdealer trades. On the other hand, the new rules should help make the interdealer market more accessible to a

broader range of market makers. Over time, a more active and accessible interdealer market could prove invaluable as the overall market develops and the investor base broadens out. Thus, the new rules appear to be appropriate at this stage of the market's development. In addition, while the maximum bid-offer spreads are wider than the typical spreads seen in this market, there is no need to narrow them in. They currently serve a useful backstop function, and the future growth of this market is probably best served by leaving it to the participants to set appropriate spreads through competition.

FINANCIAL SECTOR ASSESSMENT PROGRAM

UNITED KINGDOM

TECHNICAL NOTE: SYSTEMIC LIQUIDITY ARRANGEMENTS IN THE UNITED KINGDOM

MAY 2003

Contents **Page**

I. Introduction 3

II. Monetary Operating Procedures..5

III. Sterling Money Market 12

IV. Pound Sterling Foreign Exchange Market...25

Text Tables
1. United Kingdom: Daily Shortage Forecast Errors...10
2. Sterling Money Markets 13
3. Distribution of Banks' Wholesale Sterling Liabilities by Group of Banks at end-December 2001...13
4. Turnover of Sterling Money Market...17
5. Daily Liquidity Supplied by Bank of England 20
6. U.K. Banks' Sterling Liquid Assets as of December 2001......................................22
7. Average Daily Global Trading in Pounds Sterling Relative to Other Currencies 26
8. Average Daily Trading in Pounds Sterling by Type of Transaction in April 2001 27

Figures
1. Sterling Money Market, Bid Offer Spreads..17

Boxes
1. Recent Reforms to Bank of England Monetary Operating Procedures 7
2. Prudential Supervision of Commercial Bank Liquidity Management..............................15

I. INTRODUCTION[1]

1. **Good systemic liquidity management practices and well functioning money and foreign exchange markets are essential preconditions for ensuring that funds are allocated efficiently in the economy and to underpin London's role as an international financial center.** Consequently, the Bank of England's monetary operating procedures were reviewed from the perspective of systemic liquidity management, as were the functioning of the sterling money and foreign exchange markets. The review was based on information provided by the U.K. authorities, as well as discussions with a broad range of financial market participants.

2. **In the case of the Bank of England's operating procedures, particular attention was paid to its ability to forecast the daily shortage in the sterling money market; the frequency and tenor of its daily monetary operations; and the ways in which it manages the risks associated with the collateral received in its repo operations. The Bank's operating procedures are fundamentally sound, and have benefited significantly from the reforms introduced in recent years.** In that context some points are as follows:

- The uncertainty inherent in projecting the demand for bank notes results in some residual uncertainty in the process used to forecast the daily shortage. However, the liquidity forecasting process works well.

- Over time, the Bank may wish to consider streamlining the number of daily operations it conducts in the market if the daily liquidity forecasting process can be improved. At the margin, this could have the salutary effect of encouraging market participants to sharpen further the management of their liquidity positions in the market, thereby contributing to a more efficient sterling money market.

- The methods used to manage the market risks of the collateral received in the course of executing monetary operations are appropriate. Credit and liquidity risk of collateral is not an issue for securities issued by the Bank of England or the U.K. government (the Bank's shareholder). While the Bank closely monitors the collateral it accepts, and has not encountered any problems in practice, prudent risk management practice would suggest that some controls be introduced for other securities accepted as collateral, particularly in light of the substantial widening of eligible collateral that has taken place in recent years, even though all of the collateral accepted by the Bank is of high quality. Such controls could include, for example, adopting minimum liquidity or credit rating thresholds, or limits on the amount of securities of a single issuer that can be pledged by a counterparty.

[1] This paper was prepared by the FSAP mission team as part of the background work for the U.K. FSAP in the summer-fall of 2002. The primary contributors to this paper were Eric Parrado and Mark Zelmer of the IMF's Monetary and Financial Systems Department.

- Down the road, the Bank may wish to consider reactivating the longer-term operations that were used to manage the demand for term liquidity during the millennium date change period to manage the composition of its balance sheet. This would enable it to acquire longer-term assets at prevailing market interest rates and manage the growth in the stock of refinancing, which has been slowly rising since April 2000. The need for such operations could become acute if the government should decide to repay the Ways and Means advance. No change is recommended to the two-week tenor for the policy interest rate given the market's comfort with the current arrangements and the U.K.'s close economic and financial linkages with the rest of Europe, where the European Central Bank also uses a two-week tenor.

3. **Turning to the behavior of the sterling money and foreign exchange markets, the review of these markets focused on the ability of the sterling money market to distribute the daily liquidity provided by the Bank of England, and the resiliency of these markets in periods of stress**. The mission's findings and recommendations can be summarized as follows:

- The money market does a good job in distributing the liquidity supplied by the Bank of England, as evidenced by the fact that the demand for precautionary balances at the Bank of England has been only £50 million compared to the £28 billion traded each day in the sterling interbank and gilt repo markets. The money and foreign exchange markets are also very liquid, although the increasing 'lumpiness' of the order flows could potentially make it difficult for traders to manage their positions in stressful situations. In light of the risks inherent in unsecured interbank exposures, the authorities were encouraged to continue with their efforts to strengthen their surveillance of bilateral unsecured exposures between banks so that they can obtain a better sense of the distribution of systemic risk in the banking system. They may also wish to consider publishing the results obtained, albeit in a highly aggregated form, so that the banks can take them into account when they decide on how much unsecured credit they are willing to extend to one another.

- Although the interbank market functions well, the available data on interbank exposures suggest that if one of the largest banks failed to honor its obligations to other banks, some of them (notably small and medium-sized banks) might experience financial difficulties. To some extent, this reflects the fact that the sterling money market mainly consists of unsecured obligations issued by banks. In this regard, the authorities may wish to champion measures that encourage netting, where feasible, and more trading between banks on a secured basis, possibly using euro-denominated securities as collateral.[2]

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[2] Indeed, in August 2002 netting was introduced for gilt transactions in LCH RepoClear.

- The Sterling Stock Liquidity Ratio, used to supervise the liquidity of the major U.K.-owned banks, seems to have come to the end of its useful life, in that the benefits it offers of encouraging a market-based solution to liquidity problems are now being outweighed by perverse behavioral effects. First, the ratio does not fully take into account the maturity distribution (in a contractual, behavioral, and stressed context) of these banks' sterling assets and liabilities. Second, it allows banks to count (to a limited extent) CDs issued by other banks as an offset against maturing wholesale liabilities. This does not encourage the greater use of unsecured instruments, which could reduce systemic vulnerabilities. Third, it does not take into account these banks' significant foreign currency-denominated assets and liabilities. The FSA is reviewing its approach to the supervision of liquidity (including bank liquidity). The approach will involve both a quantitative and qualitative assessment against a common framework. This framework will include liquidity data on a consolidated basis where appropriate and will take into account the maturity distribution of assets and liabilities in a contractual, behavioral, and stressed context.

4. **The rest of the chapter discusses the recommendations in more detail.** Section A reviews the Bank of England's monetary operating procedures, while the functioning of the sterling money and foreign exchange markets are discussed in Sections B and C respectively.

II. Monetary Operating Procedures

5. **The Bank implements monetary policy by lending to its counterparties in the sterling money market at rates that are anchored by the official two-week repo rate chosen by the MPC.**[3] The Bank holds on its balance sheet assets acquired from its counterparties in its money market operations. These are mostly repos involving mainly U.K. government bonds (gilts) and euro-denominated European government securities as collateral, they are short-term, and a portion of them matures every business day. This means that at the start of each day, the private sector is due to pay money to the Bank to redeem these obligations. However, in order to do so, the Bank's counterparties typically have to borrow additional funds from the Bank. This gives the Bank the opportunity to provide the necessary funds once more, at a rate tied to its official repo rate. The fact that this 'stock of refinancing' is turning over regularly is the main factor creating the demand for base money (the 'shortage') in the market each day.

6. **In its open market operations, the Bank deals with a small group of counterparties who are active in the money market: banks, securities dealers, and**

[3] As will be described later, eligible institutions are free to choose whether they wish to borrow money for a roughly two week tenor at a rate equal to the Bank's two-week repo rate, or on an overnight basis at a rate equal to the two-week repo rate plus one percent. This choice is often highly dependent on expectations regarding future changes in the Bank's monetary policy stance. For example, eligible institutions will often borrow on an overnight basis when they are anticipating a near-term reduction in the Bank's two-week repo rate.

building societies are eligible to take on this role.[4] Funds are supplied by the Bank primarily in the form of repo. Counterparties sell assets to the Bank with an agreement to repurchase them in about two weeks time.[5] The Bank also buys outright treasury bills and other eligible bills with remaining maturities of about two weeks or less. See Box 1 for a summary of some key reforms that have been made to the Bank's operations in recent years.

7. **Liquidity forecasts are published and market operations are conducted by the Bank several times over the course of a trading day.** At 9:45 a.m., the Bank announces the estimated size of that day's shortage and the main factors behind it.[6] On non-MPC meeting days, the first round of operations is held at that time (12:15 p.m. on MPC meeting days, 15 minutes after the publication of the meeting's outcome). Results from each operations are announced to the market about 10 minutes later. The liquidity forecast is updated again at 2:30 p.m., and a second round of operations is conducted. If the remaining shortage is not entirely relieved at 2:30 p.m., the Bank holds a round of overnight repo operations at 3:30 p.m. at a rate of one percent above the Bank's repo rate. If the system is still short at 4:20 p.m. after the money market has closed, the Bank deals directly via a late-repo facility

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[4] There have been around 15-20 counterparties in recent years. The list of counterparties is not made public because the Bank wants to avoid creating the perception in the market that the obligations of these institutions would receive special treatment in the event of financial distress. Nonetheless, some market participants believe they have a fair understanding of which institutions are on the list. Four 'functional criteria' are used by the Bank to select its counterparties and to monitor their performance: (i) counterparties must maintain an active presence in the markets for at least one of the instruments eligible in the Bank's operations; (ii) they must have the technical capability to respond quickly and efficiently to the Bank's daily rounds of operations; (iii) they are expected to participate regularly in the Bank's daily rounds of open market operations; and (iv) they are expected to provide useful information to the Bank on a regular basis on market conditions and developments in the sterling money markets.

[5] The length of the repo period is sometimes adjusted by a couple of days to provide for a smoother flow of daily shortages. A list of eligible assets is maintained on the Bank's web site. It includes: gilts (including gilt strips); sterling treasury bills; Bank of England euro bills and notes; eligible bank and local authority bills; U.K. government non-sterling marketable debt; sterling securities issued by European Economic Area (EEA) central governments and central banks and major international institutions; and euro-denominated securities (including strips) issued by EEA central governments and central banks and major international institutions where they are eligible for use in the European System of Central Banks' monetary policy operations.

[6] The Debt Management Office (DMO) assumed full responsibility for managing the government's daily cash position in April 2000. Since then, the level of the outstanding 'Ways and Means advance' to the government on the Bank's balance sheet has been stable, and the DMO, rather than the Bank, offsets the government cash position with the money market each day. It aims for a small, constant, precautionary deposit with the Bank each day, and does not carry out operations, which by their nature or timing could be perceived to clash with the Bank's open market operations. As a result, the Bank's balance sheet has become more stable and predictable, and the money market's funding need from the Bank is no longer influenced by the government's net cash position. The two key factors that now influence the money market's need for refinancing from the Bank are changes in the note issue and the maturity of the existing stock of refinancing operations.

Box 1. Recent Reforms to Bank of England Monetary Operating Procedures

There have been two key reforms to the Bank of England's monetary operations in recent years. The first, in 1997, was the shift from discounting bills of exchange (government and commercial bank) to repurchase agreements collateralized by gilts (government bonds) in the Bank's monetary policy operations, and broadening the range of counterparties that could deal directly with the Bank. The shift to repos reflected the need for more collateral in the system to facilitate the distribution of secured liquidity (gilt repo offered more than £100 billion versus the £10-15 billion that was expected to be available from bills). Similarly, expanding the range of counterparties to include the commercial and investment banks led to more efficient liquidity management in the market, since discount houses (the Bank's traditional counterparties) were becoming obsolete. These changes did not have any negative implications for the Bank's ability to conduct monetary policy. Rather, they were introduced to reduce volatility in short-term interest rates and alleviate difficulties financial institutions were encountering in the management of their liquidity due to growing technical distortions in the pricing of collateral.

The second, in 1999, was a further expansion in the range of collateral accepted by the Bank ahead of the millennium date change to alleviate market pressures that were emerging due to a reduced supply of gilt repo collateral caused by a healthy fiscal situation and increased foreign exchange swap activity. The Bank now accepts debt issued by EEA governments, which it can access through European central banks. This action expanded the potential collateral pool from about £350 billion to about £2 trillion—well in excess of the current stock of refinancing associated with the Bank's monetary operations (typically about £15-20 billion). Ready access to such a large pool of collateral enables the Bank to manage spikes in the demand for liquidity on either an intra-day or longer basis that can arise in response to shocks in the financial system. However, it is important to note that demands on this collateral pool could emerge not only in the U.K., but also in other jurisdictions that accept the same collateral. This could be especially true in situations where markets are under stress in more than one jurisdiction at the same time, say in response to a global shock.

with the settlement banks, whose accounts at the Bank need to be in credit at the end of the day. As with the 3:30 p.m. operation, the rate on the 4:20 p.m. facility is one percent above the Bank's repo rate.

8. **In June 2001, the Bank supplemented its daily open market operations with a collateralized overnight deposit facility (i.e., an overnight reverse repo facility) in order to moderate the extent to which overnight interest rates trade below the Bank's two-week repo rate.** This facility also enhances the means available to the Bank to intermediate between firms with liquidity shortages and surpluses in rare circumstances where market mechanisms are impaired (e.g., because of infrastructure or confidence problems). As noted previously, the Bank already had in place an overnight repo lending facility, which helped to limit the extent to which overnight rates trade above its official repo rate. The deposit facility puts the Bank's overnight operations at the end of each day on a more symmetrical basis, and reportedly has helped to reduce some of the volatility in sterling overnight rates.

9. **Like the lending facility, the new deposit facility is available to the Bank's counterparties at 3:30 p.m. every business day.** (If deposits are made at 3:30, the Bank adds the funds deposited to the amount of liquidity supplied to settlement banks at 4:20 p.m.). To ensure that it does not discourage active trading between market participants, the interest rate that the Bank pays on overnight deposits has been set at one percent below the Bank's two-week repo rate.

10. **Bank officials noted that the width of the corridor for the overnight rate (200 basis points) represents a trade-off between a desire to limit excessive volatility in the overnight rate, and the Bank's preference that private sector participants regularly test their names by trading with each other as much as possible before accessing central bank facilities.** This imposes a market discipline on banks to manage their liquidity prudently so that they can maintain their access to the markets for funding purposes. In addition, the corridor allows for credit tiering in the market, since widening spreads might be an important signal for market participants and financial sector supervisors of potential financial distress. Allowing these market mechanisms to operate thus contributes to financial stability. **Market participants generally welcomed the introduction of the new deposit facility, noting that it has helped to limit short-term interest rate volatility, and may help to broaden the range of participants in the market over time.**

11. **There are no statutory reserve requirements in the United Kingdom.**[7] Settlement banks are also able to obtain *intraday* credit from the Bank on a collateralized basis. This credit is available in both sterling and euro to facilitate the smooth functioning of the sterling and euro CHAPS payment systems operating in the United Kingdom. No interest is charged on this credit, but it must be repaid before the payment system closes for the day. To help ensure that intraday liquidity does not spill over into overnight liquidity (and potentially affect monetary conditions), the Bank has taken steps to: (i) apply early cut-offs, first for customer payments and a little later for interbank CHAPS payments, within the RTGS operating day so that CHAPS banks have a final period in which to square their positions; and (ii) by applying penal rates for any overnight repo required to prevent a bank that has failed to balance its books by the end of the business day from going into overdraft. The penalty charged by the Bank for the provision of such a repo depends on the circumstances in which the overdraft arises, but is usually a minimum of 300 basis points above the Bank's repo rate.

12. **The Bank auctions three- and six-month euro-denominated bills each month, and also auctions three-year euro-denominated notes in order to obtain the euro liquidity it needs to support the functioning of the TARGET payment system for banks located in the United Kingdom.** The arrangements agreed with the European Central Bank under which the Bank of England may provide intraday liquidity incorporate a €3 billion limit on the total amount of intraday liquidity that can be provided to the U.K. market by the

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[7] As noted above, settlement banks are required to maintain positive credit balances in their accounts at the Bank at the end of each business day. However, they are required to hold non-interest bearing "cash ratio deposits" (CRDs) at the Bank, set at a rate of 0.15 percent of their domestic deposit base. These deposits are meant to provide the Bank with seignorage revenues to finance the unrecovered costs associated with its monetary policy and financial stability activities. The CRD scheme is scheduled to be reviewed in 2003. These reviews are expected to be conducted every five years.

Bank of England (€1 billion limit to any one participant). Excess funds are held in the Bank of England's own foreign exchange reserves.

13. **The Bank has not conducted any foreign exchange market intervention for monetary policy purposes since the introduction of the current monetary framework in 1997.** The Government is responsible for determining the exchange rate regime for the U.K., but the Bank is allowed to have its own separate pool of foreign exchange reserves, which it can use at its discretion to intervene in support of its monetary objectives. It is also required to execute foreign exchange market intervention as the government's agent for non-monetary policy purposes, such as intervention carried out by the U.K. in support of coordinated G-7 intervention, using the government's foreign exchange reserves. These interventions are automatically sterilized. When sterling money market shortages have been large, the Bank occasionally used foreign exchange swaps to supply liquidity to the sterling money market.

Key issues

The Bank's ability to forecast the daily shortage

14. **The transfer of the management of Exchequer cash management from the Bank to the DMO in April 2000 has modestly helped to improve the Bank's ability to forecast the shortage**. The two principal factors that now influence the money market's need for financing from the Bank are changes in the note issue and the maturity of the existing stock of refinancing operations. Table 1 summarizes the Bank's daily forecast errors from January 1999 through December 2001. The liquidity forecasting process functions well, and the mean absolute forecasting errors have fallen sharply since the transfer of government cash management to the DMO in April 2000. However, the improvement in the standard deviation of the forecast errors—perhaps a more precise indicator of the consistent ability of the forecasters to achieve better forecasts—is less pronounced in level terms at the 2:30 and 4:20 rounds, and it is not clear that there has been any significant improvement at the 9:45 round. This not to say that the forecasts are weak. Indeed, the standard deviations of the errors were less than 10 percent of the average daily shortages in 2001. Instead, there has been, and continues to be, some residual uncertainty in the remaining items of the forecast, particularly the note issue. This should decline further when the Bank completes the restructuring of its bank note operation. **Further improvements to the shortage forecasting process could, if the Bank wished, help set the stage for less frequent operations by the Bank in the sterling money market.**

Table 1. United Kingdom: Daily Shortage Forecast Errors 1/
(GBP millions)

	Mean of Absolute Daily Errors			Standard Deviation of Daily Errors		
Date	9.45am forecast	2.30pm forecast	4.20pm forecast	9.45am forecast	2.30pm forecast	4.20pm forecast
1999	145	51	31	224	94	72
2000 (Jan. - Mar.)	181	50	23	237	109	53
2000 (Apr. - Dec.)	89	38	17	130	78	38
2001	81	33	13	216	67	49

Source: Bank of England.

1/ Errors are defined as projections minus actual shortage.

Frequency and tenor of the Bank's monetary operations

15. **Notable features of the Bank of England's monetary operations are the number of operations conducted each day (four if one includes the late-day round for settlement banks) and the two-week tenor of the policy rate.** Reasonable questions one could pose are: (i) could the Bank operate less frequently each day, and (ii) would it be more appropriate to set the target policy rate with reference to an overnight interest rate given that central banks typically have more control over interest rates at this tenor in their operations? Turning to the first question, Bank officials suggested that the multiple rounds of operations is a handy means of building relations with market participants because the operations in the market provide a starting point for discussions on market developments, which can be a useful source of intelligence on emerging vulnerabilities in the financial system. In addition, multiple rounds of operations help the market cope with the uncertainties surrounding the forecasted shortage, which tend to decline as the day goes on. While these are important arguments, they should be kept in perspective. For example, some market participants indicated that their willingness to speak with the Bank reflects the quality of the discussions and their overall respect for the Bank, not the operations themselves. **Thus, as the shortage forecasting process improves over time, the Bank may want to reflect on whether it could operate with fewer rounds in the market** (for example, by aiming for two rounds of daily operations in the long run). This could further reduce the presence of the Bank in the market over the course of the day, and perhaps, at the margin, impose some added market discipline on market participants to trade more efficiently with one another. So long as the Bank's discussions with the market continue to offer value to market participants, it is not clear that this would necessarily impede the Bank's ability to gather market intelligence.

16. **Turning to the question of the tenor of the policy rate, Bank officials indicated three major reasons in support of the current arrangement.** First, by operating at the two-week tenor, it is easier for the Bank to influence one month interest rates—the tenor that is thought to be important for the transmission of monetary policy actions to tenors further out the yield curve. Operating directly at the one month tenor is probably not practical because at that point interest rates start becoming sensitive to factors other than monetary

policy actions, thereby impairing the clarity of the monetary policy signal. Second, changes to the Bank's operations have evolved gradually over time, and a policy rate defined with respect to two-week interest rates has been the practice for many years, and is one that the market is comfortable with.

17. **And third, some might argue that a two-week tenor is useful from a balance sheet management perspective because, compared to an overnight tenor, it obviates the need to rollover all operations each day, thereby helping to limit the Bank's presence in the sterling money market.** This is not a major constraint. The Bank could always follow the practice of some other central banks and adjust the composition of its balance sheet by conducting some longer-term operations at prevailing market interest rates, such as it did over the millennium date changeover period. **Indeed, at some point in the future, the Bank may wish to consider reactivating the longer-term repo facilities used during the millennium date change period, and acquire assets on a repo basis in order to reduce the average size of the stock of refinancing, which has been on an upward trend since April 2000 (from £14 billion in April 2000 to £18 billion in January 2002).** This issue could become acute if the government should decide at some point to repay the Ways and Means advance.[8]

18. **Of course, a two-week tenor also offers the added convenience of being consistent with the tenor used by the European Central Bank to signal its monetary policy intentions.** In practice, there is little to choose between operating at either tenor. **Given the market's comfort with the current arrangements and the U.K.'s close economic and financial linkages with the rest of Europe, continued focus on the two-week tenor is appropriate.**

Managing the risks associated with the collateral underpinning monetary operations

19. **All securities held as collateral by the Bank are valued daily in sterling at the close of business; the aggregate exposure to each open market operation counterparty is calculated.** Any counterparty whose margin-adjusted value of collateral is more than £1 million lower than the amount (including interest) owed to the Bank is required to post additional collateral (i.e., a variation margin) the next day to reconstitute the appropriate amount of margin.

20. **Margins are set using a value-at-risk (VAR) approach, which is reviewed annually to ensure that the assumptions underpinning the margin requirements are appropriate.** The requirements are designed to protect the value of the collateral against both interest rate risk, and where appropriate, exchange rate risk. Also, close contact is maintained between the Bank's front and back office staff, and the causes of persistent or unusual

[8] By the same token, if the Bank was faced with a daily surplus at some point in the future, it could ask the DMO to issue additional Treasury bills on its behalf, or it could begin issuing its own securities to mop up liquidity.

variation margin calls are monitored and investigated if necessary. Given the high-quality of the underlying collateral, the Bank has not introduced formal credit or liquidity risk controls for the collateral it accepts, although it does monitor the quality and liquidity of the collateral being pledged and has not encountered any problems in practice. Moreover, it indicated a willingness to introduce more formal measures should they be required. It also sets limits on the amount of acceptances that eligible financial institutions can issue in the market. (The Bank can take them as repo collateral or purchase on an outright basis). By limiting the amount of securities each institution can issue, the Bank indirectly places a ceiling on its potential exposure to any one accepting institution. Each institution's issuing limit is based on a calculation of its capital and scale of its sterling business.

21. **While the credit and liquidity risk of collateral is not an issue for securities issued by the Bank of England or the U.K. government (the Bank's shareholder), prudent risk management practice would suggest that some controls be introduced for other securities accepted as collateral by the Bank even though the remaining collateral is all high-grade in nature. In this regard, the Bank may wish to follow the practice of some other central banks and consider the practicality of introducing minimum liquidity or credit rating thresholds or limiting the amount of securities of a single issuer that can be posted by a counterparty in order to achieve a broader diversification of the collateral.** Although the Bank closely monitors the collateral it accepts and has not encountered any difficulties in practice, application of good risk management practices in-house helps to set a good example for market participants, and is a concrete way to demonstrate the Bank's commitment to a more resilient financial system.

III. Sterling Money Market

22. **The sterling money market is primarily a market for unsecured short-term interbank deposits and certificates of deposits (CDs).** As of the end of 2001, interbank deposits and CDs accounted for 58 percent of sterling money market instruments outstanding (Table 2).[9] Most of them are issued by the nine major U.K. banks, although some European banks are also large issuers of CDs (Table 3). The stock of interbank deposits and CDs has grown by about 4 percent annually since 1990. However, their share of the money market has declined markedly from the 80 percent level that prevailed prior to the introduction of gilt repos (repos collateralized by U.K. government bonds) in the mid-1990s. Since 1997, gilt repos have grown rapidly—to about a 24 percent share of the money market—as banks took advantage of the introduction of the repo market to shift from holding gilts on an outright basis to a repo basis so that they could better manage their liquidity positions. Other

[9] These data need to be interpreted with care, since the interbank deposit component is materially inflated by intragroup business, e.g., lending from the treasury area of a bank to the rest of the group.

Table 2. Sterling Money Markets

(Amounts Outstanding, £ billions)

	1990	1995	2001
Interbank	89 (49) 1/	93 (48)	185 (34)
CDs	53 (29)	66 (34)	131 (24)
Gilt Repo	…	…	129 (24) 2/
Stock Lending	…	…	52 (10) 3/
Eligible bills	23 (13)	20 (10)	11 (2)
Commercial Paper	5 (3)	6 (3)	21 (4) 4/
Other 5/	13 (7)	10 (5)	14 (3)
Total	183 (100)	195 (100)	555 (100)

Source: Bank of England.

1/ Numbers in parentheses represent percent of total sterling money market claims.
2/ As of November 2001.
3/ As of September 2001
4/ As of August 2001
5/ Includes Treasury bills, sell/buybacks, and local authority bills

Table 3. Distribution of Banks' Wholesale Sterling Liabilities by Group of Banks at end-December 2001
(in percent)

	Interbank	CDs Issued	Gilt Repo
U.K.-owned	80.5	45.1	36.1
Other EU-owned	8.8	47.2	33.3
U.S.-owned	3.5	0.3	0.0
Japan-owned	1.4	1.3	0.8
Other	5.8	6.0	29.8
o/w other developed	5.4	5.9	29.8
o/w other	0.4	0.1	0.0

segments of the money market are fairly small; for example, treasury bills and commercial paper represent less than 5 percent of sterling money market instruments outstanding.[10]

23. **Market participants report that the rapid growth of the repo market has also benefited from the introduction of more stringent capital adequacy regulations and a contraction in unsecured credit lines in the interbank market.** More stringent capital adequacy rules have contributed to lower costs for repo financing relative to unsecured financing because the institution providing the funds does not need to hold as much capital against a secured investment as it would against an unsecured one given the high quality of the underlying collateral in a repo transaction. In addition, many institutions are reportedly shifting toward dealing on a repo basis in order to limit the use of unsecured credit lines, which are declining in aggregate as banks merge. Credit departments in banks tend to grant smaller credit lines to a newly-merged institution than the sum total of those previously granted to the antecedent institutions.

24. **The importance of the interbank and CD markets in the U.K. stands in marked contrast to money markets in the United States and Canada, for example, where securities issued by governments and nonfinancial corporations tend to dominate.**[11] However, it is similar to that in the euro area, where unsecured bank claims also represent the largest segment of the market. Several factors explain the difference between the sterling and North American money markets. First, the amount of government debt outstanding in the U.K. is fairly modest at less than 30 percent of GDP, and it is heavily skewed toward issues of long-term bonds reflecting: (i) a preference in the early 1990s to limit the issuance of Treasury bills to avoid potential conflicts with monetary policy;[12] and (ii) the government's desire to minimize its exposure to market and rollover risks. As a result, the government has not issued much in the way of treasury bills. Second, U.K. corporations have tended to rely more on bank loans to meet their short-term credit needs than commercial paper or bank-guaranteed paper. Third, CD issuance activity by major banks grew rapidly in the latter half of the 1990s as the introduction of gilt repo led some banks to repo gilts on to their balance sheets in exchange for CDs. And fourth, banks' willingness to hold each other's CDs was helped by the introduction of the stock sterling liquidity regime (SSLR) in 1996 (see Box 2), which allowed U.K. banks to count (to a limited extent) their holdings of CDs issued by other banks as liquidity to meet the SSLR requirement.

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[10] Another relatively new market segment, for which data were not available, is the sterling overnight index average (SONIA) swap market.

[11] There is, however, an active offshore interbank market in unsecured deposits denominated in U.S. dollars and other currencies, of which London is an important trading center.

[12] However, as these concerns abated, the government began issuing floating-rate gilts in the mid-1990s, and over the past year has begun issuing Treasury bills in larger volumes as these gilts matured. The government plans to dematerialize T-bills and other money market instruments, which would help to promote the future growth of this market.

Box 2. Prudential Supervision of Commercial Bank Liquidity Management

The SSLR was introduced in 1996 as a means for ensuring that major U.K. banks hold sufficient liquidity to protect themselves against a potential loss of short-term sterling wholesale funding. It also helped to level the playing field among these banks by ensuring that they were subject to a common liquidity supervision scheme. Previously, a maturity ladder-based regime had applied to all banks, comparing contractual outflows and inflows of cash within a number of time bands (next day; the next week; etc.), the details of which varied from bank to bank. However, this was unsuited to retail banks, which have extensive deposits that are contractually callable (or virtually callable), but which in normal conditions are generally fairly stable. It is also vital that larger banks have ready access to liquidity in stressed market conditions so as to be able to meet liquidity demands from elsewhere in the financial system or from non-financial customers. This liquidity can come from selling or repo-ing highly liquid assets in the market, or (within constraints set by the size of official operations) to the central bank. The SSLR recognized this and, for their sterling deposits, required major U.K. banks to hold a stock of sterling and euro-denominated liquid assets (defined as those assets accepted as collateral by the Bank of England) against a potential loss of short-term wholesale funding.

There are two requirements in the SSLR:

- A bank must work to a sterling stock liquidity ratio of at least 100 percent at all times. The ratio is calculated as the stock of eligible liquid assets divided by a measure of outflows. This measure is defined as the contracted wholesale sterling net outflows over the next 5 business days minus sterling CDs held, up to 50 percent of the wholesale sterling net outflow, plus 5 percent of maturing retail deposits. CDs are subject to a 15 percent discount to reflect market risk. Undrawn committed facilities are not included as contingent outflows.

- A bank must also hold a sterling stock 'floor' of liquid assets at all times, agreed with the FSA, and usually set at 50 percent of a bank's internal limit for its maximum net outflow over five working days. CDs are not included in the permanent 'floor' requirement.

The SSLR does not cover foreign currency activity.
CDs are treated in the SSLR as 'second tier' liquidity. They are not accepted in the Bank of England's open market operations, and they are 'inside' liquidity for the banking system because they are issued by banks. Thus, holding a sterling CD is not like holding a U.K. government Treasury bill or short-maturity gilt. Liquid assets (other than CDs) which count toward U.K. regulatory liquidity requirements can also be used to obtain intraday credit from the Bank in the context of the RTGS payment system.

In addition to its general rules on liquidity, various other FSA regulations touch on liquidity considerations. For example, banks which securitize their assets are expected to demonstrate that they can cope with the liquidity implications of assets eventually returning to their balance sheet, as can occur, for example, with securitization of revolving credits.

Since 1999, a revised version of the 1982 maturity mismatch approach has applied to all banks other than those subject to the SSLR. This includes some branches of foreign banks. Most banks supervised under the maturity mismatch regime do not have direct access to the Bank of England's facilities, and may be less active in wholesale markets—smaller banks tend to rely on committed funding lines from the larger banks, and provided the FSA is satisfied with the availability of these facilities in stress conditions, the banks are permitted to include a portion of undrawn commitments available to them in the maturity ladder. The percentage is set on a case-by-case basis taking account of factors such as whether the facility is legally binding, the existence of covenants, regular usage of the facility, etc. A broader range of assets is treated as liquid than under the SSLR to reflect the markets in which banks operate. Discounts to market value are applied to securities that are judged, by the regulators, to be vulnerable to changes in market prices.

Banks are required to report all cash flows (not just principal amounts) in the maturity ladder for periods out to six months. Mismatch guidelines are for the cumulative periods up to eight days and up to one month. Typically these would be zero and minus 5 percent respectively. For some assets and liabilities where the behavioral characteristics of the cash flows do not bear a close resemblance to actual maturities, banks may request, or the FSA require, that they are treated on a behavioral basis instead. Committed facilities provided by a bank are taken into account, and an attempt is made to capture cash flows arising from options. In 1999, the FSA decided that sterling and foreign currency information should normally be aggregated for routine reporting purposes. However, banks are expected to have a separate management policy for foreign currency liquidity positions, and the FSA can request reports on these. Some branches of overseas banks are permitted by the FSA to manage their liquidity on a global basis from their home country head office, provided that the FSA is content with the home country supervisory regime and can rely on the branch being fully integrated with the head office for liquidity management purposes.

Source: G. Chaplin, A. Emblow, and I. Michael, "Banking system liquidity: developments and issues," Bank of England Financial Stability Review (December 2000).

25. **Secondary market trading in the money market is dominated by trading in short sterling futures contracts and options on these futures contracts, both of which are traded on the London International Financial Futures Exchange** (LIFFE) (Table 4). The futures and options markets are accessible to a wide range of participants, provided they are able to meet the margin requirements, and trading now takes place electronically via the exchange's computer system, rather than on the floor of the exchange. Major banks in London actively transact in these markets to hedge their exposures to future movements in short-term interest rates, and to arbitrage any pricing discrepancies between the futures and underlying interbank markets. Trading activity on the exchange is particularly heavy in periods of heightened uncertainty about the future course of sterling interest rates, since traders can take advantage of the leverage inherent in the margin requirements to create large speculative positions, and avail themselves of the security provided by the fact that the London Clearing House (LCH) interposes itself as counterparty to all trades executed on the exchange.

26. **Transactions in the traditional cash markets and non-exchange-traded derivatives markets, such as the SONIA swap market, are conducted between counterparties on an over-the-counter (OTC) basis, usually through screen-based interdealer brokers, but in some cases directly by telephone.** The broker simply brings the counterparties together. They are then responsible for settling transactions and managing their own counterparty risk exposures. Usage of screen-based inter-dealer brokers helps to minimize search costs and protect the anonymity of the traders until the transaction is completed, thereby lowering the risk that the market might move against a trader before he or she can complete the transaction. In some market segments, notably gilt repo, electronic proprietary trading systems such as BrokerTec are growing in popularity, and are helping traders discover prices with fewer transactions and execute their transactions more efficiently.

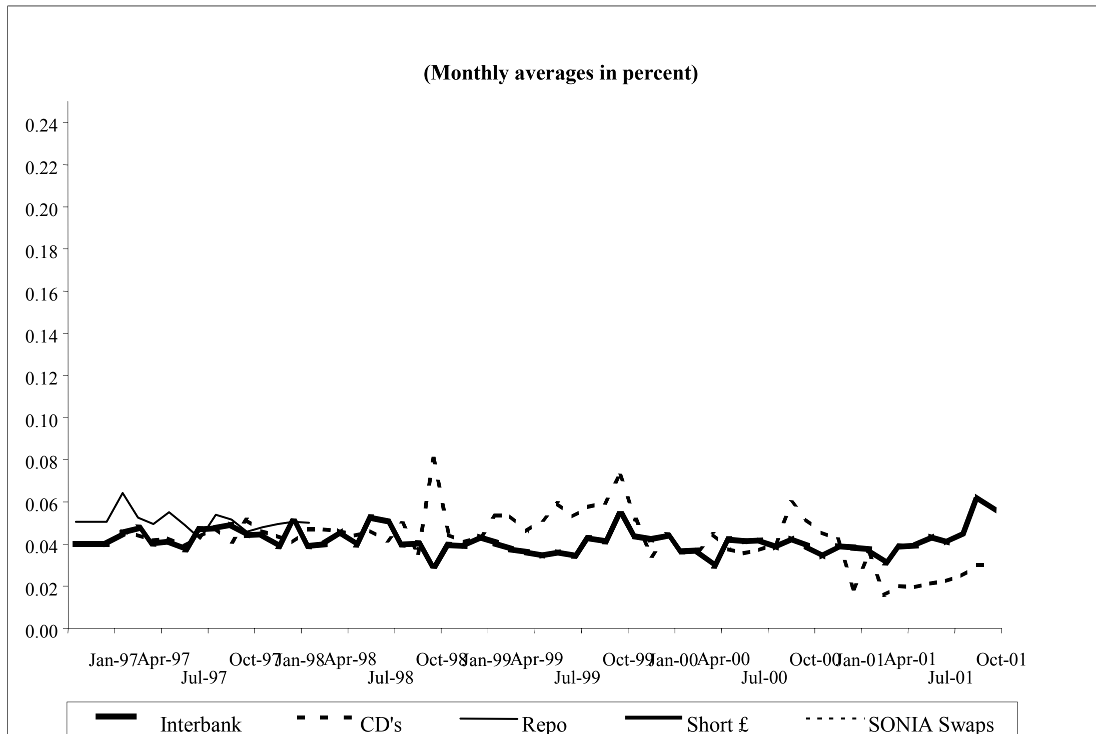
27. **Trading volumes have been fairly stable in recent years in both the gilt repo and the unsecured segments of the money market.** However, market participants noted that the trading flow in the interbank market is becoming more lumpy over time, and thus harder for traders to manage, as the number of active participants dwindles in response to consolidation in the number of large institutions in the financial services industry and as the size of average transactions—which now range between £100 and £500 million for interbank deposits and CDs—increases. In times of stress, this lumpiness may foster the emergence of disorderly markets as traders shy away from taking positions for fear of being caught offside by the course of events. In contrast, those institutions that are major players in the gilt repo market report that that market is very deep and liquid, with most counterparties willing to regularly trade in lots of £100 million in the broker market rather than the £25 million minimum transaction size. Indicative bid-offer spreads in the various segments of the money market have been fairly stable, widening by only a few basis points in periods of heightened uncertainty, such as the millennium date change and post-September 11 (Figure 1).

Table 4. Turnover of Sterling Money Market
(Average Daily Amounts, £ billion)

	1997	1998	1999	2000	2001
Short Sterling Futures	40	67	54	45	67
Short Sterling Options	6	15	13	8	15
Interbank (overnight) (a)	6	7.5	8	10	10
Gilt Repo	15	15	14	18	18
CDs, bank bills and treasury bills	...	...	...	...	12

Source: U.K. authorities. (a) Figures based on unsecured cash transactions brokered in London as reported to the WMBA.

Figure 1. Sterling Money Market, Bid Offer Spreads



28. **Interest rates paid by banks to fund themselves in the interbank deposit and CD markets do not vary much in relation to the credit rating of the banks.** Instead, market participants report that the size of informal, normally stable bilateral credit lines governs the allocation of credit in the market. Access to the market on an unsecured basis is generally limited to banks that are perceived by their peers to have a credit rating equivalent to single-A or better. Weaker institutions typically are only able to raise funds on a secured basis. This contributes to the resiliency of the unsecured market because there is less risk that it will be undermined by the failure of a weak institution.

29. **Participants in the sterling interbank market report that they generally review the credit lines granted to other banks on a regular basis (quarterly appears to be the norm), although more frequent ad-hoc reviews are conducted when a counterparty is hit by a shock (such as when the news broke of large foreign exchange trading losses at Allied Irish Bank).** In the past, such shocks would have led market participants to limit their interbank exposures to all banks from the country or region in question, whereas now participants believe that the market is more discriminating, assessing each participant's credit lines more on a case-by-case basis, and less on its country or region of origin.

30. **Market participants also noted that bank credit lines are often adjusted in response to shifts in trading activity between counterparties, even when there has not been any change in the credit assessment of the bank counterparty.** This suggests that credit line determination is not only a function of the credit standing of the counterparty, but is also governed to some extent by the potential profits to be earned from the trading relationship. There is also a widespread view that the credit lines extended to the most active participants in the sterling interbank market—the major U.K. clearing banks—may be somewhat larger than their credit standing might suggest owing to a latent belief that the Bank of England will ultimately stand behind the unsecured interbank obligations of these banks if one of them was to fail. However, this is thought to be a less important factor now; the failure of Barings in 1995 (its obligations were not covered by the Bank of England) has encouraged banks to be more cautious in the granting of unsecured credit lines to one another. In addition, to the extent that such a distortion exists, it is not perceived to be simply a U.K. phenomenon; similar treatment is reportedly granted to the largest domestic banks in other currency interbank markets. The interest rates paid by the largest U.K. banks on their sterling CDs are also thought to be a few basis points less than those paid by similarly-rated institutions in the market; however, this was mainly attributed to a liquidity premium effect, since the sterling CDs issued by those banks tend to be the most active-traded in the market.

31. **The Bank of England and the FSA play an active role in working with market participants to champion the development of the sterling money market. In addition to a continuous bilateral relationship with market participants, the Bank and FSA liaise with them through three key committees—the Foreign Exchange Joint Standing Committee, the Sterling Money Markets Liaison Group (MMLG), and the Stock Lending and Repo Committee (SLRC).** All three are chaired by senior Bank officials, they include a wide range of private and public sector participants, and minutes of meetings of the groups are posted on the Bank's internet web site. Market participants generally praised the

Bank's willingness to work with them in an open collaborative fashion to foster the development of well-functioning deep and liquid money and foreign exchange markets. Examples of some issues that have been dealt with by these committees include: preparations in financial markets for the millennium date change; the preparation of guidance on good trading practices in wholesale financial markets; a review of money market instruments and plans for their dematerialization so that they can be settled in the CREST system; and reviews of the main legal agreements used in the various markets.

Key issues

Efficiency of the sterling money market in distributing monetary liquidity

32. **As noted previously, the Bank of England in its monetary policy operations normally aims to supply the market's net liquidity requirement each day plus a small margin to address the market's demand for precautionary balances**. This encourages market participants to trade in the money market with each other to clear their long and short positions. A key issue is whether the market is in fact able to distribute the liquidity supplied by the Bank in an effective fashion so that at the end of the day market participants do not need to access the Bank's facilities for amounts significantly in excess of the daily shortage. The data suggest that this is indeed the case (Table 5). First, the average amount of liquidity provided by the Bank each day (about £2.5 billion in 2001 with a standard deviation of £1.5 billion) is low relative to the £28 billion average daily volumes transacted in the interbank and repo markets. More importantly, the demand for precautionary balances at the Bank of England appears to be quite modest—around £50 million in 2001 with a standard deviation of 70 million—and not sensitive to the degree of uncertainty in the market. For example, the level of balances held at the Bank of England did not rise following the terrorist attack on September 11.

33. **One issue that has concerned market participants in the past was attempts by some banks to hoard the liquidity provided by the Bank of England to fund their own operations, rather than make it available to other market participants.** Some participants argued that this practice contributed to undue concentration of the Bank's liquidity injections among a few market participants that were not willing to on-lend the funds to the rest of the market, thereby contributing to excessive volatility in overnight interest rates. This, in turn, may have discouraged a broader range of institutions from trading in the market, thereby impeding the liquidity of the market. In December 2001, the Bank notified its counterparties that to avoid undue concentration it may individually scale counterparties' bids in its open market operations (for which there is a general provision in the Operational Notice governing these operations). Such a step would help to ensure that access to the liquidity provided by the Bank is available as smoothly as possible to all market participants.

Table 5. Daily Liquidity Supplied by Bank of England
(£ billions)

	1999	2000	2001
Average Liquidity Supplied by Bank of England	1.2	2	2.5
(Standard deviation)	(0.8)	(1.0)	(1.5)
of which:			
Overnight	0.2	0.3	0.6
Two-week	1.0	1.7	1.9
Average End-of-Day Balances at Bank of England	0.1	0.1	0.05
(Standard deviation)	(0.1)	(0.07)	(0.07)
Average Daily Turnover in Gilt Repo	23	28	28

Sources: Bank of England and Fund staff calculations.

34. **Discussions with market participants revealed that they are pleased with the Bank's action, and that it has helped to alleviate technical distortions in the overnight market.** For example, several banks reported that short-term interest rates are now more in-line with the Bank's two-week policy rate since the Bank's action (in an unchanged policy rate environment). However, they cautioned that the Bank will need to be vigilant against attempts by participants to collude with an aim of hoarding the Bank's liquidity and avoiding the triggering of the scaling back of bids to the detriment of others in the market. The Bank, in fact, does this by monitoring correlations in the trading behavior of major participants. In addition, some market participants admitted that they are not exactly sure how much liquidity they can bid for before their bids would be scaled back, although the Bank has indicated it would let them know ahead of time if there was any risk of their bids being scaled back. This lack of certainty reflects the fact that there is no fixed ratio or formula used by the Bank to set the degree of scaling; indeed, it could be relaxed in circumstances of general financial strain. And some uncertainty in this regard can be a useful tactical device to prevent market participants from 'gaming' the Bank.

Resiliency of the unsecured sterling interbank market in periods of stress

35. **As noted previously, the interbank market primarily allocates credit on the basis of quantity credit rationing through credit lines granted by market participants to one another.** Some observers argue that there is a deficiency in pricing according to counterparty risk in that it can lead to excessive dependence on central banks during periods of crisis because the size of credit lines in the market is highly dependent on the degree of confidence participants have in one another in an environment of imperfect information.[13]

[13] This point is discussed at length in: H. Bernard and J. Bisignano, 2000, "Information, Liquidity and Risk in the International Interbank Market: Implicit Guarantees and Private Credit Market Failure," *BIS Working Papers No. 86* (March).

36. **The failure of banks to honor their unsecured interbank deposit and CD obligations has been a rare event in the United Kingdom, and mainly limited to smaller institutions.** As a result, the market has generally performed well across a wide range of trading conditions, such as in the wake of the failure of LTCM; over the millennium date change; and in the days following the September 11 terrorist attack. The sterling interbank market has not experienced a loss of confidence due to the failure of a major U.K. bank for many years. The most recent cases of official emergency liquidity support to U.K. banks occurred in the early 1990s, when the Bank lent to a few small banks in order to prevent a wider loss of confidence in the banking system. A rather larger group of small banks experienced difficulties and was subject to intensified supervision by the authorities; 25 banks failed or closed due to problems during this period.[14] In contrast, the Bank did not intervene to prevent the collapse of Barings in 1995, which was a larger and more prominent institution, but whose problems did not in fact threaten the system given the economic and market conditions at that time. The interbank market took this event in stride, which is a good indicator of its resiliency in periods of heightened uncertainty. U.K. authorities stressed that when they are considering whether to intervene to provide emergency assistance, the decision is determined by whether they are dealing with a systemically important situation, rather than by the size of the institution.

37. **Although the interbank market functions well, there is the potential for the interbank market to act as a contagion channel in the unlikely event that a major U.K. clearing bank was unable to honor its unsecured interbank and CD obligations.** This is due to the fact that these banks stand at the fulcrum of the sterling market inasmuch as banks hold significant portions of their sterling liquid assets in the form of claims issued by other banks (Table 6), and the major U.K.-owned banks are large issuers of sterling interbank deposits and CDs (Table 3). Thus, it is important to assess the extent to which the U.K. interbank market is dependent on the financial condition of individual participants and the adequacy of the methods used to supervise bank liquidity management practices.

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[14] Another crisis was the secondary banking crisis in the 1970s when the Bank launched the 'lifeboat' operation to prevent a loss of confidence in the U.K. banking system—see Bank of England, 1978, "The secondary banking crisis and the Bank of England's support operations," *Bank of England Quarterly Bulletin* (June).

Table 6. U.K. Banks' Sterling Liquid Assets as of December 2001
(in percent of Total Sterling Liquid Assets)

	Major U.K. Banks	Other Large U.K. Banks	Small U.K. Banks	Foreign Banks
Bank Obligations	53	79	82	53
U.K. Government Gilts and Treasury Bills 1/	-21	...	15	-105
Other U.K. Debt Securities	19	21	2	32
Gilt Repo	39	...	...	101
Other Repo	3	...	...	17
Bank notes and Bank of England Deposits	7	...	1	2
Total	100	100	100	100

Source: Bank of England
1/ Negative numbers reflect the repo-ing of gilts in exchange for cash.

Bilateral interbank market exposures of U.K. banks

38. **One way to assess the vulnerability of the interbank market to the financial condition of individual participants could be to examine data on bilateral unsecured interbank claims between individual banks.** In the course of the discussions on how to conduct the stress testing exercise for U.K. financial institutions, the FSAP team noted for illustrative purposes only that these data could be used to prepare frequency distributions of the exposures so that the authorities can obtain a sense of whether the market would be vulnerable in the event of a failure of one or more institutions. The exposures that are most likely to generate problems for the authorities would be those that involve large unsecured liabilities of some banks that are held by a small number of banks—i.e., the 'tails' of the distribution of bilateral interbank exposures rather than the mean exposures. In turn, these can lead to 'chain-reactions' whereby the failure of one bank, by contributing to the failure of another, can raise the probability of others encountering difficulties. The implication being that the potential vulnerability of the system as a whole can be larger than what is implied by simply looking at the bilateral exposures of individual banks—one must also examine how they interact with one another. **The authorities were encouraged to continue with their efforts to increase their surveillance of bilateral unsecured exposures between banks (including sterling and foreign currency-denominated interbank deposits and CDs, foreign exchange, and payment system exposures) so that they can conduct a more thorough regular assessment of the systemic vulnerability of the interbank market to undue concentration of risk.**[15] This point was accepted by the authorities, and they have stepped up its surveillance in this area. However, in order to obtain a complete picture of these exposures, there could ultimately be a need for close collaboration with authorities in

[15] It is important to bear in mind that the usefulness of these data will be limited by the inability of the Bank to monitor exposures that arise offshore, since many important players in the U.K. interbank market are branches of foreign banking groups—thus, the offshore exposures of the parent institution of these branches are also relevant in order to gain a precise indication of the vulnerability of the U.K. banking system. Nevertheless, a partial picture is more informative than no picture.

other jurisdictions, since many of these exposures involve foreign institutions that are not supervised by the U.K. authorities.

39. **The authorities may also wish to consider publishing the results obtained, albeit in a highly aggregated form to protect the confidentiality of individual banks.** Individual market participants are not able to obtain such information on their own, since the raw data are considered to be highly confidential by individual institutions. By publishing highly-aggregated frequency distributions of the results, the authorities would inject some market discipline into the process by enabling market participants to gain an appreciation over time of the vulnerability of the market as a whole to the failure of an institution(s) without impairing the confidentiality of individual banks. In turn, this could help bank credit departments set credit lines on a more informed basis.

40. **The available data suggest that if a bank failed, other banks might also be threatened.** As noted previously, many banks hold a large share of their sterling liquidity in the form of claims issued by other banks. Moreover, more than half of sterling and foreign currency interbank claims are held by less than ten institutions. Relative to their total balance sheets, these claims were estimated by IMF staff to represent about 4 percent of total assets for the largest U.K.-owned banks, and more than 12 percent for other U.K.-owned banks, or about 35 percept of Tier 1 capital for both groups. However, this does not take into account the potential chain-reactions that may feed back onto the largest banks if the failure of one bank undermined the health of others in the system. Nor does it take into account any interbank exposures denominated in foreign currencies, or those that arise through foreign exchange trading or payment system activities.

Supervision of bank liquidity management practices

41. **As indicated previously, Box 2 summarizes the FSA's approach to regulating commercial bank liquidity management practices.** Several features were identified in the sterling stock liquidity ratio that appear to be adversely affecting the functioning of markets. Indeed, some of the smaller banks that are supervised under the SSLR appear to be focusing too much on meeting the supervisory requirement, and not using the more sophisticated liquidity management practices found elsewhere in the market.

- While perhaps a good starting point for monitoring the liquidity condition of the largest U.K.-owned banks, the SSLR does not fully take into account the maturity distribution of their assets and liabilities. However, as noted in Box 2, maturity mismatch data are collected for other banks operating in the U.K. In the absence of other information, one could easily miss potentially significant liquidity mismatches lying outside the five business-day horizon used in the ratio. This deficiency may not be too significant, since these institutions are subject to intensive day-to-day supervision by the FSA. Thus, the authorities may be able to spot emerging liquidity concerns at individual institutions through the broad range of information at their disposal. Nonetheless, the authorities should also monitor the liquidity risks in the banking system at a systemic level so that they can be prepared to deal with the chain-

reactions that can result when the failure of one bank threatens the stability of other banks in the system. To conduct such an exercise, maturity mismatch data would need to be collected using a common reporting system that is applicable to all banks. A potential benefit of collecting these data from the major U.K.-owned banks too, is that it might encourage some of them to focus more on their mis-match positions when managing liquidity, rather than focusing on whether they have met the SSLR by a comfortable margin.

- The SSLR allows the major U.K.-owned banks to net (to a certain extent) their holdings of sterling CDs issued by other banks against their own maturing deposits for purpose of calculating their SSLRs. Liquidity held in the form of sterling CDs issued by other U.K. banks may not be readily available when the failure of one bank threatens the stability of other banks in the U.K. banking system. Moreover, as noted previously, this provision has contributed to the growth of CDs in recent years—an outcome that is incompatible with encouraging banks to deal with one another on a secured basis. The latter is an important ingredient for reducing systemic risks in the sterling money market with its already large amounts of unsecured exposures. Consequently, the authorities were encouraged to reconsider the treatment of owned CDs in the calculation of the SSLR. It is conceivable that the banks might be willing to go along with such a review if it is linked to the recommendation contained in the next bullet.

- No consideration is given to the major U.K.-owned banks' significant holdings of foreign currency liquid assets (except those euro-denominated securities that are accepted by the Bank as collateral in its market operations) and their foreign currency liabilities in the calculation of the SSLR. Should one of these banks experience difficulties, these liabilities could also run-off fairly quickly. Investors tend to behave the same regardless of their location or the currency denomination of their investments. And, to the extent that the banks' foreign currency liquid assets are held in securities and currencies that enjoy deep and liquid markets (such as those in the euro area and the United States), they could be used by the bank to help address a liquidity crisis. Liquidity is fungible in normal market conditions. So long as the assets involved can be readily liquidated and the proceeds converted into sterling, the liquidity of all banks should be supervised on a global basis, as is done for some foreign-owned banks, although the authorities may want to give some preference to holding liquidity in sterling assets, since this is the currency whose liquidity over which they have the most control.

42. **The FSA recognizes the deficiencies inherent in its current approach to supervising commercial bank liquidity management practices, and plans to revise its approach in the near future**. In March 2002, it issued a consultation paper to begin the dialogue with stakeholders on how best to regulate and supervise bank liquidity management practices, and indicated to the FSAP team that it will bear in mind the above points as it goes through the consultation process. Implementation of the FSA's proposals is expected to take place in 2004 and 2005.

Measures to encourage banks to deal with one another on a secured basis

43. **An active unsecured segment of the sterling money market can be a useful instrument for encouraging banks to test their names on a regular basis, thereby imposing some market discipline on their activities.** However, this could still continue to take place if the unsecured segment was a much smaller segment of the market than it is today, where it constitutes more than half of the sterling money market. Moreover, the discussions with market participants alluded to earlier suggest that banks may still, at the margin, be setting credit limits on the basis that there is a non-zero probability that the Bank of England will not allow a major U.K. clearing bank to fail. So what steps can be taken to encourage more trading on a secured basis? The suggestion above to remove the preferential treatment given to CDs in the SSLR might at least ensure that the supervision of bank liquidity management practices is not inadvertently encouraging more unsecured trading. Similarly the suggestion to supervise liquidity positions on a global basis might, at the margin, remove an impediment to the major U.K.-owned banks adopting a more efficient approach to global liquidity management. **In addition, given the limited supply of sterling government securities in the market, the authorities may wish to consider championing measures that would facilitate netting arrangements and other risk mitigation techniques, such as trading of sterling liquidity using other sterling securities and euro-denominated instruments as collatera**l. (The latter securities could be used with the help of foreign exchange swaps to minimize exchange rate risk.) This will obviously not happen overnight, but continued improvements to payment and securities settlement procedures and systems may make render such an option increasingly attractive over time. However, there is also a need to ensure that such steps do not go so far as to unduly undermine the positions of a bank's unsecured creditors

IV. Pound Sterling Foreign Exchange Market

44. **Complementing the sterling money market is a very active foreign exchange market for the pound.** According to the results of the triennial foreign exchange market survey conducted by central banks in April 2001, the pound was the fourth most actively-traded currency in the world, accounting for 13 percent of global market turnover (Table 7). Most transactions are conducted against the U.S. dollar, although pound-euro transactions are not insignificant. In terms of transaction-type, most are conducted in the form of foreign exchange swaps for tenors ranging up to 12 months (Table 8)—a finding that is also true in other currency markets. These swaps are used by market participants to transfer liquidity between domestic money markets on a fully-hedged basis, and to smooth pricing discrepancies that can arise from time to time in domestic money markets due to local liquidity imbalances. Thus, foreign exchange swaps play an important role in helping to ensure that covered interest parity holds between interest rates in different countries.

Table 7. Average Daily Global Trading in Pounds Sterling Relative to Other Currencies

(Billions of US$ equivalent)

	1992	1995	1998	2001
US Dollar	672	991	1301	1094
Euro Currencies	453	710	782	455
Japanese Yen	192	287	301	275
Pound Sterling	**112**	**112**	**164**	**160**
Swiss Franc	69	87	106	74
Other	142	193	326	362
Total 1/	820	1190	1490	1210
Memo:				
Pound Sterling/US Dollar	77	78	118	125
Pound Sterling/Eurocurrencies	23	21	31	24

Source: Bank for International Settlements.

1/ Because 2 currencies are involved each transaction, the sum of individual currencies equals twice the repeated total.

45. **Reported trading volumes for the pound declined in absolute terms between 1998 and 2001, but the pound's share of global foreign exchange market activity rose from 11 to 13 percent. However, the contraction in trading volumes for the pound and other currencies does not appear to be a cause for concern, and may in fact suggest that the foreign exchange market is becoming more efficient**. Market participants and the authorities reported that the decline in trading volumes in the foreign exchange market can be partly explained by consolidation in the banking industry, and also by an increase in the use of electronic broking, particularly in the spot inter-dealer market. Consolidation in the banking industry has enabled banks to handle a larger share of their customer flows in-house without having to trade in the inter-dealer market to manage their exposures. As for electronic broking, market estimates suggest that that over two-thirds of U.K. inter-dealer spot activity is now conducted using electronic brokers, such as EBS and Reuters, compared to 30 percent in 1998.[16] Electronic trading systems increase the transparency of market prices meaning that deals traditionally executed between dealers by phone to facilitate price discovery are no longer necessary, leading to a more efficient market, less opportunities for arbitrage, and an overall decline in turnover.

[16] An increasing amount of trading is being conducted over the internet, but the extent of this is reportedly small in both percentage and volume terms.

Table 8. Average Daily Trading in Pounds Sterling by Type of Transaction in April 2001

(Transactions Booked in London)

	US$ Billion Equivalent	Percent
Spot	**28**	**23**
of which: Local	12	9
Cross-Border	16	13
Outright Forward	**14**	**11**
of which: Local	7	5
Cross-Border	7	6
Foreign Exchange Swaps	**81**	**66**
of which: Local	34	28
Cross-Border	47	38
Total	123	100

Source: Bank of England

46. **The depth and liquidity of the market for pound sterling is corroborated by indications that transaction costs in the wholesale market are low and that traders can execute large transactions without moving the market against them**. Market participants report that bid-offer spreads in the interdealer market for the pound are less than 5 basis points for spot and short-term swap transactions and consistent with spreads seen for transactions involving euros. In addition, if a trader is willing to work a large order patiently in the market and not try to trade it all at once, transactions of several hundred million pounds reportedly can be absorbed by the market without triggering a significant move in the exchange rate.

47. **There are standard confirmation and messaging systems used to settle transactions in the market, for example SWIFT.** Within foreign exchange settlement, there exists the well-documented Herstatt Risk, where two legs of the same trade may not be settled simultaneously because of international time zone differences. The introduction of the Continuous-Linked Settlement Bank (CLS) in September 2002, initially covering trades between CLS members in the seven largest currencies (including the pound), should help to reduce this risk as settlement of both legs of the transaction will be undertaken at the same time. In the case of foreign exchange swaps, unsecured credit risk can also arise during the tenor of a swap because if a counterparty failed to deliver its side of the transaction at the maturity of a swap, a bank would have to re-enter the market to offset the resulting unexpected exposure at prevailing exchange rates. Banks manage their exposures in this regard using limits on the amount of swaps they can undertake with individual counterparties, similar to what is done in the domestic interbank deposit market.

Resiliency of the market in times of stress

48. **The depth and breadth of the foreign exchange market has meant that the market has continued to function normally in times of market volatility—prices may have moved sharply, but liquidity and price-making continued as normal**. Indeed, the Bank of England has not had to intervene in the foreign exchange market to promote orderly trading conditions in the market for the pound since the adoption of the current monetary framework in 1997. After the events of September 11, the market continued to operate efficiently, albeit in much reduced volumes as dealers focused on ensuring their positions were in order and settling smoothly. There was also a general reluctance to deal aggressively given the heightened uncertainty in the wake of the terrorist attack.

49. **While market participants were able to obtain the necessary dollar liquidity following the terrorist attacks to settle transactions involving dollars without recourse to the Bank of England,[17] some U.K. banks expressed some dissatisfaction with the amount of time it took the Bank of England to announce the availability of the emergency swap facility with the Federal Reserv**e. Bank officials explained that previously-negotiated swap facility with the Federal Reserve had lapsed, and needed to be renegotiated and redocumented. In light of this experience, steps have been taken by the Bank and the Federal Reserve to ensure that in the future this facility can be initiated quickly with a minimum amount of new paperwork. Nonetheless, this highlights the need for close cooperation between central banks around the world in order to ensure that when currency markets outside the home country are experiencing distress, the situation is brought under control before it undermines the health of the foreign financial system.

50. T**he events in September 2001 also served to highlight potential operational vulnerabilities in the electronic broking systems used in the market**. For example, EBS encountered some operational difficulties, and some dealers were forced to trade bilaterally with one another by telephone. Fortunately, the competencies required to trade by telephone have not completely disappeared from the market, since electronic broking systems are a fairly recent innovation. Nonetheless, U.K. authorities reported that the sponsors of the electronic broking systems have taken steps to improve the resiliency of their systems, and the major dealers have also ensured that direct dealing could resume if necessary.

[17] Market participants were also advised that a smaller £/US$ swap facility was also available throughout this period from the U.K. government's own foreign exchange reserves. However, no bank chose to access this facility.

FINANCIAL SECTOR ASSESSMENT PROGRAM

UNITED KINGDOM

TECHNICAL NOTE: FINANCIAL STABILITY IMPLICATIONS OF LONDON'S ROLE AS A GLOBAL MARKETS TRADING CENTER

MAY 2003

Contents **Page**

I. Introduction 3

II. London's Attraction as a Global Trading Center 9

III. Implications of Recent Trends in Global Market Structure 10

IV. Potential Linkages for Transmitting Financial Risks Between Global and Sterling Financial Markets...11

V. Potential Implications of London's Global Market Activities for U.K. Financial Authorities...17

VI. Concluding Observations..18

Text Tables
1. U.K. Share of Cross-Border Interbank Claims in BIS Reporting Countries 3
2. Breakdown of U.K. Cross-Border Interbank Claims by Bank Nationality 4
3. U.K. Foreign Exchange Market Share of Global Foreign Exchange Trading Activity.........5
4. U.K. Foreign Exchange Turnover by Transaction Type and Currency 6
5. London Stock Exchange 7
6. Geographical Distribution of Reported OTC Derivatives Turnover 7
7. U.K. OTC Derivatives Transactions by Instrument in 2001 8
8. Major British Banking Groups' Share of Selected Global OTC Markets in 2001 8

Boxes
1. Risk Transfer Markets in the U.K...13
2. The London Clearing House (LCH) 16
3. U.K. Authorities' Role in Supervising Global OTC Markets...19

I. INTRODUCTION[1]

1. **A unique feature of the U.K. financial system compared to other national financial systems is that trading of sterling-denominated claims is small when compared to cross-border trading activity denominated in U.S. dollars and euros**. In the money market, the domestic sterling interbank market is less than half of the total global interbank trading activity that takes place in London between unrelated institutions. The remainder mainly consists of a cross-border market in interbank deposits that are largely denominated in U.S. dollars and euros. Indeed, the trading that takes place in London represents the largest segment of the global market for euro-denominated interbank deposits (Table 1), even though the U.K. is not part of the euro area, and it is the largest offshore center for trading in interbank deposits denominated in other currencies.

2. **Over the past decade, the London interbank market has become increasingly dominated by U.K.-owned and other European banking groups.** To a large extent this reflects the withdrawal of Japanese banks from the market when their credit ratings slipped in response to events in their home country (Table 2).

Table 1. U.K. Share of Cross-Border Interbank Claims in BIS Reporting Countries
(December 2001; percent of total global cross-border claims)1/

U.S. Dollar	17
Euro	22
Japanese Yen	18
U.K. Pound	49
Other 2/	8
Total U.K. Share	**18**

Source: U.K. authorities and Bank for International Settlements
1/ Percent shares reflect banks located in the U.K. regardless of country of origin, and include claims against related and unrelated banks.
2/ Other category includes other currencies and unallocated amounts.

[1] This paper was prepared by the FSAP mission team as part of the background work for the U.K. FSAP in the summer-fall of 2002. The primary contributor to this paper was Mark Zelmer of the IMF's Monetary and Financial Systems Department.

Table 2. Breakdown of U.K. Cross-Border Interbank Claims by Bank Nationality
(Billions of U.S. dollars equivalent; percentages in italics) 1/

	1990		1995		2000		2001	
U.K.-Headquartered Banks	**72**	***16***	**81**	***17***	**168**	***33***	**179**	***35***
Foreign Banks	354	*83*	356	*83*	345	*67*	339	*65*
Of which:								
French Banks	16	*4*	27	*6*	24	*5*	32	*6*
German Banks	43	*10*	91	*21*	93	*18*	100	*19*
Japanese Banks	162	*38*	100	*23*	50	*10*	38	*7*
Dutch Banks	3	*1*	6	*1*	19	*4*	15	*3*
Swiss Banks	12	*3*	12	*3*	42	*8*	44	9
U.S. Banks	22	*5*	20	*4*	33	*6*	28	*5*
Other	96	*22*	100	*23*	84	*16*	82	*16*
Total	425	*100*	437	*100*	513	*100*	518	*100*

Source: U.K. authorities and Bank for International Settlements
1/ Excludes claims on related banks and those on official monetary institutions. Claims on related institutions accounted for more than 60 percent of cross-border interbank transactions involving U.K.-domiciled banks in 2001.

3. **The importance of London as a trading center in the global interbank deposit market is mirrored in the foreign exchange market.** London is the most active trading center in foreign exchange, with daily trading volumes in excess of $500 billion in 2001 (31 percent of daily global foreign exchange turnover) (Table 3), even though transactions involving pound sterling only accounted for 13 percent of global market turnover. And, it is typically the most active trading center for currencies outside their home market. Consistent with international practice, most transactions in the London market are conducted as foreign exchange swaps (60 percent), while spot and outright forwards transactions accounted for 30 and 10 percent, respectively (Table 4). As is the case in other countries, most transactions involve cross-border flows between banking institutions.

Table 3. U.K. Foreign Exchange Market Share of Global Foreign Exchange Trading Activity
(In percent)

	1992	1995	1998	2001
U.K. market total	**27**	**30**	**33**	**31**
By currency:				
U.S. dollar	25	29	30	31
Euro currencies	26	26	34	35
Pound sterling	49	55	83	61
Japanese yen	16	24	22	24
Swiss franc	22	26	29	29
Other	14	18	19	20
Pound sterling (global total)	**14**	**9**	**11**	**13**

Source: Bank of England and Bank for International Settlements.

4. **Fixed-income trading in the U.K. mainly involves trading of foreign instruments.** Data on trading activity in global debt markets are not available due to the informal structure of the market. However, bond trading in London is estimated by *International Financial Services, London* to account for 70 percent of the global market for eurobonds. The *International Financing Review* noted that the largest borrowers in the 12 months ending April 30, 2001 were mainly U.S. entities, notably Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

5. **The international character of U.K. markets is also reflected in the equity market.** The market capitalization of foreign companies traded on the London Stock Exchange was £2.6 trillion at the end of December 2001, compared with £1.5 trillion for domestic companies. More foreign companies are listed on the London Stock Exchange than on any other exchange. Daily trading volumes for international equities in London are almost double those for domestic companies (Table 5). London is also the largest center of funds management of institutional equity holdings, with $2.5 trillion of institutional equities under management in 1999; more than Zurich, Paris, Amsterdam, and Frankfurt combined.

Table 4. U.K. Foreign Exchange Turnover by Transaction Type and Currency
Net average daily turnover in notional amounts ($ billions)

	1992	1995	1998	2001
Spot	**148**	**186**	**217**	**151**
Of which (percent):				
U.S. dollar	68	68	76	84
Euro currencies	66	67	64	48
Pound sterling	23	16	21	18
Japanese yen	15	19	19	24
Swiss franc	9	8	8	6
Other	19	22	10	18
Outright forward	**20**	**34**	**48**	**53**
Of which (percent):				
U.S. dollar	80	79	83	86
Euro currencies	52	50	50	44
Pound sterling	28	18	21	26
Japanese yen	18	24	14	15
Swiss franc	7	7	6	5
Other	15	22	26	23
Foreign exchange swaps	**123**	**244**	**372**	**300**
Of which (percent):				
U.S. dollar	96	96	95	96
Euro currencies	45	48	51	37
Pound sterling	24	16	16	27
Japanese yen	15	20	11	14
Swiss franc	7	6	7	6
Other	13	14	20	20
Total	**290**	**464**	**637**	**504**
Of which (percent):				
U.S. dollar	81	84	88	92
Euro currencies	62	56	58	41
Pound sterling	24	16	18	24
Japanese yen	15	20	14	17
Swiss franc	8	7	7	6
Other	10	17	15	20
Of which (percent):				
Domestic	33	36	34	33
Cross-border	67	64	66	67

Source: Bank of England
Note: Since two currencies are involved in each transactions, the sum of the percentage shares of individual currencies total 200 percent instead of 100 percent.

Table 5. London Stock Exchange

	1990	1995	1997	1998	1999	2000	2001
U.K. Equities (£ billions)							
Market Capitalization	450	900	1,251	1,422	1,820	1,797	1,524
Average Daily Trading Volume	1.25	2.56	4.02	4.12	5.60	7.52	7.53
Number of Listed Companies	2,006	2,078	2,157	2,087	1,945	1,904	1,809
International Equities (£ billions)							
Mark Capitalization	1,124	2,357	2,429	2,805	3,577	3,525	2,580
Average Daily Trading Volume	1.16	3.14	5.70	8.66	9.60	13.97	14.53
Number of Listed Companies	553	525	526	522	499	501	453

Source: London Stock Exchange

6. **The international presence of the U.K. is also reflected in financial derivatives markets.** According to a BIS survey in 2001, London is the most active trading center for over-the-counter (OTC) derivatives, with a market share of 36 percent (sterling denominated transactions accounted for only eight percent globally) (Table 6). Consistent with international trends, cross-border transactions in single-currency interest rate swaps and forward-rate agreements (FRAs) constitute the largest segments of the London market, with most transactions denominated in either U.S. dollars or euros (Table 7). Among exchange-traded derivatives markets, Euronext LIFFE is the seventh most active derivatives exchange in the world, the London Metal Exchange was 16th, and the London-based International Petroleum Exchange was 25th. Overall, London is the fifth largest center for exchange-traded derivatives contracts with a 7 percent share of global trading activity.

Table 6. Geographical Distribution of Reported OTC Derivatives Turnover
(Daily averages of notional amounts in billions of U.S. dollars; percent of total global turnover in italics)

	1995		1998		2001	
United Kingdom	**74**	***27***	**171**	***36***	**275**	***36***
United States	53	*20*	90	*19*	135	*18*
Germany	14	*5*	34	*7*	97	*13*
France	22	*8*	46	*10*	67	*9*
Other	107	*40*	134	*28*	190	*25*
Total	270		475		764	

Source: Bank for International Settlements

Table 7. U.K. OTC Derivatives Transactions by Instrument in 2001
(Daily averages of notional amounts in billions of U.S. dollars)

Interest rate instruments		***Foreign exchange instruments***	
FRAs	83	Currency swaps	4
Swaps	142	Options	33
Options	13		

Source: Bank of England

7. **The principal market participants in the London wholesale markets are mainly branches or subsidiaries of foreign financial institutions, although several of the largest U.K.-owned institutions (for example, Barclays and HSBC) are also important players in this regard (Table 8)**. Market participants and U.K. officials noted that foreign commercial banks prefer to conduct wholesale OTC market trading through branches rather than through locally-incorporated subsidiaries in order to economize on the use of capital.

Table 8. Major British Banking Groups' Share of Selected Global OTC Markets in 2001
(In percent)

Foreign Exchange	London Market	Sterling	26 1/
		Other Currencies	20 1/
	Global Market		7 2/
OTC Derivatives	London Market	Sterling	45 1/
		Other Currencies	31 1/
Global Debt Markets			8 3/

Sources: Bank of England and *Euromoney.*
1/ Share of global market trading in London as collected by the Bank of England in its tri-ennial survey of foreign exchange and OTC derivatives markets. Data are adjusted for local double-counting but not for cross-border double-counting, and thus are not directly comparable with *Euromoney* data.
2/ Share of trading in the global foreign exchange market as reported in *Euromoney* (May 2001).
3/ Share of debt arrangements in the global debt market as reported in *Euromoney* (June 2001).

8. **A natural question to pose is whether the trading in global wholesale financial markets taking place in London represents a significant source of vulnerability for the U.K. financial system.** There is a consensus in both the markets and the official community in London (and elsewhere) that the global financial market activity that takes place in London does not appear to pose significant risks to the stability of U.K. financial markets and

to the domestic financial system more generally. It may in fact, at the margin, contribute to more efficient markets for sterling-denominated claims.

9. **The remainder of this note is organized as follows.** The next section contains a brief review of the reasons why market participants have chosen to conduct a large segment of their trading in global markets in London. Section B summarizes some recent trends in the trading dynamics in global markets, and offers some thoughts on their potential implications for the U.K. financial system. Section C turns to the potential linkages between the global markets and their sterling counterparts. Section D discusses the role played by U.K. authorities in overseeing the activities of global markets, and Section E concludes.

II. London's Attraction as a Global Trading Center

10. **London is an important center for trading in global markets even though the U.K. has generally run a current account deficit since the mid-1980s, and has thus been a net importer of capital**.[2] Its attraction as a major trading center for global markets reflects a number of factors:

- London benefited from being the first trading center in Europe to undergo a major deregulation of the financial services industry;

  This gave it a head start over other prospective European cities as a place where foreign financial institutions could conduct their global trading activities in a supportive regulatory environment. Consequently, a number of market participants, including all of the large and complex financial institutions (LCFIs), have devoted considerable amounts of energy and resources toward building their trading operations in London. These advantages would be extremely costly to replicate in other European trading centers, especially given the network externalities that exist with market liquidity in that liquidity tends to concentrate in the most active trading centers.

- London benefits from the fact that in the global wholesale markets, trading takes place in English and trading practices are governed by Anglo-American law;

- Market participants see U.K. labor laws as being significantly more flexible than those in other European trading centers, which makes workforce adjustments to changing business conditions possible both in terms of speed and cost of adjusting employment levels; and

- London offers a highly-trained workforce spanning a wide range of disciplines that can be tapped as needed to support their trading activities.

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[2] See the article by Stephen Senior and Robert Westwood in the Winter 2001 Bank of England Quarterly Bulletin on the U.K.'s external balance sheet.

III. Implications of Recent Trends in Global Market Structure

11. **Because London is a major center for global financial trading, financial activity in London clearly reflects the changes that have taken place in trading environments around the world.** As has been documented in various IMF *International Capital Markets Reports*, the microstructure governing trading in global markets is changing in many ways, some of which may have implications for the future resiliency of these markets, including when they are operating in London.

12. **One of the structural changes that is most evident in global financial activity in London is the increasing reliance on electronic trading in wholesale markets, including some over-the-counter (OTC) markets.**[3] In contrast to the traditional telephone dealing arrangements, electronic systems increase the accessibility of wholesale markets to a broader range of market participants. These participants can use these electronic systems to monitor prices in a transparent manner, quickly find a broad range of counterparties in a relatively anonymous fashion, and execute transactions at low transaction costs without the need to deal bilaterally with the major market makers over the telephone. Several market participants suggested that some OTC trading resembles exchange trading in that small to medium-sized transactions are conducted through the electronic systems, while larger trades are conducted by the largest market-makers (the LCFIs) on a bilateral basis by telephone (akin to the informal "off-exchange market" often seen for the large block trades executed by market makers in equity markets).

13. **As a result of financial consolidation and market integration, global markets are also experiencing lumpier order flows as the number of market players declines over time and as trade size increases.** All things being equal, this makes it more challenging for market makers to manage their order flow because it takes them longer to lay-off positions in the market. Some of the market makers operating actively in London suggested that this might affect their ability to supply liquidity to the wholesale markets when they are operating in London trading hours—and thus possibly the resiliency of these markets—during periods of heightened uncertainty.

14. **Market participants operating in London acknowledged that the growing use of benchmarking of investment returns and risk management systems is contributing to an increasing propensity toward herding behavior**. The growing use of short-term benchmarks to monitor the performance of institutional investors was cited as a contributing factor to herding behavior because it encourages those investors to invest more passively (i.e., track their benchmarks more closely) for fear of underperforming their benchmarks. It was thought by some that this reduces the diversity of trading strategies used in the market—a key factor in promoting two-way trading flows. In addition, they suggested that as risk management systems become more comprehensive and better able to provide people at all

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[3] For example, see the 1996 *International Capital Markets Report* published by the IMF.

levels of the organization with "real-time" information on a bank's risk exposures, senior management at financial institutions are increasingly inclined to rely on these systems to reign in their traders when markets are unsettled. This may also contribute to herding behavior in times of market stress as traders all try to reduce positions in response to signals emanating from their risk management systems.

15. **Taken together, these observations by market participants suggest that while global markets are deep and liquid in normal circumstances, going forward they might become less resilient in periods of heightened uncertainty.** However, market participants and the authorities all agreed that while these trends are evident globally, there is no evidence to suggest that their effect will be any more significant in London than in other trading centers or that they are any more visible in sterling markets than in markets in which trading is denominated in other currencies.

IV. Potential Linkages for Transmitting Financial Risks Between Global and Sterling Financial Markets

16. **Channels of transmission for financial stresses and strains between the global financial markets and the U.K. domestic financial system could exist at both macro and micro levels.** At the macro level, important issues include the extent to which shocks emanating from the global markets affect their U.K. counterparts, or vice versa, and to what extent the transmission of these shocks is affected by London's role in the global financial markets. More precisely: Is the U.K. financial system more susceptible to shocks than would otherwise be the case were it not for the fact that a large segment of global market trading activity takes place in London? From a real economy perspective, because U.K. economic activity has been positively affected by London's international role, a change in the business conditions of this financial sector could have significant effects on the performance of the real economy, and hence on the domestic activities of U.K. financial institutions.

17. **At the micro level, the main issue seems to be the extent to which additional demands and risks are placed by global trading activities on the infrastructure that underpins the U.K. domestic financial system.** For example, to what extent are U.K. payment and securities settlement systems involved in the processing of global market transactions initiated in London? How easy would it be to relocate this trading activity to another location should the need arise?

Potential macro linkages

18. **There does not appear to be any evidence to suggest that, because of London's role as an international financial center, the U.K. financial system has been disproportionally adversely affected by the large number of financial shocks that have reverberated through the global financial system in recent years.** During the 1990s, the global financial system has absorbed a number of financial shocks such as: the September 11 terrorist attack; the millennium date change; the introduction of the euro; the collapse of Long Term Capital Management (LTCM); a number of emerging market country debt crises;

and a number of episodes of major bond and major currency market turbulence. While these shocks had significant effects on emerging market countries, and in the case of the failure of LTCM and September 11, on U.S. and dollar-based financial markets, on each of these occasions the U.K. financial system functioned as smoothly as one might expect despite the major role played by London in the global wholesale markets.

19. **The problems that have arisen from time to time in the financial markets in the United Kingdom have been home-grown in nature: the failure of Barings in 1995; the small bank crises in the early 1990s; and the collapse of a number of small U.K. financial institutions in the 1970s**. While these U.K.-source shocks affected the sterling markets, they did not have noticeable material effects on the global financial system or on London as an international trading center.

20. **There are a couple of factors that can help explain the relative insulation of the U.K. financial system from the events that have taken place in global markets.** The links between foreign financial institutions operating in London and their domestic counterparts are mainly found in wholesale market activities, in part because the large global and regional institutions generally are not actively involved in providing retail financial services in the United Kingdom.[4] Thus, the financial condition of foreign institutions operating in London typically has not had direct consequences for the intermediation of funds in the U.K. An illustration of this general point that has particular topical interest is the operation of the market for risk (especially credit risk) transfers in the U.K. where, to date at least the involvement of U.K.-owned insurers has not been very active (see Box 1). Similarly, U.K. financial institutions obtain most of their profits from their domestic retail operations; hence, their activities in the London wholesale markets do not have an important bearing on the flow of funds domestically.

21. **Another potential source of vulnerability is that many large U.K. financial institutions have significant counterparty relationships with foreign institutions through the global wholesale markets, which could be adversely affected by a failure of a foreign counterparty**. Some also have important activities overseas, which could expose them to shocks emanating from abroad. However, such exposures are a normal part of doing business in international markets, and there is no evidence to suggest that the activities of U.K. financial institutions would be any different if the European window on the global wholesale markets was located in another European city instead of London.

22. **London's role as a major global markets trading center may make it easier for U.K. residents to invest offshore, and for nonresidents to invest in securities issued by U.K. residents.** In fact, compared to other G-7 countries, the U.K. has very large holdings of foreign securities and nonresidents' portfolio claims against U.K. residents are also large.

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[4] Some exceptions include Deutsche Bank, which is actively involved in lending to the property market, and Citibank, which operates a small retail banking network. However, it is not clear that such activities are linked to the fact that London is a center for trading in global markets.

Box 1. Risk Transfer Markets in the U.K.

The market for risk transfers is an OTC market that comprises different types of transactions designed to transfer different forms of risk from financial institutions to other financial institutions or to the capital markets. Typical forms of risk transfers involve the transfer of credit risk from banks to insurance or security firms (e.g., through a credit default swap or asset-backed securities) and also, on a smaller scale to date, the transfer of insurance risk from insurance companies to the capital markets (e.g., through a catastrophe bond). At the end of 2000 the global market size was estimated in around $893 billion and expected to be around $1,500 billion by end-2002 (a 9-fold increase in the 5-year period 1997 to 2002). However this is still a small market when compared with an aggregate stock of outstanding contracts in the Global OTC markets of around $100 trillion.1/ Banks are the main credit protection buyers (63 percent of the market) in the global market while the main protection sellers are banks (47 percent), insurance companies (23 percent) and securities houses (16 percent). According to the last BBA survey, around 50 percent of the global OTC credit derivatives markets trade in London.2/

As with other global markets in the U.K., transactions between foreign institutions are a large part of the risk transfer activity undertaken in London. For example, a recent FSA survey indicates that to date, U.K. insurers appear to have had a limited involvement in selling credit risk protection, with foreign insurers appearing to have far more appetite for this type of risk. Nevertheless, the limitations of the present reporting system makes the degree of involvement difficult to assess with full certainty, and in any event, given the current stresses in the insurance industry, some U.K. insurers could feel there are incentives for more active involvement in these markets in the future. U.K. banks involved in these markets as protection buyers or sellers are subject to requirements based on an interpretation of the provisions of the existing Basel Capital Accord (developed prior to the appearance of such risk transfer transactions); the proposed new Capital Accord, when implemented, will deal more explicitly with them.

Careful ongoing monitoring of the risk transfer markets, and the involvement in them of U.K. institutions—not least insurers—is therefore required. Further work by the U.K. authorities and supervisors internationally will be needed to develop an improved reporting system for risk transfers. This has proved to be a challenge to date, mainly because of the different types of transactions, which in most cases are not standardized. Apart from some simple statistics such as notional amounts traded, type and number of transactions, an improved reporting system may need to involve institutions reporting the expected and unexpected losses in their portfolio of risk transfers. For this purpose, institutions would have to be allowed to report based on their own internal models.

1/ BIS's Triennial Central Bank Survey on Foreign Exchange and Derivatives Market Activity in the Global OTC markets.
2/ For an extensive review of the market characteristics and participants see Rule, D., *The Credit Derivatives Market: its Development and Possible Implications for Financial Stability*, FSR, June 2001; and *Risk Transfers Between Banks, Insurance Companies and Capital Markets*, FSR, December 2001. For a discussion of the London market, see the FSA consultation paper *Cross-Sector Risk Transfers*. May 2002.

Both of these items exceed 90 percent of GDP in the U.K. compared to less than 60 percent for other G-7 countries. However, this comparison should be treated with caution, since the U.K. statistics include a large number of foreign financial institutions, which book their global markets transactions in the U.K.

23. **A potentially important macro linkage arises from the significant contribution that the global trading activities taking place in London make to the level of U.K. economic activity.** The U.K. financial sector is a large contributor to U.K. GDP, employment, and balance of payments. For example, it accounts for about five percent of GDP,[5] employed more than one million people in March 2002, and consistently makes a significant contribution to the U.K. balance of payments. And, the financial sector's net overseas earnings have been rising steadily over the past decade from less than £10 billion in the early 1990s to over £30 billion in the past three years. The buoyant conditions in the London financial sector in recent years are widely cited as an important underpinning to the buoyancy of economic conditions in London and southern England, as manifested, for example, by the rise in the value of housing in London and surrounding communities. Should the global trading activities taking place in London experience weaker business conditions in the future—with a consequent reduction in employment levels—it could pose increased risks to U.K. financial institutions' domestic lending activities through the deleterious effects on local economic conditions.

Potential micro linkages

24. **A potentially important issue is the extent to which the trading in global wholesale markets that takes place in London places extra demands on U.K. payment and securities settlement systems.** Overall, market participants and U.K. officials generally believe that London's role as an international financial center does not appear to place significant additional demands on these systems. An important illustration of this general observation is the very active currency trading that takes place in London each day. London is the most active currency trading place in the world. Despite this trading and the significant amount of trade processing that takes place in the U.K., the U.K. payments and settlement infrastructure is not involved, except if sterling is one leg of the transaction. That is, foreign currency payments associated with London trading involving foreign currencies ultimately reach final settlement through the payment systems of the countries of the currency involved, and not through the U.K. payment systems. For example, the U.S. dollar leg of a currency trade that takes place in London settles through CHIPS, the payment system in the United

[5] The financial sector definition here incorporates banking, insurance, fund management, securities, derivatives, and venture capital. The contribution to the GDP reaches 8 percent if a broader definition including professional and support services related to the sector is used.

States, and similarly for transactions in other currencies with the important exception of the euro.[6]

25. **Settlement of the euro leg of transactions is somewhat more complicated as these initially pass through CHAPS-Euro and TARGET in the U.K. on their way to euro area.** These systems are considered by market participants and officials to be capable of handling the flows associated with transactions emanating out of London—see the assessment of these systems against the CPSS Core Principles for Systemically Important Payment Systems. Similarly, the transfer of non-U.K. securities ultimately takes place through securities settlement systems located outside of the United Kingdom, such as Euroclear. Thus, while trades may be initiated in London, the final settlement of them generally happens elsewhere, save for some important trade processing work that takes place in the U.K. offices of the relevant counterparties.

26. **The second major exception to the general observation that the U.K. financial infrastructure is not significantly affected by London's role as an international financial center is the London Clearing House (LCH).** In addition to its traditional role in serving as the central counterparty in exchange-traded markets, LCH is playing an increasingly important role in serving as the central counterparty for trades conducted in OTC markets as well. For example, LCH now serves as the central counterparty for OTC interest rate swaps, denominated in sterling and other currencies. If LCH became unable to operate normally, it could disrupt, and possibly result in the closure of, all markets that settle trades though it, including the relevant trades emanating from the global wholesale markets. Although important improvements can be made—and progress is indeed underway—in some areas of LCH arrangements, there is nothing to suggest that LCH's capabilities for risk management and containment are adversely affected by its role as central counterparty in global markets per se. Box 2 summarizes key points relating to LCH, from the FSAP assessment of the U.K.'s securities settlement systems against the IOSCO/CPSS Recommendations for Securities Settlement Systems.

27. **In light of September 11, another issue is whether the global market trading that takes place in London could be rerouted to another financial center in the event of operational difficulties in London.** While such a transfer of trade negotiation and processing would not be easy, there is a general consensus among market participants and officials that this could be accomplished if necessary without seriously disrupting the global or U.K. financial systems. In the wake of the September 11, market participants have been taking measures to ensure that they have proper backup facilities for their trading operations, and many of them have formulated contingency plans to shift trading to other cities in Europe if necessary. Given London's past history of terrorist incidents, many institutions have had some form of contingency plans for many years. They also take some comfort from

[6] The settlement of foreign exchange market transactions changed somewhat with the introduction of continuous-linked net settlement later in 2002.

Box 2. The London Clearing House (LCH)

LCH is the major central counterparty clearer in the U.K. market. LCH act as counterparty to a significant number of trades including those undertaken on derivative exchanges, the LSE's electronic trading system (SETS) and OTC (swaps and repos). Overall, LCH seems to apply a conservative view in setting margin requirements. The monitoring of clearing members is very well developed with, among other things, daily stress testing of members' positions.

Despite this conservative approach to risk management, however, at the time of the FSAP assessment, there were weaknesses in LCH's payment scheme, which the authorities and LCH are currently in the process of addressing. In particular, LCH settles its cash payments across accounts held at various commercial banks, rather than in a default-risk free settlement asset. The resulting intraday risk exposures are material. While the exposures are with large, well capitalised and closely regulated banks, LCH is considering whether there are ways of reducing further the potential risk. LCH is currently discussing with the Bank of England the practicalities of replacing these current payments arrangements with one based on settlement across the books of the BoE, for settlements in sterling and Euro.

Traditionally and in line with many other clearing houses LCH has invested its cash resources in the unsecured deposit market, which brings exposure to credit risk. Again, the exposures are with high quality, well regulated counterparties and LCH has a prudent policy on managing the credit exposures. Furthermore, LCH has introduced an active programme to transfer the placement of funds in the money market from an unsecured basis to a collateralized basis, in order to limit further unnecessary credit risk exposure of LCH.

LCH has had special protection under English law since 1989 and that protection has since been extended twice to cover its OTC business and through designation for the purposes of the EU's Settlement Finality Directive. There are nonetheless further small changes that could be made to remove any remaining uncertainty as to whether all of LCH's arrangements are covered by the protections: work is underway to address this.

the fact that the global wholesale market community pulled together and overcame competitive differences in the days following September 11 to transfer trading activities temporarily from New York to London, and to ensure that all trades settled following the breakdown of the settlement systems in New York. Whether such cooperation can be counted on again is an open question. Nevertheless, the number of LCFIs—which are the major players in the global financial markets—is small, a factor that can help to facilitate the reaching of a consensus on the need for cooperative efforts when circumstances are dire.

28. **There are also potential benefits that might accrue to sterling financial markets from London's role as an international trading center**. Market participants noted that, at the margin, the fact that a large number of foreign institutions maintain trading operations in London can be a source of liquidity from time to time in the sterling markets. This can occur as financial institutions make use of their global trading operations in London to exploit arbitrage opportunities that may emerge in the sterling markets. This potential benefit should not be overstated, however, because such opportunities could be pursued from offshore. Nonetheless, being physically present in the market may offer some marginal benefits.

29. **Similarly, the presence of sophisticated foreign financial trading operations in London can help disseminate new trading techniques and financial instruments to the sterling markets.** For example, some participants noted that one of the reasons why the introduction of repo contracts to the sterling market in 1996 went fairly smoothly was because many foreign institutions had experience in using these instruments in their trading operations elsewhere.

V. Potential Implications of London's Global Market Activities for U.K. Financial Authorities

30. **In contrast to the exchange-traded markets and sterling markets where U.K. authorities have well-defined roles for supervising the activities of the exchanges and domestic financial institutions, the roles appear to be somewhat less clear-cut in the case of the global financial trading of foreign financial institutions during the period of time when London is open for trading.** In the case of global trading in London, significant reliance on cross-border supervisory cooperation would seem to be important and necessary, since foreign financial institutions operating in London are predominantly chartered and supervised elsewhere. As a result, the FSA will only grant foreign banks branching licenses to non-EU banks when they originate from jurisdictions in which the U.K. authorities are satisfied with the level of home-country supervision and when they have a good working relationship with the supervisor in question.

31. **U.K. authorities also play an informal role in the supervision of trading practices in the global OTC derivatives markets, such as the interest-rate and foreign-exchange swaps markets.** To a large extent, these are interbank markets, led by the LCFIs, who generally serve as market-makers. While the markets are mostly self-regulated, the major market-maker and dealer institutions are subject to either banking or securities regulations and supervision in their home jurisdictions. Both the Bank of England and the FSA work

closely with market participants through various market committees to promote improvements to trading conventions and appropriate trade documentation (see Box 3). For example, the Bank worked very closely with market participants to introduce the necessary changes to the financial market infrastructure in London to handle the introduction of the euro, even though the United Kingdom has not adopted the euro as its currency. The authorities are also in regular contact with market participants to keep abreast of market developments with the aim of spotting emerging issues, such as regarding the prudential standing of a market participant or unusual trading practices.

32. **The U.K. authorities believe that the presence of global markets trading in London imposes extra responsibilities on them in that they feel they have a special obligation, together with the U.S. authorities, for safeguarding the stability of global financial markets.** As a result, the Bank of England and the FSA devote additional resources to encouraging efforts by other national authorities and market participants to improve the functioning of global financial markets. Moreover, their high quality surveillance of conjunctural developments and structural changes taking place in the global financial system is an important instrument for influencing the evolution of market practices and international policy responses. In this way, the U.K. authorities are part of the evolving informal surveillance of global financial markets. In addition, the presence of the global trading window in London provides U.K. authorities with information on the functioning of global markets that is useful in the surveillance of the major U.K. financial institutions and the potential international threats to U.K. financial stability.

VI. Concluding Observations

33. **The U.K. is unique in that a very large share of financial market trading that takes place in London represents the trading of claims between foreign financial institutions denominated in currencies other than the British pound.** To a large extent, it appears that this trading activity is insulated from the U.K. domestic financial system, in part because this trading activity primarily involves wholesale market transactions between foreign institutions that have little connection to the U.K. domestic financial system, although several large U.K.-banking groups are important players in these markets. Meanwhile, U.K. financial institutions typically obtain most of their profits from the provision of financial services to the U.K. domestic economy.

34. **Thus at the macro level, the most important channel between the global financial markets when they are operating in London and the U.K. domestic financial system is an indirect one and an economic one.** The health of London's financial services industry plays an important role in determining the health of the U.K. economy in the London area, which can have an impact on the quality of loan portfolios for mostly U.K. financial institutions providing loans in this part of the U.K. economy.

Box 3. U.K. Authorities' Role in Supervising Global OTC Markets

The global OTC markets are subjected to significantly less supervision than the domestic exchange-traded markets. This is not too surprising inasmuch as the OTC markets are professional wholesale markets involving transactions between sophisticated financial institutions with no direct participation from unsophisticated retail investors. Moreover, trading in these markets does not take place on organized exchanges, such as the LSE or LIFFE. Rather, the OTC markets largely consist of a network of financial institutions, which informally negotiate customized large-value transactions between themselves using telephones and electronic dealing systems.

In order for OTC markets to function smoothly, market participants need to have confidence in the prudential standing of their counterparties. The FSA is the prudential regulator for the entities it authorizes, including U.K.-incorporated subsidiaries of foreign financial institutions. However, the FSA does not have prudential responsibility for U.K. branches of passporting EEA institutions, some of which are major participants in the London segment of the global OTC markets. Prudential responsibility for these institutions lies with the authorities in the country of incorporation, although the FSA may take responsibility for supervising branch liquidity. Under the EC Banking Investment Services and Insurance Directives the U.K. authorities rely on the prudential regulation of the home country in respect of EEA-incorporated banks and investment firms. In the case of 'third country' incorporated institutions, the U.K. authorities must be given comfort that the foreign institution is properly supervised by its home regulator before it is granted permission to operate a branch in the U.K. If it is not content with the level of supervision provided by the home regulator, the institution in question is only allowed to operate in the U.K. as a locally-incorporated subsidiary so that the U.K. activities come under formal supervision by the FSA.

Even though OTC markets do not operate on formal centralized trading platforms, U.K. authorities work with market participants and foreign regulators to ensure that these markets are deep and liquid, and able to function smoothly under a wide range of trading conditions. This reflects their view that the smooth functioning of the global OTC markets is an important contributor to the stability of the U.K. financial system as well as the international financial system more generally. The Bank of England and the FSA maintain a continuous bilateral relationship with key market participants, and liaise with them through various local committees chaired by Bank of England staff, such as the Foreign Exchange Joint Standing Committee, the Sterling Money Market Liaison Group, and the Stock Lending and Repo Committee. These committees include a wide range of private and public sector participants, and minutes of their deliberations are posted on the Bank's website. Examples of some issues that they have recently dealt with include: preparing financial markets for the millennium date change and the introduction of the euro, and the formulation of good trading practices for wholesale markets. These activities have no statutory basis, but appear to be well accepted and effective.

At a more formal level, the FSA has issued material on Inter Professional Conduct as part of its Handbook of rules and guidance. This material was prepared on a collaborative basis with market participants, and is aimed at securing good market practice by institutions undertaking bilateral dealings in the OTC markets. It contains special rules as to suitability and advice, communication of advice, clarifying whether one is acting as agent, arranger, or as principal, and rules as to inducements: such as soft commissions, entertainment, and the like. But the scope of the rules can be quite limited, reflecting the light touch of regulation which market participants have had in the past, and are happy to continue. On the other hand, the Handbook does have extensive provisions designed to ensure that these markets are not used improperly; for example, by ensuring that transactions are not undertaken at prices other than market prices.

35. **At the micro level, the nature of global financial markets activity in London is such that the location of trading in London is to an important extent divorced from the settlement of transactions.** Although a significant amount of trade processing takes place in the U.K., the global market trading activity in London does not place much of an additional demand on the U.K. payment and securities settlement systems. There are two major exceptions: the London Clearing House, which is playing a growing role in serving as the central counterparty to global OTC market transactions, and the RTGS payment system for the euro, which has an important node in London. It is critical that these parts of the U.K. payment and settlement systems maintain their efficiency and risk containment systems to ensure that they can handle the demands placed on them by the global financial markets activity that takes place in London.

36. **Overall, the presence of global financial market activity in London does not pose undue risks for the U.K. domestic financial system beyond those that would normally accrue to the cross-border activities of U.K. financial institutions.** Nonetheless, this global activity in London does seem to require some additional surveillance and informal supervisory responsibilities for the Bank of England and the FSA, who, together with central banks and supervisors in other major international financial centers, play an especially important role in promoting and fostering the smooth functioning of global financial markets. The presence of the trading window in London for global activity also provides U.K. authorities with a valuable perspective on developments and trends in the global financial markets, which can be invaluable when assessing the potential sources of strain that could affect the U.K. domestic financial system.

FINANCIAL SECTOR ASSESSMENT PROGRAM

UNITED KINGDOM

TECHNICAL NOTE: THE INSTITUTIONAL FRAMEWORK FOR U.K. FINANCIAL STABILITY POLICY

MAY 2003

Contents **Page**

I. Introduction 3

II. Focus, Accountability, and Coordination in the United Kingdom Context 4

III. FSMA and the FSA....................5

IV. The Bank of England's Financial Stability Role 12

Boxes
1. The FSA's Risk to Our Objectives Framework....................10
2. The Further Development of Insurance Supervision in the U.K. 11
3. The Bank of England's Financial Stability Report 14

I. Introduction[1]

1. **The new framework for financial stability was set out in the 1997 Memorandum of Understanding between HM Treasury, the Bank of England, and the Financial Services Authorities.** A new legal framework for financial sector regulation and supervision came fully into effect from November 30, 2001. Under the Financial Services and Markets Act 2000 (FSMA), which replaced the 1987 Banking Act and other financial services legislation, the U.K. has now moved from a regulatory structure with multiple regulators and a complex range of statutes, to a single regulatory agency with responsibility for virtually all financial sector businesses (the Financial Services Authority, FSA) and one governing statute. In terms of financial stability policy, then, the FSA is responsible for regulating, in particular, deposit taking, insurance and investment business in terms of the objectives set out in FSMA (see below), as well as responsibility for the regulation of clearing and settlement systems. This covers both prudential supervision as normally understood, and conduct of business regulation (unlike some other sectorally integrated supervisors in other countries). The Bank of England (BoE) has a broader financial system stability objective, plus prime responsibility for payments system oversight. The U.K. Treasury (HMT), meanwhile, as the central economic and financial advisor to Government, has a general oversight role for financial stability policy and arrangements at a higher level, including as to the institutional set-up and legislation.

2. **The creation of FSA as an autonomous organization, undertaking public policy functions,[2] predates FSMA by several years, and is associated with the separation of banking supervision functions from the BoE at the time when the latter gained monetary policy "instrument" independence.** There has of course been a reasonably extensive debate for some time about the merits or otherwise of placing or keeping the banking supervision function in the central bank; as well as, more recently, about the merits or otherwise of integrating supervision of the various financial market segments within a single institution, be it the central bank or another organization.[3] At the conceptual level, the debate makes clear that there are arguments for and against each side of those issues, and that the relative empirical importance of each argument is likely to depend importantly on

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[1] This paper was prepared by the FSAP mission team as part of the background work for the U.K. FSAP in the summer-fall of 2002. The primary contributor to this paper was Mark Swinburne of the IMF's Monetary and Financial Systems Department.

[2] More formally, FSA is an independent non-governmental body, given statutory powers under FSMA; its legal form is as a company limited by guarantee, and it is financed by the financial services industry. FSA's Board, comprising an executive Chairman, three other executive Directors, and 11 non executive director, is appointed by HMT, with a process outlined in the "Nolan procedures" for public appointments. In addition, the FSAP team understands that in future, the positions of FSA chairman and chief executive will be separated.

[3] See, *inter alia*, Richard K Abrams and Michael W. Taylor, *Issues in the Unification of Financial Sector Supervision,* IMF Working Paper WP/00/213, 2000; and, for a more U.K. FSA perspective, Clive Briault, *The Rationale for a Single National Financial Services Regulator*, FSA Occasional Paper No. 2, 1999.

country circumstances. Therefore, while individual country circumstances may point more toward one structure than another, for policymakers the real issue is the need to find mechanisms which best manage a number of potentially important trade-offs that underlie the arguments on both sides of the conceptual debate. Amongst the most important of these is the need for coordination and information-sharing among the organizations responsible for financial stability. In other words, and cliché though it may be, the devil is undoubtedly in the details.

II. Focus, Accountability, and Coordination in the United Kingdom Context

3. **In the United Kingdom, the most important overall judgment lying behind the establishment of the current institutional structure appears to have been that there were net gains to be made in the efficiency and effectiveness of financial sector supervision and regulation given:**

- the continuing growth in the importance of financial conglomerates and the continuing blurring of distinctions between financial products and institutions; and
- the economies of scale and scope for an integrated regulator, e.g., in terms of being able to allocate scarce regulatory resources more easily amongst competing needs.

4. **In addition, although clear objectives and sharpened accountability would be desirable under any institutional structure, there is an argument that this may be more easily achieved under the current institutional structure than under the previous one.**[4] For example, at the level of a central bank with both monetary policy and bank supervision responsibilities, this is not so much an issue about a potential conflict between the objectives of these two functions; but rather an issue of whether these two quite different but very important responsibilities may involve a loss of focus at the overall organization level, as the issues in either area may distract management attention from the other.

5. **Nevertheless, many of the opposing considerations have also been taken into account in the United Kingdom, and substantial thought has gone into how to make the new institutional structure work well, so that the anticipated advantages are realized.** To this end, a variety of mechanisms have been established to help minimize and manage the tradeoffs. Perhaps the most important and visible institutional instrument for this purpose is the 1997 Memorandum of Understanding (MoU) between the BoE, FSA, and HMT.[5] The next section discusses mechanisms at the level of the FSA itself.

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[4] For a more recent discussion for the U.K., see e.g., Clive Briault, *Revisiting the Rationale for a Single National Financial Services Regulator*, FSA Occasional Paper No. 162002.

[5] The full text of the MoU can be found on official websites—e.g., at *http://www.bankofengland.co.U.K./financialstability/mou.htm*

6. **The MoU spells out in some detail the different roles and focuses that the three organizations will pursue towards the joint objective of promoting financial stability, both in a crisis situation and more generally.** It stresses that each institution must be accountable for its performance in respect of those responsibilities, and that transparency is needed. As discussed in the detailed assessments of transparency practices for the BoE and FSA, transparency practices are indeed very strong in the United Kingdom.

7. **While there is an emphasis on avoiding duplication on the one hand, the tripartite MoU also creates a strong framework for information exchange and effective coordination, on the other.** It establishes the high level financial stability Standing Committee (FSSC) for regular discussions, and for emergency consultations in a crisis; it records that the BoE's Deputy Governor for Financial Stability will be a member of the FSA Board, and the FSA Chairman a member of the BoE "Court"; and requires that "at all levels, there will be close and regular contact" between the FSA and BoE, including through a program of mutual secondments. Moreover, from the FSAP mission's discussions with the U.K. authorities, it is clear that there is a rather long list of more or less formal channels for coordination and information exchange in addition to those specifically mentioned in the MoU.

8. **It is important to note that the MoU goes on to state clearly that the FSA and BoE "will establish information sharing arrangements to ensure that *all information which is or may be relevant to the discharge of their respective responsibilities will be shared fully and freely*"** (emphasis added). Thus, once identified by one party as relevant to its responsibilities, the requisite information would need to be shared promptly (subject only to applicable confidentiality requirements as regards further release). The FSAP mission puts considerable store on the importance of effective information exchange and coordination in this context, and believes that the MoU framework in the United Kingdom provides strong incentives to ensure that this happens. In this environment, any coordination or information sharing glitches that might occur should be no more than second-order administrative issues to be quickly fixed by managers.

III. FSMA AND THE FSA

9. **The role and performance of the FSA as the first fully integrated regulator in a major economy has attracted world-wide attention.** The organizational restructuring involved in combining and regrouping up to 11 predecessor agencies has itself been a major, if still incomplete, accomplishment. The changes in the supervisory regime, however, go well beyond the consolidation of multiple separate agencies into a single organization. The FSMA represents a comprehensive update of U.K. financial supervision legislation. It consolidates authority for financial supervision under the FSA, and it gives the FSA broad new statutory authority to carry out its responsibilities. Statutory regulation has displaced most of the self-regulatory arrangements that had been a traditional feature of U.K. financial markets. With its four statutory objectives and seven principles of good regulation (see below), the FSMA has also reoriented the U.K. approach to financial regulation. Reducing financial crime and ensuring appropriate consumer protection have been made explicit statutory objectives.

Traditional prudential objectives such as depositor protection and investor protection remain in the objective of "appropriately protecting consumers", but are set alongside the broader, more general objectives of maintaining confidence in the financial system and promoting awareness and understanding of the financial system. The traditional U.K. emphasis on strong governance by regulated parties and a preference for minimally prescriptive regulation has been retained.

10. **Although it is a large and relatively complex statute addressing a broad range of areas, the FSMA generally provides only a framework within which the FSA is to prepare more detailed rules on the various issues covered.** One of the most important powers delegated to the FSA is thus the power to produce Rulebooks governing the contents of FSMA. After lengthy consultation processes, the FSA has produced a handbook that supplements the general powers given to the FSA under FSMA and sets out in detail Rules relating to individual areas of regulated activity.

11. **More specifically, the new framework consists of three levels of regulations:** (i) Primary Legislation—i.e., the FSMA itself: beyond the objectives outlined above, the FSMA contains seven principles of good regulation, the FSA powers and functions, the applicable accountability mechanisms, etc.;[6] (ii) Secondary Legislation, that comprises a set of acts that regulates different aspects of FSMA in a more precise way (e.g., FSMA refers to regulatory activities but never defines them; they are defined in the secondary legislation)—there are around 90 pieces of such secondary legislation; and (iii) the FSA Handbook, that collects all the regulations issued by the FSA.

12. **FSMA identifies four regulatory objectives for the FSA, which cover conduct of business aspects, as well as purely prudential supervisory/financial stability issues:**

- maintaining confidence in the financial system;
- promoting public awareness and understanding of the financial system;
- appropriately protecting consumers of financial services; and
- the reduction of financial crime.

13. **In addition, in pursuing these four objectives, the FSA must also take into account seven "principles of good regulation."** They are as follows:

[6] In this context, the FSA chairman is appointed/removed by the Treasury, so that the chairman is not as *formally* independent as in the sense commonly advocated for an independent central bank. As discussed more fully in the detailed standards assessments, however (especially the transparency assessment), there are, nevertheless, some other important constraints in the U.K. system that help ensure that appointments and removals do not become unduly political matters.

- minimizing adverse effects of regulation on competition;
- encouraging competition among firms regulated by FSA;
- using its resources economically;
- taking account of the responsibilities of those who manage the affairs of authorized persons;
- following the principle that a burden or restriction imposed on a regulated firm should be proportionate to the benefits expected;
- being attentive to facilitating innovation in connection with regulated activities; and
- observing the international character of financial services and markets and the desirability of maintaining the competitive position of the U.K.

14. **The distinction between the four statutory objectives and the seven principles is important.** Since the latter are to be taken into account, rather than directly pursued by FSA, the formulation establishes a clear sense of priority between the two sets of criteria, to guide both implementation by the FSA of its responsibilities, and the internal and external accountability processes. For example, if the principles related to competition had been enshrined as an objective rather than as matters for consideration (as proposed at one stage during the process of enacting FSMA), it is not difficult to conceive of situations where, in the short term at least, there could have been quite sharp conflicts between, say, a competition-oriented objective and a market confidence objective.[7] In addition, a competition objective under FSMA would have cut across the competition-related objectives of other parts of the U.K. government, tending to dilute accountability.

15. **Nevertheless, the fact that the seven principles are explicitly spelled out in the law is a significant innovation that reflects the complexity of the issues in financial stability policy.** Most if not all jurisdictions would acknowledge that, e.g., supervision and regulation should not negate the responsibilities of owners and managers of financial institutions, nor should supervisory policies and actions be unduly burdensome or restrictive. But having these consideration explicitly set out in FSMA serves to bring such considerations into sharp relief, and "gives them some teeth." The legal framework requires FSA to quite clearly account for its action to meet its objectives, in terms relevant to the principles—one specific example where this part of the framework "bites" is in the derived obligation for FSA to produce explicit cost-benefit analyses for its regulatory policies and actions. Just as important, it is also a strong signal to those to whom FSA is accountable—

[7] Even if, in the medium-longer run, there may be no conflict between the two objectives: as in the time-inconsistency argument for a single price-stability objective for monetary policy, it is often the short-term trade-off that matters for performance over time.

including Government, Parliament, the general public, the industry and in some cases the courts—about what should be expected of the FSA and what should not.

16. **None of the above is to deny that there may still be conflicts or tensions between the objectives and principles.** For example, even if there are no fundamental inconsistencies between the four objectives, it is conceivable that there may be tensions between, say, responsibilities related to the financial stability aspects of the objectives, and those related to the conduct-of-business or financial crime aspects. These may be felt at the level of the higher-level organizational focus (the "distraction" issue), especially if problems in the latter areas are prone to become politicized; or at the micro level of resourcing. By way of comparison, and as noted above, one of the arguments advanced for separating banking supervision from a central bank focused on price stability is the potential distraction value of problems in the former that can become quite politicized.[8] As we interpret it, the empirical judgment that the U.K. authorities are making here, at least implicitly, is essentially that, in the United Kingdom, the synergies between prudential and other forms of financial sector regulation outweigh any such risks, provided the legal and institutional framework for the integrated regulator is strong enough. At the same time, it is important to work hard to ensure that coordination and communication between, for example, the Bank of England and the FSA ensure that other synergies (e.g., between banking supervision and monetary policy) can be exploited even if responsibility for these two functions is split between two different institutions.

17. **The proviso above, about the strength of the legal and institutional framework, is critical. If trade-offs between different objectives and constraints are to be well made within one organization, transparency, accountability and governance arrangements need to be well designed.** In our view, the FSA meets this criterion.[9] As already noted, transparency practices are very strong. The FSA has been exemplary in formulating and outlining how it is approaching its tasks, in its corporate plan and annual report, as well as in a range of more ad hoc publications (such as its *Progress Reports.*) Further, the FSA is required to consult quite extensively and publicly on proposed rules and regulatory guidance.

18. **In addition to transparency aspects per se, there are numerous checks and balances in the FSA's governance structure.** For example,

- though the FSA Board currently contains some appointees from the financial services industry, it also contains some appointees with other business or consumer backgrounds so that there is a balance between practitioners and others, with a majority of non-executive directors required. And in any event, the deliberations of

[8] More formally, this can be seen as a need to manage additional reputation risks to minimize any negative spillover to monetary policy credibility.

[9] Briault (2002), op. cit, contains a more detailed discussion of the mechanisms.

the Board are tied back to the objectives and principles under FSMA, as well as to the U.K.'s principles of good corporate governance.

- likewise the role of government in Board member appointments (and their removal) is constrained both by FSMA and the established, published procedures for public appointees;

- FSMA formalized the operation of two additional advisory panels for the FSA, a Practitioner Panel and a Consumer Panel, so that both sides of the financial services industry have a channel to formally feed their views to the FSA Board, through reports which they also make public. (These two panels had actually been established by the FSA some time previously.)

- The exercise of FSA's wide supervisory powers are, or can be, reviewed in several ways: by an independent Tribunal for case-related decisions; by an independent FSA Complaints Commissioner who can report publicly on findings and recommend payment of compensation by FSA in appropriate cases; by governmental agencies dealing with competition (with respect to competition implications of FSA policies); and through "value-for-money" audits or specific independent inquiries that the government can commission.

19. **To make more concrete the application of its statutory objectives and regulatory principles, the FSA has elaborated an operational framework—it's "risks to our objectives" (RTO) framework—for setting supervisory priorities and allocating scarce supervisory resources.** (See Box 1.) The framework facilitates consistency, transparency and accountability in the implementation of supervisory responsibilities. Consistent with that framework, the FSA's emphasis on further development of its insurance supervision framework (Box 2) is one illustration of how supervisory priorities and associated resource reallocation can work within the FSA, as an integrated supervisor.

20. **The guiding principle that similar risks should be regulated in the same way, regardless of type of institution, is giving a strong impetus to integrating FSA rules as well as its organization and processes, although this is still at a fairly early stage.** Implementation of the FSMA has allowed the FSA to introduce a single enforcement regime applicable to all firms and individuals it regulates. The new regime sets out which regulated activities require authorization, and the FSA authorizes firms by giving permissions defining which activities they can carry out. The FSA has developed an authorization process that applies across all sectors, and it includes giving approval to individuals responsible for key designated duties in authorized firms. Development of the authorized-persons regime is also giving the FSA an important tool for implementing its supervisory strategy which looks to firms' directors and management to take responsibility for compliance with rules and regulations. Conduct-of-business rules have been developed that apply across all regulated firms. Prudential requirements across banks, insurance companies, and independent securities firms remain quite distinct, although projects are underway to achieve greater harmonization.

Box 1. The FSA's Risk to Our Objectives Framework

The FSA's RTO approach is in essence a form of corporate planning framework for establishing supervisory strategies, guiding the FSA's work program, allocating supervisory resources, designing regulations, and evaluating the effectiveness of supervisory efforts. It should be distinguished from what is normally thought of as risk-based supervision, which focuses on the risk exposures of individual firms, such as credit risk, liquidity risk, market risk, operational risk, litigation risk, without explicit reference to higher-level supervisory objectives. The FSA approach, in contrast, considers the risks posed by regulated individuals and firms, and by industry-wide developments, to the achievement of the FSA's four statutory objectives. Reflecting this, under the RTO framework, the risks of primary concern to the FSA are the risks that developments in firms or markets will undermine market confidence in the financial system, that financial institutions and individuals will be subject to abuse by criminal elements, or that uninformed individuals will be mislead by financial operators. To the extent that the priorities between the FSA's broad objectives shift over time, it can be expected that this would be reflected fairly explicitly, through the RTO framework, in the FSA's corporate plan, annual report, and other publications. However, this has yet to be fully tested.

To make the RTO framework operational and to allow it to be applied consistently across all firms, the FSA has developed a classification scheme that links firm risk and environmental risk to the risks to its objectives. The FSA has identified seven high level risk groups linked to one or more of the four statutory objectives. The seven risk groups are: financial failure, misconduct/mismanagement, consumer understanding, incidence of fraud or dishonesty, market quality, incidence of market abuse, and incidence of money laundering. Firm specific risk is divided into two broad categories: business risk and control risk. These categories, in turn, are subdivided into some 40 risk elements. Based on a risk assessment, firms are categorized as High Impact, Medium High Impact, Medium Low Impact, or Low Impact. This categorization, in turn, determines the nature and intensity of the supervision of individual firms by FSA. Firm size is not the exclusive factor in determining where a firm lies on the spectrum between high and low impact, but it is a central factor.

The RTO approach still allows room for flexibility and judgment in its application, however. For example, the risk analysis that leads to the categorization of individual firms is, unavoidably, highly subjective; nor does the framework itself provide much operational guidance for determining, overall, how much supervision is enough or which risks are most important for which firms. At the firm level, the supervisory strategies adopted by FSA appear to be guided as much by conventional risk assessments (credit, liquidity, interest rate, operational, litigation, etc.) as by the RTO factors. Beyond that, judgments about supervisory policies are shaped by the requirement to undertake explicit cost-benefit analyses for material proposals, as well as the broad consultation requirements. In short, the RTO framework, while certainly not providing all the answers itself, does help to make the operation of supervision more consistent, more open, and more open to challenge at several levels.

Box 2. The Further Development of Insurance Supervision in the U.K.

The U.K. authorities are in the process of significantly strengthening insurance supervision and are shifting resources within the FSA to insurance sector oversight. This is appropriate in light of the importance of U.K. insurance companies and markets in both the U.K. financial system and the global insurance industry, as well as the highly sophisticated nature of the U.K. market. It is also particularly timely given the significant current stress in the industry and the potentially strong incentive for excessive risk taking in the current environment. The state of the industry has required the FSA to grapple with the more immediate "bushfires" arising from the current situation—reflected in increased supervisory activity, including enhanced monitoring of insurers' financial modeling, and modifications and temporary suspensions of the FSAs "resilience tests" for insurers (to avoid "fire-sale" problems from forced asset sales)—at the same time as it progresses forcefully the more fundamental but more medium-term task of overhauling the supervision regime.

The FSA had already begun developing a strengthened approach to insurance supervision under its risk-based framework (the "Tiner project") at the time of the FSAP assessment of the U.K. insurance supervision and regulation regime against the *IAIS Insurance Core Principles,* and the early implementation stages have proceeded further in the interim. 1/ The FSAP assessment was therefore able to give further encouragement to the reforms proposed under the Tiner project, as well as suggesting a few other additional measures for consideration. The main findings (at the time of the FSAP assessment at least) included that the FSA's regulatory and prudential regime required an increased degree of hands-on prudential supervision and was not sufficiently proactive; reflecting in part the absence of formal actuarial, general insurance, and reinsurance involvement in the risk review and assessment process, the current prudential regime may not ensure a sufficiently comprehensive review of the appropriateness of firms' risk management systems, asset allocation limits, and internal controls, in light of the nature and amount of business underwritten; 2/ and the desk-based analysis of statutory returns may not adequately capture the nature and scale of risks of underlying asset and reinsurance exposures. The authorities were encouraged to consider a further strengthening of insurance supervisory resources and processes within the FSA. In addition, the assessment also stressed the need for improved transparency of early intervention actions was stressed, and stronger reporting, disclosure, and governance-related requirements for insurance companies. 3/ The reforms planned under the Tiner project are expected to remedy most of the shortcomings noted in the assessment of observance of the (enhanced version) of the IAIS Principles.

One further issue, closely related to the abovementioned weaknesses, is the dearth of timely, public aggregate financial indicators for the U.K. insurance industry (as, indeed, in many other countries).

The FSAP team drew also on aggregated data and analyses available (at a price) from private market participants, but even the most recent of these were quite dated. Stronger reporting and disclosure will hopefully facilitate better availability of financial soundness indicators for the insurance sector, which is a high priority for further strengthening the overall surveillance of the U.K. financial system.

1/ More specifically, the formal assessment was against higher standards applicable to a major insurance center like the U.K., rather than the regular standards.
2/ More recently, however, the FSA has integrated into its supervision team the previous work of the Government Actuary's Department (GAD).
3/ See the FSAP detailed assessment of the IAIS Insurance Core Principles for a full description.

The fundamental review of insurance supervision referred to above may well lead to adoption of elements of the risk-based strategies used in the regulation of banks. Reporting requirements are also undergoing a systematic re-evaluation that is likely to lead to more commonality across financial sectors.

IV. The Bank of England's Financial Stability Role

21. **The MoU clearly recognizes that core central banking functions are as much a part of the overall financial stability regime as the more institution-specific supervision functions.** Indeed, the whole pursuit of monetary (price) stability is itself a cornerstone of financial stability in its broader sense. And at a somewhat narrower level, the arrangements to manage liquidity at a system-wide level to ensure key financial markets continue to function effectively, even in time of stress, are the same arrangements that are required to undertake effective and efficient monetary policy. (Systemic liquidity arrangements are discussed in detail in another FSAP Technical Note.)

22. **In addition to those aspects of the BoE's core functions, the MoU also stresses the BoE's central role in advising on, overseeing and helping to implement appropriate changes in the payments system infrastructure; in undertaking surveillance of the financial system as a whole; and, in exceptional cases, undertaking last resort lending of one form or another.** The payments system responsibility stems quite naturally from the BoE's role as "bankers' bank" and its provision of the central settlement asset underpinning the whole infrastructure. The system–level surveillance role, including a major component related to surveillance of international financial market activity (given London's role as a major international financial center), stems from the BoE's ability to supplement the institution-by-institution perspective with a perspective drawn from financial markets and payments systems (where, e.g., more system-level issues and budding crises can often be perceived earliest); and from the international and domestic analysis and forecasting that is necessary to underpin the day-to-day formulation of monetary policy. One further financial stability function of the BoE that can be noted is its role in facilitating corporate workouts under the "London Approach". This is less common now than it was several years ago, but nevertheless, the BoE stands ready to help facilitate a London Approach workout if requested, as it has in several cases in the past.

23. **While it cannot be definitively linked to the institutional reforms of 1997-98, there has been a distinctly sharper focus in recent years on broader financial sector trends, issues, risks and vulnerabilities by the BoE; a process of constant improvement and innovation in this area has been underway.** This is most clearly seen in the development of the BoE's six-monthly *Financial Stability Review* (FSR), which has progressed from its early form as a somewhat ad hoc collection of articles on stability-related topics[10] to a comprehensive and well-presented compendium of conjunctural and

[10] The FSR was first published in Autumn 1996.

structural/institutional trend and issues. The FSR also reflects the BoE's considerable efforts in international market surveillance, and possible linkages back to the U.K. financial system (see Box 3). As demonstrated, inter alia, in this publication, financial sector surveillance in the United Kingdom, in the FSAP mission's view, is at the forefront internationally.

24. **Nevertheless, the agenda for further strengthening financial sector surveillance in the United Kingdom contains some significant tasks.** One key task is to extend and deepen the knowledge of inter-intitutional exposures, especially in regard to unsecured interbank funding. These exposures relate to both explicit exposures between banks in the interbank market per se, and possibly less explicit, intraday exposures between indirect clearing banks and their direct clearing sponsor banks.[11] An analysis in the June 2002 FSR[12] made a major first step in analysis of such exposures, and we encourage the BoE to continue to give a high priority to improved monitoring and analysis in this area. A similar issue is the potential interinstitutional exposures in derivatives markets, not least the risk transfer markets.[13] These will likewise need close monitoring, both in the institution- or market-specific supervision context, and in the broader system-wide surveillance context.

25. **A second important area is the need to continue pushing ahead with improvements to the quality and timeliness of aggregate financial soundness indicators** (FSIs) for the United Kingdom. This is not straightforward given the variety of existing data that has been developed historically, with different objectives in mind and with different institutional coverage. But again, recent work published in the FSR have been important steps forward,[14] and the BoE has been actively engaged in broader efforts to make progress in this area at the international level as well. The FSAP team encouraged continued work in this area, and stressed, *inter alia*, the desirability of producing timely official FSI data for the insurance sector. As noted in Box 2, the significant proposed changes to the insurance supervision regime (the "Tiner Report" project) should facilitate this.

[11] These transactions do not benefit from the risk reduction / transparency arrangements under RTGS, which directly effects only the clearing banks.

[12] See especially Box 11, p. 93.

[13] See the articles by David Rule in the December 2001 FSR "Risk Transfer Between Banks, Insurance Companies and Capital Markets: an Overview," and the June 2001 FSR "The Credit Derivatives Market: Its Development and Possible Implications for Financial Stability."

[14] In particular, the articles in the June 2002 FSR by Andrew Gracie and Andrew Logan, "U.K. Bank Exposures: Data Sources and Financial Stability Analysis"; and by Glen Hoggarth and Darren Pain, "Bank Provisioning: the U.K. Experience".

Box 3. The Bank of England's Financial Stability Report

In their detailed analysis of the financial stability "conjuncture and outlook", the 6-monthly FSRs seek to identify and track potential risks to the U.K. financial system arising from macroeconomic, macrofinancial, and infrastructural developments in global financial markets and major economies or groups of economies (e.g., U.S., Europe, Japan, emerging markets), and from within the U.K. itself. Following the assessment of international and domestic risk factors, analysis of the U.K. financial system, including aspects of the underlying financial stability polity framework, then seeks to assess how resilient or vulnerable the system might be to the risks, should they eventuate. (This distinction between risks and vulnerabilities is one that the FSAP mission also finds a helpful construct.) Increasingly, these analyses have examined different sectors and peer groups within the U.K. system, and the interlinkages between them. They have also put some emphasis on the need to look at the *distribution* of strengths and weaknesses across the system, rather than simply the overall aggregate or average position.

Apart from the conjunctural analysis, FSRs have included individual stability-related articles on a wide range of topical matters. To illustrate, the June and December 2002 FSRs included special articles on U.K. bank exposures (data sources and interpretation); U.K. bank provisioning; spillovers from emerging markets crises; state of play, and implications of "Basel II"; effects of market risk management systems; "dynamic provisioning"; renewing market confidence in the wake of recent high-profile corporate and accounting problems, and the nature of different measures of corporate earnings; insolvency law; resolving financial crises; risk modeling in central counterparty clearing houses; and U.K. interbank exposures. The FSAP team found many of these and earlier FSR articles very useful background for its own work.

26. **A third area, also already underway within the BoE, is the strengthening of quantitative analysis of the aggregate indicators of the financial sector, including through linking these in to the BoE's macroeconomic model.** BoE work fed importantly into the design and calibration of the "stress testing" scenarios used by banks as part of the U.K. FSAP exercise, as well as into the authorities' own "top-down" stress analysis, with related work again depicted in the June 2002 FSR.[15] Again, the FSAP team encouraged further work of this sort so that some form of system-wide stress testing analysis could develop into a fairly standard part of financial sector surveillance in the United Kingdom.

[15] See the article by Hoggarth and Pain referenced in the preceding footnote.

Financial Sector Assessment Program

United Kingdom

Detailed Assessments of Standards and Codes

May 2003

Contents **Page**

List of Acronyms and Abbreviations....5

I. Basel Core Principles for Effective Banking Supervision....7
A. General....7
B. Information and Methodology Used for the Assessment....7
C. Institutional and Macroprudential Setting—Overview....7
D. General Preconditions for Effective Banking Supervision....8
E. Recommended Action Plan and Authorities' Response to the Assessment....48

II. IAIS Insurance Core Principles....51
A. General....51
B. Information and Methodology Used for Assessment....51
C. Institutional and Macroprudential Setting—Overview....52
D. General Preconditions for Effective Insurance Supervision....54
E. Principle-by-Principle Assessment....56
F. Recommended Action Plan and Authorities' Response to the Assessment....76

III. IOSCO Objectives and Principles of Securities Regulation....84
A. General....84
B. Information and Methodology used for Assessment....84
C. Institutional and Macroprudential Setting, Market Structure....84
D. General Preconditions for Effective Securities Regulation....85
E. Principle-by-Principle Assessment....87
F. Recommended Actions and Authorities' Response to the Assessment....101
G. Authorities' Response....102

IV. CPSS Core Principles for SIPS and Central Bank Responsibilities in Applying the CPs—NewCHAPS....104
A. General....104
B. The Functioning of the NewCHAPS System....106
C. Main Findings—Summary....112
D. Recommended Actions and Authorities' Response to the Assessment....123
E. Authorities' Response....125

V. IMF's MFP Transparency Code—Transparency of Monetary Policy....126
A. General....126
B. Information and Methodology Used for Assessment....126
C. Institutional and Market Structure—Overview....126
D. Practice-by-Practice Assessment....127
E. Recommended Action Plan and Authorities' Response to the Assessment....143

VI. IMF's MFP Transparency Code—Transparency of Payment Systems Oversight and Other Financial Stability functions of the Bank of England....145
A. General....145
B. Information and Methodology Used for the Assessment....145
C. Institutional and Market Structure—Overview....145
D. Practice-by-Practice Assessment....146
E. Recommended Action Plan and Authorities' Response to the Assessment....162

VII. MFP Transparency Code—Transparency of Financial Policies (Financial Services Authority)....165
A. General....165
B. Information and Methodology Used for Assessment....165
C. Institutional and Market Structure—Overview....165
D. Practice-by-Practice Assessment....167
E. Recommended Action Plan and Authorities' Response to the Assessment....182

VIII. Compliance with CPSS/IOSCO Recommendations for Securities Settlement Systems....183
A. Introduction....183
B. Institutional and Market Structure....183
C. Description of Regulatory Structure and Practices....185
D. Information and Methodology Used for Assessment....185
E. The Assessment of the Observance with RSSS—The CREST System....186
F. Recommendation-by-Recommendation Assessment....188
G. The Assessment of the Observance with RSSS—The CMO System....203
H. Recommendation-by-recommendation assessment....204

IX. Assessment of Anti-Money Laundering and Combating the Financing of Terrorism214
A. General....214
B. Detailed Assessment....217
C. Assessing the Criminal Justice Measures and International Cooperation....217
D. Assessing the Preventive Measures for Financial Institutions....241
E. Specific Criteria for the Banking, Securities, and Insurance Sectors....269
F. Description of the Controls and Monitoring of Cash and Cross Border Transactions291
G. Ratings of Compliance with FATF Recommendations, Summary of Effectiveness of AML/CFT efforts, Recommended Action Plan and Authorities' Response to the Assessment....292

Text Tables

1. Detailed Assessment of Compliance of the Basel Core Principles....10
2. Summary Compliance with the Basel Core Principles....48
3. Recommended Action Plan with Respect to the Basel Core Principles....49
4. Gross Direct U.K. Sourced Premium Revenues....53
5. Insurance Sector Asset Allocation, end-1999....54
6. Holdings of U.K. Securities 1998....54

7. Detailed Assessment of Observance of the IAIS Insurance Core Principles......................57
8. Summary Observance of IAIS Insurance Core Principles 75
9. Recommended Action Plan to Improve Observance of IAIS Insurance Core Principles....76
10. Detailed Assessment of Observance of the IOSCO Objectives and Principles of Securities Regulation 87
11. Summary Observance of the IOSCO Objectives and Principles of Securities Regulation101
12. Detailed Assessment of Observance of CPSS Core Principles for SIPS and Central Bank Responsibilities in Applying the CPs—NewCHAPS..112
13. Summary Observance of CPSS Core Principles and Central Bank Responsibilities in Applying the CPs—NewCHAPS 123
14. Detailed Assessment of Observance of MFP Transparency Code—Monetary Policy....130
15. Summary Observance of IMF's MFP Transparency Code—Monetary Policy.............143
16. Recommended Plan of Actions to Improve Observance of IMF's MFP Transparency Code Practices—Monetary Policy 143
17. Detailed Assessment of Observance of MFP Transparency Code—Financial 151
18. Summary Observance of IMF's MFP Transparency Code—Monetary Policy.............162
19. Recommended Plan of Actions to Improve Observance of IMF's MFP Transparency Code Practices—Monetary Policy 163
20. Detailed Assessment of Observance of IMF's MFP Transparency Code—Financial Policies (FSA)..170
21. Summary Observance of IMF's MFP Transparency Code—Financial Policies (FSA)..182
22. Summary Observance of CPSS/IOSCO Recommendations for Securities Settlement Systems—CREST 187
23. Detailed Assessment of Observance of CPSS/IOSCO Recommendations for Securities Settlement Systems—CREST...188
24. Recommended Actions to Improve Observance of CPSS/IOSCO—CREST 201
25. Summary Observance of CPSS/IOSCO Recommendations for Securities Settlement Systems—CMO..204
26. Detailed Assessment of Observance of CPSS/IOSCO Recommendations for Securities Settlement Systems—CMO...204
27. Recommended Actions to Improve Observance of CPSS/IOSCO—CMO 211
28. Detailed Assessment of the Criminal Justice Measures and International Corporation..217
29. Detailed Assessment of the Legal and Institutional Framework for All Financial..........242
30. Detailed Assessment of the Banking Sector Based on Sector-Specific Criteria 274
31. Detailed Assessment of the Insurance Sector Based on Sector Specific Criteria............285
32. Detailed Assessment of Securities Sector based on Sector Specific Criteria..................290
33. Description of the Controls and Monitoring of Cash and Cross Border Transactions....292
34. Ratings of Compliance with FATF Recommendations Requiring Specific Action........293
35. Summary of Effectiveness of AML/CFT Efforts for Each Heading..............................294
36. Recommended Action Plan to Improve the Legal and Institutional Framework and to Strengthen the Implementation of AML/CFT Measures in Banking, Insurance and Securities Sectors 299

LIST OF ACRONYMS AND ABBREVIATIONS

AML	Anti-money laundering
ASB	Accounting Standards Board
BACS	The U.K. electronic retail payments system (previously, Bankers' Automated Clearing System)
BCP	Basel Core Principles for Effective Banking Supervision
BIS	Bank for International Settlements
BoE	Bank of England
CFT	Combating the financing of terrorism
CHAPS	Clearing House Automatic Payments System. NewCHAPS is latest variant of the system
CLS	Continuous Linked Settlement
CMO	Central Money Markets Office (settlement system for money market instruments)
CPSS	Committee on Payment and Settlement Systems
CREST	The U.K. securities settlement system
CRESTCo	Company operating the CREST and CMO systems. (Now merged with Euroclear, the European securities settlement agency)
DMO	Debt Management Office
DVP	Delivery versus Payment
EEA	European Economic Area
ERI	Exchange Rate Index (Nominal effective)
ESCB	European System of Central Banks
EU	European Union
FI(s)	Financial institution(s)
FIU	Financial Intelligence Unit
FRC	Financial Reporting Council
FSA	Financial Services Authority
FSAP	Financial Sector Assessment Program
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act
FSR	Financial Stability Review
FSSA	Financial System Stability Assessment
FSSC	Financial stability Standing Committee
GAAP	Generally Accepted Accounting Principles
GAD	Government Actuary's Department
HLFI	Highly Leveraged Financial Institutions (hedge funds)
HMCE	HM Customs and Excise
HMG	HM Government
HMT	HM Treasury
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
IOSCO	International Organization of Securities Commissions
IPE	International Petroleum Exchange
IT	Information Technology
LCFI	Large Complex Financial Institution
LCH	London Clearing House (central counterparty clearing house)
LIFFE	London International Financial Futures and Options Exchange. Now Euronext LIFFE
LME	London Metal Exchange
LSE	London Stock Exchange
MFP Code	IMF Code of Good Practices on Transparency in Monetary and Financial Policies
MMIs	Money market instruments
MoU	(U.K. financial stability) Memorandum of Understanding
NCIS	National Criminal Intelligence Service

NPLs	Non-performing loans
OFCs	Off-shore Financial Center
OTC	Over the counter
PVP	Payment-versus-payment
RBS	Royal Bank of Scotland
RTGS	Real-Time Gross Settlements
ROE	Return on equity
ROSCs	Reports on Standards and Codes
RSSS	Recommendations for Securities Settlement Systems
RTO	Risk to objectives
TARGET	Trans-European Automated Real-Time Gross Express Transfer System
UKLA	U.K. Listing Authority

I. BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

A. General

1. This assessment of U.K. compliance with the Basel Core Principles for Effective Banking Supervision was undertaken as part of the Financial Sector Assessment Program (FSAP) that the IMF has conducted at the request of the U.K. authorities over the period February–July 2002. The assessment was conducted by John Abbott (IMF-MAE), Laurie Edlund (Office of the Comptroller of the Currency), and Jan Rein Pruntel (Netherlands Bank).

B. Information and Methodology Used for the Assessment

2. The assessment has been based on the Core Principles Methodology that was published by the Basel Committee On Banking Supervision in October 1999.

3. In view of the highly developed nature of the U.K. banking sector, this assessment takes into account both the essential and the additional criteria that have been set out in the Core Principles Methodology.

4. The assessment takes into account a comprehensive self-assessment of compliance with the Basel Core Principles that was submitted by the U.K. authorities to the IMF prior to the May mission. Major further sources used for the assessment include numerous publications available from the FSA website, the Financial Services and Markets Act 2000 (FSMA), a CD-ROM provided by the FSA containing its Handbook of rules and guidance, presentation material and internal documents provided by FSA officers, and background material from various industry sources.

5. In addition extensive interviews were held with FSA officers, representatives of major U.K. incorporated banks and U.K. branches of overseas banks, senior representatives of the British Bankers Association, the Foreign Bankers and Securities Association, the Practitioners Panel on transparency established under the FSMA, and the Institute of Chartered Accountants in England and Wales. The assessment team gratefully acknowledges the cooperation received from all concerned which has added substantially to the effectiveness of the assessment.

C. Institutional and Macroprudential Setting—Overview

6. The FSA was established by the U.K. Government in May 1997, and commenced operation in an interim or transitional way in June 1998. The relevant law, the FSMA, was passed in 2000, and took full legal effect on December 1, 2001, a date usually referred to in this context as N2. The FSA initially absorbed the activities of a nine previous regulators or government departments, and in bank supervision specifically, the previous supervisory function of the Bank of England, and has since taken on even more responsibilities.

7. The U.K. banking industry has benefited from a remarkably stable macroeconomic environment and sustained growth over nearly a decade. The favorable environment owes much to sound macroeconomic policies as well as a strong policy framework, and to sustained structural reforms. Recently, however imbalances have emerged, particularly in the expansion of credit to consumers and businesses and burgeoning house prices. Although these imbalances are, on the whole, not large and likely to be resolved gradually, they do pose risks to the financial system that require monitoring and management.

D. General Preconditions for Effective Banking Supervision

8. The United Kingdom has a well developed judicial system with a reputation for probity and professionalism. Civil commercial matters are normally heard in one of the divisions of the High Court, with appeal processes available through the Court of Appeal and, if accepted, the House of Lords. The senior EU Court is the European Court of Justice and it has similar professional standing to the English upper courts. The legal system is based on case law as modified by equity considerations and domestic legislation. As the U.K. has no written constitution, Parliament is the supreme domestic law making body, but as a general principle EU law overrides domestic law under the Treaty of Rome. EU directives agreed by the Council of Ministers do not have the status of law but must be converted into national law by member states. From a regulatory point of view the legal and judicial precondition to effective banking supervision are very well satisfied.

9. The professions important to the financial sector are also well developed in the U.K. and are subject to full liability for breach of duty. The U.K. chartered accountants are expected to continuously maintain minimum levels of professional training. They have world class qualification and accreditation requirements and are seen as best practice resources by educators and professionals in many other countries. A new system of non-statutory independent regulation of the accountancy profession's audit activities has recently been established under the auspices of the Accountancy Federation, which will raise the standards for oversight of the accountancy profession. The convergence toward fair value accounting (IAS 39) will introduce new issues for both firms and for regulators, issues that the U.K. profession is now beginning to address. Again, this precondition for effective regulation and supervision is well satisfied.

10. The auditing profession is also well established. External auditors need to be members of recognized supervisory organizations and to remain eligible to be a member under the rules of that organization (leading to a practicing certificate). Recognized organizations have to ensure that all their members are 'fit and proper' and that audit processes are carried out in a professional manner and with integrity. The main coordinating body for the six U.K. accounting bodies, the Counsultative Committee of Accounting Bodies, is a recognized supervisory body. The assessment team was not able to determine the level of performance of the internal audit function within the banking sector, but there appear to be varying degrees of competence and awareness of the risk based approach.

11. The United Kingdom is among the leading countries in the world in setting standards for corporate governance, including public disclosure practices. With regard to the regulated financial sector, market discipline is reinforced by the fact that the U.K. authorities have publicly stated their view that it is neither possible nor desirable to remove all risk of financial failure.

12. The United Kingdom has no special statutory insolvency procedures for banks. As limited liability companies, banks and other FSA-supervised financial institutions are generally subject to the same insolvency laws and procedures as those that apply for non-regulated companies. FSMA gives the FSA a limited role in statutory insolvency procedures for financial institutions, including the power to petition for an institution to be placed in administration or winding-up proceedings. Under the current system, bank depositors are treated like other creditors at the beginning of administration proceedings and delays in repayment of deposits can span several weeks. In terms of pre-statutory resolution of a troubled institution, however, the FSMA provides the FSA with a broad range of powers to resolve problems in banks, ranging from public censure to withdrawal of authorization, and the financial stability Memorandum of Understanding (between HMT, the FSA and the Bank) provides a broad framework within which official intervention of various sorts could be contemplated in more systemically important cases.

13. Overall the U.K. satisfies the Basel Core Principles preconditions for effective banking supervision.

Table 1. Detailed Assessment of Compliance of the Basel Core Principles

Principle 1.	**Objectives, Autonomy, Powers, and Resources** An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to the authorization of banking establishments and their ongoing supervision; powers to address compliance with laws, as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Principle 1(1)	An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks.
Description	Responsibilities and objectives of the FSA as supervisor and regulator are set out in the FSMA. The FSA's general functions are set out in the FSMA Section 2 (4), and consist of rulemaking, preparing and issuing codes, providing guidance, and determining the general policy and principles by which the FSA will perform its functions. In carrying out the general functions, the FSA is required to act in a way that is compatible with the regulatory objectives and have regard for the principles of good regulation. The four regulatory objectives, identified in the FSMA Section 2 (6), are market confidence, public awareness, protection of consumers, and reduction of financial crime. The seven principles of good regulation identified in FSMA Section 2 (3), which FSA is required to take into consideration, include minimizing adverse effects of regulation on competition; encouraging competition among firms regulated by FSA; using its resources economically; taking account of the responsibilities of those who manage the affairs of authorized persons; following the principle that a burden or restriction imposed on a regulated firm should be proportionate to the benefits expected; being attentive to facilitating innovation in connection with regulated activities; and observing the international character of financial services and markets and the desirability of maintaining the competitive position of the U.K. The FSMA gives the FSA rulemaking powers that may be used to introduce new rules or change existing rules. Rules and Guidance are set out in the FSA Handbook, and primarily cover prudential matters. Banks are required to meet "threshold conditions" (TC), set out in FSMA Schedule 6, and elaborated on in the Threshold Conditions chapter of the FSA Handbook (COND). Banks are also required to comply with rules made by the FSA. In general, the FSA has the sole responsibility for supervising banks in the United Kingdom. Branches of EEA banks are also supervised by their home country supervisors. The FSA has broad powers under the FSMA to take action against banks that do not comply with legal and regulatory requirements. The FSA has formal powers to take action to deal with problem banks, but where appropriate may pursue informal action to resolve problem bank issues. The FSMA is a comprehensive update of previous banking laws. Prior to the enactment of the FSMA, banking laws had been amended periodically to enhance supervisory standards, increase supervisory powers, and reflect the requirements of EU directives. The FSMA requires transparency of the FSA in a number of ways. FSMA Schedule 1, paragraph 10 requires the FSA to report (on the discharge of its functions) to the Treasury at least annually, and Treasury is required to provide a copy of this report to Parliament. In addition, FSMA Schedule 1, paragraph 11 requires the FSA to hold an annual public meeting to discuss the contents of the report. Schedule 1, paragraph 12 of the FSMA charges the FSA's non-executive committee with reviewing the FSA's internal financial controls, and reports on these matters to the Treasury. In addition, the Treasury has the authority to make formal inquiries relating to the FSA's use of resources in discharging its functions, and where there has been a serious failure in the regulatory system. Information on the FSA's regulatory objectives is published in its plan and budget, and other publications. The FSMA, section 8, also requires the FSA to consult on the extent to which its

	general policies and practices are consistent with its general duties. The FSA does not publish regular information on the financial strength and performance of the banking industry; however, industry information is available from other sources. Historically, the Bank of England collected regulatory returns for the banks and published statistical information on the banking industry. Under the FSMA, the regulatory returns are collected by the Bank under the FSA's authority; however, the Bank continues to publish the aggregate information on the industry. The Bank of England's semi-annual Financial Stability Review contains prudential information on the banking industry, including information on aggregate profitability, capital, and liquidity. In addition, the Bank publishes Monetary and Financial Statistics on a monthly and quarterly basis. These statistics provide some information on the lending sector, and national accounts level information on capital and profitability. In addition, the British Bankers Association publishes an annual report that aggregates publicly available financial information from the large banks to provide an industry wide view. The FSA does have two projects (discussion papers on harnessing market forces, and on the regulatory reporting environment) underway to explore, among other things, whether they should provide any additional industry information to the public.
Assessment	Compliant
Comments	The FSMA clearly defines the FSA's role as bank supervisor, sets out regulatory objectives and principles, and provides broad rulemaking powers. Systems are in place to ensure the FSA's activities are carried out in a transparent manner. Information on the financial strength and performance of the banking industry is publicly available, but is published by the Bank of England and the British Bankers' Association.
Principle 1(2)	Each such agency should possess operational independence and adequate resources.
Description	The FSA is an independent non-governmental body, established as a company limited by guarantee. The FSA is accountable to Treasury Ministers and, through them, to Parliament. A Board appointed by HM Treasury governs the FSA. In addition to the Executive Chairman, there are currently three Managing Directors and eleven non-executive members, of whom one, the Deputy Governor (Financial Stability) of the Bank of England, is an ex officio director. One of the non-executive members is Deputy Chairman and 'lead' non-executive. The Board sets the FSA's overall policy, but is not involved in the day-to-day operations. The FSA's funding is provided by the industry, and regulated firms pay annual fees directly to the FSA. The FSMA (Schedule 1, paragraph 17) gives the FSA the authority to require the payment of fees. The FSA is required to consult on its proposed fees, and has issued a series of consultation papers (CPs) that explain how the fees are calculated. CP111 addresses the post-N2 fee assessment process. FSMA requires the FSA to carry out its regulatory responsibilities in a way that uses its resources in an economic and efficient manner. To this end the FSA has developed four resources strategies - for People, Space, Cash and Information. A monthly Resources Report is published within the FSA, monitoring progress against key measures in each of the resource categories. This report includes tracking of things like staff turnover. Salaries paid by the FSA take into account pay levels within the financial services industry and the FSA is able to recruit expert assistance where needed. The FSA spent approximately £2.8million on training in 2001/2, with an average of 6.2 days per person spent on formal training activities over the same period. The FSA uses secondments from the industry and professional firms to add skills and experience not readily available in the marketplace. The FSA also provides outward secondment opportunities to staff as part of its Graduate Development Program. HM Treasury appoints the FSA Board, including the chairman, and also has the authority to remove the chairman or other board members. The FSMA does not set out a term for the chairman. In addition, the FSMA does not set out reasons for removal of the chairman, nor does it require that the reasons for removal be made public.
Assessment	Compliant

Comments	The FSA's Board reports to HM Treasury, and ultimately the Parliament. While the day-to-day operations of the FSA are removed from HM Treasury, there is concern within the industry that political pressures, particularly related to the consumer focused objectives, may cause the FSA to become (a) more prescriptive or rule based, and (b) more consumerist. The prominence of consumer protection among the FSA's regulatory objectives may cause tensions within its risk-based approach to supervision. The strong and transparent accountability regime surrounding all aspects of FSA operations provides the safeguard that the fiscal regime of assessments on regulated firms would not compromise its independence or autonomy. The FSA has the authority to increase assessments to fund increasing supervision needs, but has made a conscious effort to hold its expenditures relatively stable over the last few years. Detailed on-site supervision work is provided either internally by line supervisors supported by the risk review division, or externally using "skilled persons" reviews. The skilled persons reviews are directed by the FSA, but paid for by the firm directly, and represent an additional cost of supervision to the industry over the FSA's assessments. FSA pursues a consistent theme of proportionality, considering the cost of supervision (including the use of skilled persons reports) against the risks to the FSA's objectives. The FSA and its staff are credible and professional. Staff at the director and manager level is experienced, many coming from the Bank of England at the time the FSA was created. Bank and industry sources stated that the FSA's level of supervision and focus was reasonable, and the FSA is focused on key risks in the industry. The sources also noted that turnover and depth of staff have been issues for the FSA. One area that bears monitoring is the adequacy of staffing levels in the supervision and risk review divisions. The FSA's internal specialist teams are quite small considering they are a cross-sector resource. The FSA's new risk assessment process is in the early stages of being rolled out. The level of requests for risk review assistance in relation to their available resources is not yet known, and is something that should be closely monitored to ensure that resources are sufficient to carry out risk mitigation programs. In addition, industry sources expressed some concern over the turnover rate in supervisory staff, and the level of firm specific knowledge that is lost due to turnover. However, the FSAP team was informed by the FSA that staff turnover rates have decreased recently. Turnover figures for the FSA divisions undertaking banking supervision (i.e., the Deposit Takers Division, the Major Financial Groups Division and the Investment Firms Division) have ranged from 3.5 percent to 9.7 percent in the twelve months to June 2002. The FSMA does not specify a minimum term for the head of the FSA, does not require that any removal be based on specified reasons, and does not require that the reasons for the removal be made public. HM Treasury is responsible for the processes surrounding the appointment and removal of the head of the FSA. Although the high-level safeguards in this area are thus limited, appointments are made on principles of good corporate governance known as the Nolan Principles, while senior officials' contracts have specific terms, and an official removed could pursue a judicial review in certain circumstances. De facto, an important safeguard in the U.K. context is the close public scrutiny over the activities of public officials provided by an independent media, as well as parliamentary scrutiny. In these circumstances, it is unlikely that a senior official could be removed from office without the government having to publicly disclose and defend the reasons behind its decision.
Principle 1(3)	A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision.
Description	The FSMA sets out the legal framework for authorization, ongoing supervision, and enforcement. The legal framework includes secondary legislation under FSMA, and the rules made by the FSA using its rulemaking powers under section 138 of the FSMA. The FSA Handbook contains manuals on Authorization, Supervision, and Enforcement. The FSA promulgates rules with which the banks must comply. The FSA also produces guidance.

	The rules and guidance mainly cover prudential matters. Under FSMA section 148 the FSA also has the power to alter or revoke rules, and to modify or waive rules in certain cases. The FSA has authority to require banks to provide information under FSMA section 165. Banks are required to submit a variety of regular reports to the FSA covering their financial condition (SUP chapter 16).
Assessment	Compliant
Comments	The FSMA provides a suitable framework for the authorization and ongoing supervision of banking establishments, and clearly identifies the FSA as the body responsible for authorization and supervision of firms. The FSA produces rules and guidance on authorization and supervision. In addition, the FSA has broad powers to require banks to provide information. Rules and guidance are prepared in consultation with the industry.
Principle 1(4)	A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws, as well as safety and soundness concerns.
Description	The FSMA (Schedule 1 paragraph 6) requires the FSA to maintain a process designed to allow it to determine whether a bank is complying with requirements under the FSMA (including FSA rules). The FSA has broad authority to determine whether a bank is in compliance with regulatory requirements. The FSA has the authority under FSMA section 165 to obtain any information or documents from banks. The FSA may also obtain information through the use of an authorized person under section 166. The FSA may also appoint investigators into a bank's affairs under FSMA sections 167 through 176. The FSA's authority and the processes for obtaining information are set out in the Enforcement manual (ENF) section of the FSA Handbook. The FSMA gives the FSA broad powers to take action against banks that do not comply with the requirements of the FSMA, or its secondary legislation or rules. The FSA may withdraw a bank's authorization, limit a bank's ability to take deposits, or require a bank to cease certain activities. The FSA can take remedial action with immediate affect under FSMA Section 45, using a supervisory notice. These notices are subject to referral by an independent FSM Tribunal. Procedures relating to the Tribunal are found in Part IX of the FSMA. The FSMA Part XIV provides the FSA with the power to fine or publicly censure a bank that fails to comply with a requirement imposed by the FSA or the FSMA. This is accomplished through the issuance of a decision notice. These actions are also referable to the Tribunal, generally within 28 days of the date of the notice. The FSA may not take the action specified in these notices until after the referral period has ended, or if the matter is referred, until after the Tribunal disposed of the appeal.
Assessment	Compliant
Comments	The FSA has broad powers to supervise banks, including requiring the banks to provide information. If the FSA determines that the bank is in non-compliance with the FSMA or its rules, it has a range of supervisory and enforcement options available. The options include prompt remedial action (restricting activities, revoking authorization) where other supervisory measures are not sufficient.
Principle 1(5)	A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.
Description	The FSMA Schedule 1 paragraph 19 provides that neither the FSA or "any person who is, or is acting as, a member, officer or member of staff of the FSA" is to be liable in damages for anything done or omitted in the discharge, or purported discharge of the FSA's functions. This protection extends to persons appointed to investigate complaints under Schedule 1 paragraph 7. An exception to the protection exists if the act or omission is in bad faith. In addition, the FSMA protection does not prevent an award of damages under Section 6(1) of the Human Rights Act of 1998.

	However, under the complaints scheme (FSMA Schedule 1 paragraphs 7 and 8), the appointed investigator must have the power to recommend, if he thinks it appropriate, that the FSA makes a compensatory payment to the complainant, remedies the matter complained of, or both. The FSA has the power to require the payment of fees, to cover the costs of defending its actions. The FSA covers the legal costs of defending its staff in legal actions against them in relation to their work as FSA employees.
Assessment	Compliant
Comments	The FSMA provides protection from liability to the FSA and its staff for any actions taken in good faith in the performance of their duties. However, the FSA may be required to pay compensation to complainants under the FSMA mandated compensation scheme, or awards for damages related to actions found to be unlawful under the Human Rights Act.
Principle 1(6)	Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Description	The FSA has an MOU with the Bank of England and HM Treasury, which covers among other things, the exchange of information. The MOU is published. FSMA Part XXIII places restrictions on the disclosure of information, there are exceptions that permit the FSA to disclose information to other regulators (U.K. and overseas) subject to compliance with EU directives. FSMA Section 354 requires the FSA to cooperate with persons who have functions similar to the FSA, and also to cooperate in relation to the prevention or detection of financial crime. Cooperation may include sharing of information that the FSA is not prevented from disclosing. The FSA has formal arrangements for information exchange in place with a number of domestic, EEA, and overseas supervisors. Information is exchanged on an ongoing basis. Confidential information disclosed by the FSA continues to be subject to the FSMA restrictions on disclosure. The FSA must satisfy itself that where confidential information is disclosed to an overseas supervisor the information will be subject to equivalent restrictions as those that apply to confidential information restrictions in the Banking Consolidation Directive. The FSA may refuse requests for confidential information except in limited cases such as court orders in criminal cases, Parliamentary inquiries, and to an extent, personal data subject to data protection legislation.
Assessment	Compliant
Comments	The FSMA provides a suitable framework for sharing of information with domestic and foreign supervisory agencies, and provides for safeguarding of confidential information. The FSMA also provides the FSA with the right to refuse requests for confidential information, with limited exceptions.
Principle 2.	**Permissible Activities** The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word "bank" in names should be controlled as far as possible.
Description	The FSMA does not expressly define the term "bank" or include it as a separate category of authorized person; however, Schedule 2 does identify deposit taking as a regulated activity. The Regulated Activities Order also sets out activities which are regulated activities for the purposes of the FSMA, and accepting deposits is one such activity. For purposes of determining which parts of the FSA Handbook apply to particular categories of firms, the FSA defines a bank as: a. A firm with Part IV permission which includes accepting deposits, and (i) which is a credit institution; or (ii) whose Part IV permission includes the requirement that it complies with IPRU (Bank);

	But which is not a building society, a friendly society, or a credit union. b. An EEA bank. The FSMA Section 19 provides that no person may carry on a regulated activity in the U.K. or purport to do so unless he is an authorized person or an exempt person. FSMA Section 24 provides that a person who is not an authorized person is guilty of an offense if he describes himself as an authorized person or holds himself out in a manner that is reasonably likely to be understood as indicating that he is an authorized person.
Assessment	Compliant
Comments	While "bank" isn't expressly defined, regulated activities are defined and included deposit taking. The FSMA mandates that all persons carrying out regulated activities are properly authorized. Any person using the term bank or banking in their name would be presumed to be carrying out regulated activities and must be authorized.
Principle 3.	**Licensing Criteria** The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organization's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.
Description	When granting or varying Part IV permissions, FSMA section 41(2) provides that the FSA must be satisfied that the applicant satisfies and will continue to satisfy the threshold conditions set out in the FSMA (Schedule 6) in relation to all regulated activities for which they will have permission. There are five threshold conditions: 1. *Legal status.* Deposit-takers must be bodies corporate or partnerships. 2. *Location of offices.* If the bank is a body corporate constituted under the laws of any part of the U.K., then it must have its head office and, if it has one, its registered office in the U.K. A body incorporated in one part of the U.K. may have its head office in any other part. If the bank has its head office in the U.K. but is not a body corporate, it must carry on business in the U.K. 3. *Close links.* This threshold condition applies when the applicant has close links with another person of such a kind as to prevent the FSA from effectively supervising the applicant. The FSMA Schedule 6 paragraph 3 provides a definition of close links. If there are close links with another person, then two tests must be satisfied. First, the links must not be likely to prevent effective supervision of the applicant by the FSA. Second, if the person to whom the applicant is linked is situated outside the EEA, then the laws, regulations, and administrative provisions that apply must not prevent effective supervision of the applicant by the FSA. 4. *Adequate resources.* This test is not only concerned with absolute levels of capital, but also non-financial resources and means of managing resources. Resources may include capital, provisioning, availability of liquid assets, human resources, and risk management systems. When considering adequacy of resources, the FSA will also review whether the firm is ready, willing, and organized to comply with the high level systems and controls requirements set out in the SYSC chapter of the FSA Handbook. 5. *Suitability.* The applicant has the burden of satisfying the fit and proper test. Section 59 of the FSMA gives the FSA the power to specify "controlled functions" within a firm that must be performed by individuals who have been assessed as fit and proper by the FSA. The FSMA also gives the FSA the power to establish how firms should apply for approval (section 60), factors to be determined (section 61), and to issue statements of principles and a code of practice which will apply to all individuals performing functions under section 59. The FSA has exercised these powers, and sets out its approach in the FIT chapter of the FSA Handbook.

	Additional information relating to the five threshold conditions, including assessment criteria, is set out in the Conditions (COND) chapter of the FSA Handbook. The Threshold Conditions are used to assess license applications, and are also considered as a part of the FSA's ongoing supervision. The FSA has the power to reject an application for authorization if the applicant fails to satisfy one or more of the threshold conditions, or if the applicant provides inadequate information. Under FSMA sections 42 and 43, the FSA has the power to impose limitations or requirements on a bank's permission, or grant permission to carry on a narrower range of activities than the applicant requested. FSMA section 45 gives the FSA the authority to vary or cancel a permission if the authorized person is failing, or is likely to fail, to satisfy the threshold conditions. The FSA Handbook chapter GN, Rule 3.3.13 requires a bank to maintain capital commensurate with the nature and scale of its business, and the risks inherent in that business. If the bank is a member of a group, those capital resources must also be commensurate with the risks inherent in the activities of the other members of the group, insofar as they impact the bank. Guidance on how banks should comply with this rule are set out in IPRU (Banks) chapter CO, with detailed guidance in a variety of other chapters. Rule 3.3.9 requires a U.K. bank and an overseas bank have capital of not less than Euro 5 million at the time it obtains its Part IV permission to accept deposits. When the FSA evaluates proposed directors and senior management, it uses the fit and proper criteria set out in the FIT chapter of the FSA Handbook. Criteria assessed as part of the fit and proper assessment include honesty, integrity and reputation (FIT 2.1); competence and capability (FIT 2.2); and the financial soundness of a person (FIT 2.3). Applicants are required to submit a variety of information, including a strategic and operating plan, a business plan, details of the applicant's management and organizational structure, operating procedures, systems and controls, and any outsourcing arrangements. This information is assessed to determine whether the system of corporate governance is proportionate to the bank's business, whether the bank will be managed in a competent and prudent manner, and whether appropriate systems and controls are in place. The assessment of knowledge of all types of financial activities the bank intends to pursue is carried out as part of the approval process for individuals. Cumulatively, senior management would be expected to have the experience and skills to cover all of the bank's proposed activities. The business plan should set out the regulated and unregulated activities of the applicant along with the related risks. The business plan should include a financial budget and projections to demonstrate the applicant is able to comply with the relevant financial resource requirements. The status of the shareholders and their ability to support the business is also considered as part of this process. The FSA would obtain letters of comfort from major shareholders in some cases. Knowingly or recklessly providing false or misleading information to the FSA is an offense under FSMA section 398. The FSA is the licensing and supervisory authority for banks (but see Principle 25, i.e., branches of EEA banks). FSMA section 354 requires the FSA to cooperate in the sharing of information with other authorities in the U.K. and overseas who have functions similar to the FSA. The FSA seeks the view of the home country supervisors in assessing the application of an overseas bank wishing to establish a branch or subsidiary.
Assessment	Compliant
Comments	The FSA has the authority to set criteria for the licensing of banks, and may reject applications if they fail to meet threshold criteria or provide sufficient information. The FSA requires sufficient information to make a determination on the ownership and management structure, and the adequacy of the bank's proposed capital, business plan, and system of controls. The FSA also has a process in place to assess the fitness and propriety of management and officers filling the key

	"controlled function" roles within a firm.
Principle 4.	**Ownership** Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.
Description	The FSMA Part XII addresses control over authorized persons. Section 178 requires a person proposing to take control (or increase the degree of control) over an authorized person, including a U.K. bank, to provide the FSA with prior notification. Detailed definitions of control are set out in sections 179 and 180 of the FSMA, but 10 percent is the general threshold for control. The voting power or holdings of the controller's associates, as defined in FSMA section 422, are also considered. The FSA may require the person giving notification to provide additional information under FSMA section 182. The FSA may object to a proposal unless it is satisfied that the acquirer is a fit and proper person to have control over the authorized person, and the interests of the consumer would not be threatened. The FSA may give unconditional approval under FSMA section 184, or may approve subject to conditions under FSMA section 185. Where shares are acquired in contravention of the FSA's objection, or a condition imposed, the FSA may direct that the shares be subject to restriction as defined in FSMA section 189. The FSA may also apply to the court to order the sale of any shares acquired in contravention of the FSA's objection or condition imposed. FSA rules and guidance related to controllers and close links (including required approvals or notifications, thresholds, and timeframes) are contained in Chapter SUP section 11 of the FSA Handbook. Section 11.4.10 requires banks to take reasonable steps to keep itself informed of the identity of controllers, although identification of beneficial owners is not specifically addressed. Banks must notify the FSA of its controllers and close links annually. The reports are discussed in the SUP chapter of the FSA Handbook, sections 16.4 (controllers) and 16.5 (close links).
Assessment	Compliant
Comments	FSA has full power to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties. Procedures for exercising this authority are spelled out in the Handbook and are carried out in practice.
Principle 5.	**Investment Criteria** Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.
Description	The FSA's Handbook Chapter SUP Section 15 includes a provision requiring a bank give the FSA notice of any proposed restructuring, reorganization, or business expansion which could have a significant impact on the firm's risk profile or resources. Chapter SUP, Section 11 of the FSA Handbook addresses notification and approval requirements related to close links and changes of control in a firm. In addition, Principle 11 of the Principles for Businesses requires firms to disclose to the FSA anything relating to the firm of which the FSA could reasonably expect to be notified. The FSA's IPRU (Bank), section LE, addresses large exposures, including investments. U.K. banks are required to notify the FSA of any investment exceeding 10 percent of its capital, and pre-notify the FSA of any investment exceeding 25 percent of capital. The FSA's policy on large exposures does not apply to U.K. branches of overseas banks; however, U.K. branches incorporated outside the EEA have large exposure reporting requirements. The FSA is required to assess a bank's acquisitions/investments according to whether the bank would continue to meet the Threshold Conditions, and whether the interests of consumers of regulated activities provided by the bank would be threatened by the acquisition/investment. The FSA has the power to prohibit a bank from undertaking a major acquisition or investment in cases

	where the bank would no longer meet the threshold conditions, or FSA rules. The FSA Handbook distinguishes between situations where notifications are required prior to the acquisition or investment, as opposed to after the fact notification. The prior notification threshold is defined in relation to the bank's capital.
Assessment	Compliant
Comments	The FSA has rules and guidance in place regarding the notification, and in some cases prior approval, requirements of major acquisitions or investments. The approval and reporting requirements allow FSA to exercise effective supervisory oversight over corporate structures to insure that risks arising from affiliations are properly identified and controlled and that unsupervisable structures do not arise.
Principle 6.	**Capital Adequacy** Banking supervisors must set minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. For internationally active banks, these requirements must not be less than those established in the Basel Capital Accord.
Description	The FSMA 2000 and the FSA's regulations require banks to maintain both an absolute minimum amount of capital and an adequate level of capital. Threshold Condition 4 requires all banks to maintain adequate resources, both financial and non-financial. The minimum amount of capital is set at Euro 5 million (or sterling equivalent) and on an on-going basis a minimum capital ratio of 8 percent has to be maintained. The components of regulatory capital and the methodology for calculating the capital ratio have been set out in detail in IPRU Banks. The U.K. capital requirements for banks are based on the relevant EU directives, which are fully in line with the Basel Capital Accord. All U.K. incorporated banks are required to maintain capital in accordance with the Basel standards, not just those banks that are internationally active. There is a general rule requiring banks to maintain capital resources which are commensurate with the nature and scale of their business and risks inherent in that business (IPRU Ch. GN 3.3.13R). If the bank is part of a group, the capital resources must also be commensurate with the risks inherent in the activities of other members of the group in as far as these risks affect the bank. In addition to the general capital adequacy rules, for each U.K. incorporated bank an individual required capital ratio is set which in almost all cases is higher (and never lower) than the Basel minimum requirement of 8 percent. Individual bank capital ratios are determined by the overall risk profile of each institution. If the FSA determines that a bank's business or control risks have increased, it may raise the bank's individual required capital ratio. The individual capital ratios are applied both on a solo and on a consolidated basis. The individual ratios are reviewed periodically within a timeframe that is consistent with a bank's supervisory cycle. Banks are required to report their solo capital ratio on a quarterly basis and their consolidated ratio on a semi-annual basis. The components of capital and the risk-weighted assets also have to be reported. Capital requirements have to be met continuously, not just on reporting dates. Banks must therefore be able to calculate their capital ratio regularly. Any breaches of individual required capital ratios must be immediately notified to the FSA. This would lead to the agreement of a clear plan and timetable to achieve swift compliance with the required ratio, either through a capital injection or a balance sheet restructuring. The FSA has a wide range of enforcement powers available if any bank fails to comply with the Threshold Conditions or the FSA's Rules (including the capital adequacy requirements), such as variation or cancellation of permitted activities and withdrawal of the license (see Principle 1.4).
Assessment	Compliant
Comments	The FSA's minimum capital requirements for banks are fully in line with the 1988 Basel Capital Accord and its subsequent amendments. The individual capital requirements anticipate the supervisory review process that is expected to be incorporated in the new Capital Accord that is

	currently being prepared. The FSA is committed to fully implementing the new Capital Accord at the earliest opportunity.
Principle 7.	**Credit Policies** An essential part of any supervisory system is the independent evaluation of a bank's policies, practices, and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.
Description	According to the Threshold Condition on Suitability, regulated firms (including banks) are expected to have identified fully, and considered, the various risks they will encounter in conducting their business and installed appropriate control systems to manage them prudently at all times. IPRU Banks Chapter AR (on accounting and other records and internal control systems) states that this can only be done if a bank has adequate accounting and other records of its business and adequate systems of control of its business and records. It is the responsibility of a bank's directors and management to take reasonable care to establish and maintain such systems and controls as are appropriate to the nature, scale and complexity of its business. There is also a general requirement for a bank's directors and management to take responsibility for deciding what management information is required and who are to be the recipients (IPRU Banks Chapter AR Section 3.2.3). A bank is expected to have management information accurately covering its risk exposures (ibid. Section 3.3.5). No specific rules or guidance exist for banks' loan and investment policies, practices and procedures since these are considered to be the responsibility of management. However, the FSA expects a bank to have set prudent credit granting and investment criteria, policies and procedures, which reflect its range and type of assets. These criteria, policies and procedures must have been approved and implemented by bank management and board of directors and should be periodically reviewed. All relevant staff members are expected to receive adequate training in the bank's internal control policies and procedures. Each bank is expected to have appropriate credit assessment procedures in place with which to identify, measure, monitor and control the credit risk. A bank's internal records should reflect details of the analysis undertaken. A bank's records should include details of counterparty exposure limits that have been approved by management and the bank should be able to measure actual exposures against these limits (IPRU Banks Chapter AR Section 3.2.2). Also, each bank is required to have a policy on large exposures (see Principle 9). This policy should outline the approval process for major credits, the circumstances in which limits may be exceeded and who is authorized to approve such excesses (e.g., a bank's board or credit committee). The FSA will verify whether a bank has followed prudent credit granting criteria, policies and procedures through desk-based analysis of prudential returns. One of the methods employed, particularly for the purpose of assessing the adequacy of management information systems, is peer group review. If the desk-based analysis indicates a need for further scrutiny, various supervisory tools may be applied, if necessary in an escalating fashion, for example visits by the supervisory team to the bank, followed by specialist credit evaluation visits, and ultimately so-called skilled persons (i.e., outside auditors) investigations. Also, ad hoc meetings with senior management may be held to assess their understanding and implementation of the criteria, policies and procedures. The supervisory team will give consideration to the size, maturity, currency, marketability and sources of repayment, the geographic dispersion of assets, whether credit decisions have been taken on an arm's-length basis and whether adequate checks are made of the total indebtedness of the entities to which the bank extends credit. No routine reviews of credit files are conducted. The FSA expects a bank to give the supervisory team full access to all information relevant to the credit and investment portfolios. However, in the event it does not prove possible to gain access to the requested information on a voluntary basis, the FSA will use its statutory powers. The FSA frequently requests receipt of banks' own management information to help it verify adherence to the credit policies set.
Assessment	Compliant
Comments	Although no specific rules have been set, the FSA requires a bank to have credit-granting

	procedures that identify, monitor and control credit risk. The bank's policies should reflect the range and type of its assets. Periodic evaluation of a bank's credit-granting criteria is undertaken by means of a mix of desk-based analysis, on-site visits, ad hoc meetings with management and skilled persons reports.
Principle 8.	**Loan Evaluation and Loan-Loss Provisioning** Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices, and procedures for evaluating the quality of assets and the adequacy of loan-loss provisions and reserves.
Description	Banks are required to maintain such systems and controls as are appropriate to their business (SYSC 3.1.1R). These should include monitoring asset quality and the adequacy and value of collateral on a net realizable basis (SYSC 3.2.11 and IPRU Chapter PN). In addition, banks must maintain adequate provisions for any depreciation in the value of their assets (IPRU Chapter GN 3.3.17R). Banks are required to set out their policy on making provisions in a written statement, which should include details of their loan classification arrangement and should be reviewed annually (IPRU Banks Chapters GN 3.4.5R and PN 3). The FSA does not prescribe a particular format for the policy statement as it does not consider one format to be appropriate for the diverse range of banks authorized in the U.K. However, the FSA expects the provisioning policy statement to cover issues such as who is responsible for drawing up and monitoring the policy, what areas of the bank's business are covered, what types of management information is generated, how is implementation of the policy checked, how are non-performing exposures identified, etcetera. A copy of the provisioning policy statement has to be supplied to the FSA. Provisioning policies should cover both on and off balance sheet positions. Provisioning and loan classification policies are not rule or formula based but must be appropriate to the bank's business. Provisioning decisions are taken by management or the board based on a true and fair view of the quality of the assets. However, banks normally follow the accounting guidelines that have been issued by the British Bankers Association and any deviations have to be explained. These guidelines require the making of provisions once assets are identified as impaired. Loans are impaired when there is reason to believe that not all amounts (both principal and interest) will be collected in accordance with the contractual terms of the loan. The external auditor has to approve the provisioning decisions made by management in the context of his review of the financial statements. However, banks' provisioning policy statements should include criteria for loans to be classified as non-performing. This would normally be when payments were a minimum number of days in arrears (usually 90 days), but a bank could make specific provisions earlier if this is considered appropriate. Provisioning decisions with regard to individual assets have to be based on an impairment that has actually been identified, in other words, no general provisions are to be included. In assessing the adequacy of a bank's provisions, the FSA looks at its provisioning policies, and the methods and systems for calculating provisions in accordance with those policies. The FSA seeks to ensure through risk mitigation programs and other work that procedures and resources for monitoring and dealing with problem loans are adequate. The FSA does not as a standard practice require periodic reporting of classified and non-performing loans. However, where the FSA has concerns over a bank's asset quality, it can seek regular reports on watch list loans. The level of provisioning is normally reported either on a quarterly or a semi-annual basis, but the frequency can be increased, and the required contents of reports expanded, if necessary. When there are doubts about a bank's credit controls or the adequacy of provisions, the FSA will have these assessed by its own credit specialists or by an external skilled person. A plan of action would be tailored to the outcome of such reviews. If the FSA continued to have doubts on a bank's provisioning practices, it may use its enforcement powers.
Assessment	Compliant
Comments	Banks are required to supply the FSA with policy statements outlining their approach to asset classification and provisioning arrangements. External auditors routinely review the adequacy of banks' provisions as part of the audit process. The FSA does not have a formal requirement that

	loans be classified when payments are contractually a minimum number of days in arrears (as called for in ***Additional Criteria 1,*** of the ***Core Principles Methodology*****)** as the classification and provisioning system is not rule but principle-based. In practice, loans tend to be classified after 90 days of arrears. This system works well and actual provisioning levels in U.K. banks appear to be adequate. The FSA should consider introducing a requirement for periodic reporting on credit quality based on each bank's own asset classification policy and internal credit ratings. This would strengthen off-site monitoring by allowing early identification of asset quality trends.
Principle 9.	**Large Exposure Limits** Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.
Description	Each bank must set out its policy on large exposures in a written statement (IPRU Chapter GN Section 3.4.1R). The policy should outline the circumstances in which limits (e.g., types of counterparty, individual counterparties and connected exposures) may be exceeded and who is authorized to approve such excesses (e.g., a bank's board or credit committee). The policy statement must be approved by the bank's board and must be agreed with and copied to the FSA. The bank must review the policy statement and if necessary update it at least once a year. Any significant departures from the stated policy, e.g., new types of lending or breaches of existing limits, should not be incorporated without prior discussion with the FSA. A bank must have adequate systems and controls to enable it to monitor and control its large exposures in conformity with its large exposures policy statement and to calculate its large exposures accurately and promptly (IPRU Chapter GN Section 3.3.19R). The supervisor will verify the existence of such systems and controls. This will be done by periodic supervisory visits to the bank, ad hoc meetings with senior management and the board, skilled person reports and any thematic work that the FSA may seek to carry out in this area. Maximum limits for exposures to individual and group borrowers are set by the EU Large Exposures Directive (now included in the Consolidated Banking Directive), which has been fully implemented in FSA guidance. The chapter on large exposures in IPRU provides a comprehensive definition of 'exposures', which includes both on and off balance sheet items, and guidance covering the 10 percent and 25 percent limits and the calculation of a bank's large exposure capital base. The limits, as well as the notification and reporting requirements, have to be met both on a solo and on a consolidated basis, as appropriate. A 'closely related group' is defined to exist either where two or more individual counterparties constitute a single risk because one of them has directly or indirectly, control over the other(s), or where individual counterparties are connected in such a way that the financial soundness of any of them may affect the financial soundness of the other(s) or the same factors may affect the financial soundness of both or all of them. Where there is doubt as to whether a number of individual persons constitute a group of closely related counterparties banks should discuss the circumstances with the FSA to determine how the exposure(s) should be reported (IPRU Chapter LE Section 5). A U.K. bank must notify the FSA if it proposes to enter into a transaction which would result in it having an exposure which exceeds 25 percent of its capital (IPRU Chapter GN Section 3.3.21R). In conformity with the EU Capital Adequacy Directive, excesses of the 25 percent limit may be allowed in certain limited cases, relating mostly to trading book positions. In such cases, an incremental capital requirement may be applied. In addition, the FSA may allow a breach of the 25 percent limit at the solo level as long as the limit is met at the consolidated level. All breaches of large exposure limits must be notified to the FSA immediately (IPRU Chapter LE Section 3). The FSA receives details of the twenty largest bank and non-bank exposures and any exposures of 10 percent or more of a bank's regulatory capital base via a large exposures report submitted quarterly by U.K.-incorporated banks (SUP 16.7.8R). Branches of non-EEA incorporated banks submit half-yearly reports of their twenty largest bank and non-bank exposures (SUP 16.7.12R). These reports should be completed on an unconsolidated or solo-consolidated basis and on a consolidated basis. Concentrations of risk should be covered in a bank's large exposure policy

	statement and significant concentrations of risk, both sectoral and geographic, would be considered during the FSA's regular risk assessments. The FSA also frequently requests receipt of banks' own management information to help verify adherence to the large exposure policy statement and limits.
Assessment	Compliant
Comments	Clear and precise regulations exist with respect to large exposures, reflecting the relevant EU Directive. The FSA's requirement for banks to submit a written policy statement on large exposures is an appropriate means of stimulating prudent behavior in banks with respect to risk concentrations. Large exposure policies are monitored and enforced by the FSA using its normal supervisory tools.
Principle 10.	**Connected Lending** In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.
Description	Banks' policies on connected lending should be included in their large exposures policy statements (IPRU Banks Chapter LE Section 8.1). Connected exposures are defined to include intra-group lending, lending to directors, senior managers, controllers (i.e., major shareholders) and their associates (including close family members), and lending to non-group companies with which the bank's directors or controllers are associated (ibid. Section 5.3). The FSA retains discretion to determine whether a particular counterparty should be deemed to be connected to a bank where doubt exists. The FSA normally expects connected exposures to remain an insignificant proportion of a bank's assets. Clear and objective credit assessment processes have to be used when banks consider proposals for connected lending. Exposures to connected parties may be entered into only for the clear commercial advantage of the bank and should be negotiated and agreed on an arm's length basis. Factors a bank has to take into account when determining whether a loan is being made on an arm's length basis include the extent to which shareholders can influence the bank's operations (e.g., through voting rights), the management role of shareholders (e.g., whether they are also directors of the bank) and whether the loan would be subject to the bank's usual monitoring and recovery procedures if repayment difficulties emerged (ibid. Section 5.3.7). Aggregated connected lending should be a maximum of 25 percent of a bank's capital base. The FSA is prepared to consider requests from banks for higher limit levels than this in certain, very limited, circumstances. An example of this might be where the bank performs a group treasury function and it is reasonable to allow a limit higher than 25 percent of capital for exposures of under one year maturity. The requirements for connected lending concessions are set out in IPRU Banks (Chapter LE 9.2.2-9.2.5). With the exception of such agreed concessions within limited parameters, aggregate regulatory limits on banks' connected exposures are as strict as those for single borrowers and groups of related borrowers. The FSA may deduct exposures to companies or persons connected to a bank from the bank's capital base if they are of the nature of a capital investment or are made on concessionary terms (IPRU Chapter LE 5.3). Aggregated connected lending is reported to the FSA on a quarterly basis via a large exposures report. One of the checks supervisors make when examining these data is to ensure that they remain within the agreed limits. Since the FSA requires banks to report connected exposures, it requires banks to have systems in place to identify all connected exposures. The mission team was informed that the FSA also requires banks to provide a detailed breakdown of their exposures to connected counterparties. As with credit policies generally, verification of compliance with the requirements relating to connected lending may be undertaken during the course of supervisory or specialist credit visits or by commissioning skilled persons reports.
Assessment	Compliant
Comments	The FSA's supervisory approach towards connected lending by banks offers sufficient safeguards that such lending will be undertaken only on an arm's length basis. The requirements for approval of proposed exposures to companies or persons connected with the bank by the bank's board of

	directors and for banks to have procedures in place to prevent persons benefiting from the loan taking part in the loan assessment process or in the loan decision(***Essential Criteria 3 and 4*** of the ***BCP Methodology)*** are covered by the general requirement for banks to take special care to ensure that a proper, objective credit assessment is undertaken for connected lending and by the more specific guidance on credit risk management and corporate governance given in the FSA's Handbook. Also, the FSA requires the risk management function of a bank to be independent and therefore parties benefiting from a lending decision should not be part of the risk assessment process.
Principle 11.	**Country Risk** Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring, and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.
Description	A bank's approach to sovereign lending and to country exposure limits should be included in its large exposure policy statement (IPRU Banks Chapter LE Section 8.1). Although there is no specific requirement in this regard, the FSA expects the policy statement to include details of limits on a country-by-country basis. Exposures to overseas countries which exceed 25 percent of a bank's capital base are not covered by the pre-notification requirements for large exposures. However, where a proposed transaction will result in an exposure which represents a significant departure from a bank's large exposure policy statement, the FSA does expect the proposed transaction to be notified in advance and discussed with it. If the FSA is dissatisfied with a bank's country risk policy, it may instruct the bank to reduce its exposures or to increase its capital. The FSA's guidance for banks' provisioning policy statements does not contain references to provisioning for country exposures. Provisioning for country risks is covered by the general requirement for banks to maintain adequate provisions. While the FSA does not set specific provisioning requirements it does expect banks to make appropriate levels of provisions after discussions with their external auditors. If the FSA thought that a bank had inadequate provisions it would seek to hold discussions with the bank and its external auditors in order to ensure that provisioning levels are reasonable. A bank's adherence to its country risk and provisioning policies will be checked by the FSA by desk-based reviews, during on-site inspection visits or, where appropriate, by means of a skilled persons report. The FSA will obtain information on country, sectoral and regional exposures from banks' internal monitoring systems and will discuss them with banks' management in the context of their large exposures policies (IPRU Banks Chapter LE Section 9.2.7.21). By doing so, the FSA is able to assess whether banks have information systems, risk management systems and internal controls that enable them to comply with their country risk policy as set out in their large exposure policy statements. The FSA also has access to country exposure statistical data collected from banks by the Bank of England, including individual banks' returns. These returns identify cross border claims by country and sector. Bank of England data relating to country risk and transfer risk are collected quarterly and must be submitted to the Bank of England within two months of the reporting date.
Assessment	Compliant
Comments	While the FSA does not provide specific guidance with regard to country risk exposures and provisioning, it does require and verify that banks devote adequate attention to these issues. The FSA has abandoned the previous policy of setting individual country risk exposure limits because it was not possible to define such exposures generically. Also, the FSA prefers to focus on control risks instead of regulating banks' business risk policies. The approach now taken by the FSA on country risk is in line with international risk management practices.
Principle 12.	**Market Risks** Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor, and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposure, if warranted.

Description	Banks are required (IPRU Chapter GN rule 3.4.7) to have a written Trading book policy statement that covers the way in which a bank identifies, values and measures market risks in the trading book, including interest rate risk. Each bank is expected to be able to identify, measure, monitor and control its exposures to foreign exchange and other market risks across all products (IPRU Banks Chapter AR Section 3.2). Each bank is also expected to be able to collect information that can be summarized in such a way as to enable actual exposures to be readily, accurately and regularly measured against the exposure limits authorized by management. Where relevant, these limits should relate to the level of trading positions (both intra-day and overnight) in securities, foreign exchange, futures, options, forward rate agreements and swaps. Periodic reviews are conducted to verify the adequacy of a bank's internal control systems. The FSA has imposed specific capital charges for market risks (IPRU Chapter CO Section 3). In accordance with the 1996 amendment to the Basel Capital Accord and the EU Capital Adequacy Directive, U.K. incorporated banks are set capital charges for foreign exchange and commodities position risk in the banking and trading books combined. Separate capital requirements are set for equity and interest rate position risk, as well as counterparty, underwriting and settlement risk, in the trading book. To ensure that the calculation of capital charges for market risks is valid firms need good management systems to collate accurate data. The supervisor will determine compliance with these requirements through desk based analysis of returns, information gained from on-site visits or on-going discussions with senior management. Also, in addition to standard regulatory reporting, banks are often requested to provide ad hoc reporting of their own management information (including analyses conducted). Because of its tailor-made nature this information usually offers greater insight into the market risk being run by the bank. On-site visits to banks by supervisory staff and/or a specialist team are used to ascertain the extent of senior management's understanding of the market risk as reflected in the risk management information. For banks with significant market risk exposure, the FSA will meet a range of staff, including senior management, staff from the front office, financial control, risk management, operations, systems development, information technology and audit areas, to assess the quality of market risk management and controls. The adequacy of a bank's system of controls is tested by periodic reviews conducted either by FSA in-house specialists or skilled persons. The FSA has established a Traded Risk Review Team within the Risk Review Department. This team focuses on banks' trading and markets activities and its management. It has specialists with the necessary expertise to undertake, among other activities, on-site visits to review treasury systems and controls. On-site visits by the Traded Risk Team typically last between one and three days. The purposes of on-site visits include the evaluation of whether a bank's internal market risk measurement and pricing models can be recognized for the purposes of calculating market risk capital requirements. Once a model is recognized, the team will conduct quarterly update visits during which the control environment in which the model is operated is discussed along with model outcomes, backtesting and other relevant data. The provision of this data is shortly to be automated to enhance the FSA's ability to track trends and make comparisons. A bank that uses an internal model to calculate supervisory capital should have in place a rigorous and comprehensive program of stress testing. As set out in IPRU (Chapter TV Section 9), the FSA attaches great importance to the stress testing of the various risks facing a bank in its overall activity. As part of the model recognition process, the FSA will examine a bank's stress testing program, including the procedures in place to assess and respond to its results. The FSA will not normally prescribe scenarios for a bank to use in stress testing, although it may do so in the event of particular market circumstances.
Assessment	Compliant
Comments	The FSA uses specific capital requirements for separate categories of market risks. Compliance with these requirements is determined through desk-based analysis and on-site visits. The adequacy

	of the bank's system of controls surrounding market operations is tested by periodic reviews conducted either by FSA in-house specialists or skilled persons. In view of the number of banks, the Traded Risk Review Team appears to be thinly staffed. This applies even though only the relatively limited number of 10 to 12 banks (most of them foreign-owned) engage in the trading of highly complex financial products, while a similar number of banks is allowed to use value-at-risk models for calculating supervisory capital adequacy requirements.
Principle 13.	**Other Risks** Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor, and control all other material risks and, where appropriate, to hold capital against these risks.
Description	Banks are required to maintain systems and controls that are appropriate to their business (IPRU SYSC 3.1.1R). According to the Threshold Condition on Suitability, regulated firms (including banks) are expected to have identified fully, and considered, the various risks they will encounter in conducting their business and installed appropriate control systems to manage them prudently at all times. It is considered to be the responsibility of a bank's directors and management to take reasonable care to establish and maintain such systems and controls as are appropriate to the nature, scale and complexity of its business. The FSA has provided banks with guidance on adequate controls and records (IPRU Banks Chapter AR Section 3). Among other things, the guidance states that banks should design and operate a system of internal controls that provides reasonable assurance that all the bank's revenues accrue to its benefit, all expenditure is properly authorized and disbursed, all assets are adequately safeguarded, all liabilities are recorded, and statutory and supervisory requirements are met. Management information should be prepared to show the bank's state of affairs and its exposure to each type of risk, compared to the relevant limits set by management. The FSA expects banks' high level controls to include the setting of strategy and plans and the establishment and review of the organizational structure and the system for delegation (including segregation of duties). In addition, management should approve the bank's risk policies, review its high level management information and maintain the framework for monitoring and detailed periodic review of risk management and control systems. The implementation of action points following such a review should be monitored by management. Internal control systems should provide reasonable assurance that management is able to monitor on a timely basis the adequacy of a bank's capital, liquidity, profitability and the quality of its assets. They should enable management to monitor and control the bank's risk and to make appropriate provisions for bad and doubtful debts. The FSA expects banks to have an internal audit function (but in some cases it may be outsourced) and an audit committee. Banks are required to provide the FSA with a statement of liquidity policy (IPRU Chapter LM Section 3) that should set out their approach to liquidity management, including a description of arrangements for management on a day-to-day basis, and should explain how much liquidity risk will be assumed. The liquidity standards that banks should maintain must be appropriate to the nature and scale of their business. A bank should have in place systems which enable it to monitor its liquidity profile on a frequent and timely basis. A bank with significant currency business should include in its policy statement the policy for monitoring and controlling its liquidity positions in individual currencies. The policy statement should also consider the management of liquidity in both normal and abnormal circumstances. The FSA monitors banks' liquidity using either a mismatch approach or a stock approach. For the majority of banks, the FSA has set mismatch guidelines that take into consideration the volatility, diversity and source of deposits, any concentrations of deposits, the degree of reliance on marketable assets and the degree of diversification, the availability and reliability of undrawn standby lines, and the impact of other factors such as off balance sheet obligations (IPRU Chapter LM Section 8.1). For the minority of banks that have a large retail deposit base in the form of

	current accounts, the FSA has set a sterling stock liquidity regime that requires a bank to hold a stock of liquid sterling assets that can easily be sold to replace funding that has been withdrawn. A more limited range of assets is treated as liquid under the stock approach than under the mismatch approach to reflect the fact that significant sales of certain assets by a large bank might unsettle the market. For U.K. branches of foreign banks, the mismatch approach is normally applied, with the additional requirement that the available liquidity actually has to be present in the U.K. However, if the FSA is satisfied that a branch is fully integrated with its head office for liquidity management purpose and that it can rely on the home country supervisory regime, it may permit the branch to have its liquidity managed on a global basis by its head office. Banks on the stock liquidity regime have to report their liquidity position to the FSA on a monthly basis, while banks on the mismatch regime have to report on a quarterly basis. In case a bank is experiencing liquidity problems, it may be required to report more frequently, if necessary on a daily basis. The stock liquidity report has to be prepared on a consolidated basis. While the FSA does not normally collect liquidity data in individual currencies it may require a bank to report on this basis if it has significant operations in illiquid currency markets. Supplementary to regulatory reporting, the FSA monitors liquidity risk through on-site visits, during which discussions may be held with a bank's ALM committee. Such visits also provide the opportunity to determine management's ability to understand and address technical issues such as those relating to multiple currency liquidity management. No specific guidance is given with respect to banks' interest rate risk outside the trading book. The mission was informed that the FSA does not see a need for such guidance since many banks have a large proportion of floating rate assets in their banking book, reducing the potential for interest rate risk. However, the FSA has made it known to banks that it will use the Basel Committee's Principles for the Management of Interest Rate Risk to asses the adequacy of a bank's interest rate risk management. The FSA conducts stress tests on interest rate positions in the banking book, particularly for the larger banks. In addition, interest rate risk in the banking book is among the issues that are explicitly considered by the FSA when setting a bank's individual capital ratio requirement (as are operational risks). In practice, individual supervisors' analysis of interest rate risk in the banking book, which is typically based on discussions with the bank and management information, rarely results in a material increase in a bank's individual capital ratio. With regard to operational risk, each bank is expected to have a control environment that minimizes loss from fraud, safeguards the assets, controls the liabilities and provides reasonable reassurance that the business is conducted in adherence to established policies (IPRU Chapter AR Section 3.3). Some specific guidance is given on controls in an IT environment (ibid. Section 3.3.6), while relatively detailed guidance is given on outsourcing (IPRU Chapter OS). Furthermore, each bank is expected to have appropriate arrangements to ensure business continuity in the event of an unforeseen interruption (SYSC 3.2.19). Through on-site visits, the FSA may check the effectiveness of allocated responsibilities, lines of reporting, the delegation of authority and other operational risk controls. As noted above, operational risk is one of the factors considered by the FSA when setting banks' individual capital ratio requirement. The FSA does not currently require a specific operational risk policy statement (in contrast to large exposures, liquidity, provisioning and, where applicable, the trading book). The FSA encourages best practice in corporate governance. This includes banks making comprehensive disclosure in their annual published accounts. The FSA has also successfully exercised pressure on individual banks to inform their customers of significant issues by means of a letter.
Assessment	Compliant
Comments	Each bank is required to maintain systems and controls that are appropriate to the risks in conducting its business. The FSA has issued guidance relating to liquidity risk, interest rate risk and key aspects of operational risk, and it applies specific capital requirements to foreign exchange risk. The FSA verifies the extent to which a bank's risk management system addresses the key banking

	risks during on-site visits. The FSA’s approach to monitoring liquidity under the mismatch or stock regimes appears somewhat dated in that it is not aligned to banks’ own approaches to measuring and managing liquidity, at least for the more sophisticated banks. The FSA has recently begun considering the development of a new approach which would give banks a choice between a standardized measurement technique and the use of liquidity modeling techniques for liabilities with a behavioral maturity and contingent claims. Such an approach would be designed to create incentives for banks to further develop their own liquidity measuring and management techniques. Although the actual implementation of this new approach still appears to be some years off, the mission believes it could constitute a significant step forward.
Principle 14.	**Internal Control and Audit** Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls, as well as applicable laws and regulations.
Description	The Companies Act 1985 prescribes the duties of directors who manage a company and are responsible for protecting the interests of members (shareholders) and employees. The Act applies to all companies, including banks. Any bank listed on the London Stock Exchange is subject to a Listing Rule and Combined Code which reflect the recommendations of the Committee on Corporate Governance (‘the Hampel Committee’). There is a requirement to produce a statement of directors’ responsibilities. The Combined Code is not prescriptive about the contents of the statement but there is an expectation that it will cover the responsibility of the directors for keeping proper accounting records, for safeguarding the assets of the company and for taking reasonable steps for the prevention and detection of fraud and other irregularities. In addition, the Combined Code (provision D.2.1) states that 'the directors should, at least annually, conduct a review of the effectiveness of the group’s system of internal control and should report to the shareholders that they have done so. The review should cover all controls including financial, operational and compliance controls and risk management.' Specific internal control requirements for banks, together with adequate record keeping requirements, are outlined in SYSC and IPRU Banks (Chapter AR). SYSC requires a bank to allocate appropriately to one or more individuals the functions of dealing with the apportionment of significant responsibilities and of overseeing the establishment and maintenance of systems and controls. Banks must take reasonable care to establish and maintain such systems of controls as are appropriate to the nature and scale of their business (SYSC, 3.1.1R). Banks are also required to have documented high level controls defining responsibilities of management and identifying lines of reporting and outlining the implementation of the requirements with respect to segregation of duties, accounting records and measures to safeguard assets (SYSC 3.2 and IPRU Chapter AR Section 3.3.5). The FSA also requires that banks have procedures to ensure that personnel have capabilities commensurate with their responsibilities and that they have implemented effective segregation of duties (IPRU Chapter AR Section 3.3.5). Furthermore, it is a requirement of IPRU (Chapter AR Sections 3.3.9 and 3.3.10) that banks have an internal audit function. However, the primary responsibility for preventing internal fraud lies with senior management. The internal audit function should have clear responsibilities and its objectivity and independence should be supported by appropriate reporting lines. In most cases this would be dual reporting lines from the head of internal audit to the chief executive officer, or equivalent, and access to the audit committee (IPRU Chapter AR Sections 3.3.9 and SYSC 3.2.16G). The internal audit function should have unrestricted access to all of a bank's activities, records, property and personnel. A bank may outsource its internal audit function but normally not to its external auditors or skilled persons, unless certain conditions aimed at safeguarding the

	independence of internal audit are met. Any proposals to outsource the internal audit function should be notified to the FSA (IPRU Chapter OS Section 4.7). External auditors test a bank's accounting procedures during their audit of the financial statements. They report significant deficiencies they have found in a letter to the bank's management. External auditors are allowed to notify the FSA of any information they have found and which appears to be relevant to the FSA's supervisory objectives (FSMA section 342). However, if the auditors consider any deficiency they have found to be material, they normally expect the bank's management to forward the management letter to the FSA. Failure to do so would be interpreted as a lack of integrity on the part of the bank's management. This would be reported to the FSA by the external auditors themselves. To carry out the role of directors and senior management, individuals have to be vetted and approved by the FSA. To gain approval they have to be considered fit and proper (FSMA Schedule 6, paragraph 5) which consists of being honest, competent to carry out their function and financially sound. The applicant has the burden of satisfying the FSA that he is a fit and proper person having regard to all circumstances. The FSA takes into account the distribution of expertise within the board when considering individual applicants. Once approved these individuals must maintain their fitness and propriety. If any of the senior management is deemed to be no longer fit and proper, the FSA has the power to initiate proceedings for the individual to be removed. The FSA follows both the Cadbury and Hampel guidance on Audit Committees and the inclusion of non-executive directors (IPRU Chapter AR Section 3.3.10). In accordance with the FSA's internal *Guidance for firm specific risk assessment and risk mitigation* (Appendix 3, Corporate Governance, version 5, November 2001), there should be an appropriate proportion of non-executive directors to executive board members. The FSA checks through meetings during on-site visits and reviews of relevant documentation (e.g., board minutes and audit committee minutes) that a bank's non-executive directors (a) have the necessary skills and background, (b) participate fully in committee meetings and (c) exercise independent judgment. Non-executive directors have to be vetted and approved by the FSA. The FSA has wide powers to require banks to provide information (FSMA Section 165) and the power to require the provision of a report on the firm by a skilled person (FSMA Section 166). If deemed necessary, the FSA can request copies of internal audit reports and minutes of audit committee meetings. The quality of the internal audit function may be assessed during on-site visits. The FSA also meets, at least annually, with the chairman of a bank's audit committee. The effectiveness of front, middle and back office functions may be reviewed either through regular on-site supervisory visits, specialist visits or via the use of skilled persons.
Assessment	Compliant
Comments	The duties of directors are prescribed by company law and banks are expected to adhere to the accepted standards of corporate governance. The FSA requires banks to take reasonable care to put in place controls that are appropriate to the nature and scale of their business. This includes high level management controls (covering management responsibilities, reporting lines, segregation of duties and measures to safeguard assets). The FSA expects banks to have an appropriately resourced internal audit function which reports to an audit committee chaired by an independent director.
Principle 15.	**Money Laundering** Banking supervisors must determine that banks have adequate policies, practices, and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.
Description	***Essential criteria*** As a statutory objective FSMA requires the FSA to reduce the potential for regulated businesses,

	including banks, to be used for a purpose connected with financial crime. Under FSMA financial crime is defined as money laundering, fraud or dishonesty, and criminal market misconduct. FSMA provides the FSA with a range of powers to make rules on firm's systems and controls relating to money laundering, to supervise firms' compliance with those requirements and to prosecute firms for systems and controls failures in this area. FSA's Money Laundering Rules and regulatory requirements are set out in the Money Laundering Sourcebook in the Handbook. The requirements for effective systems and controls to protect against money laundering are elaborated in ML 7.2. ML 3 details customer identification requirements. ML 4 specifies the requirements with respect of suspicious transactions reporting. ML 7.3 specifies record keeping requirements on customer identification and individual transactions and the record keeping period. Awareness and training are required under ML 6 and the appointment of a senior officer as Money Laundering Reporting Officer (MLRO), including the requirement that the MLRO be an approved person by FSA, is provided for in ML 7. Both the FSA's Rules and the Money Laundering Regulations 1993 ("the "Regulations") require banks to verify the identity of customers as soon as is reasonably practicable after contact is first made, in order to carry out any regulated financial activities for them. The obligation to verify identity extends to business undertaken on behalf of another person. To assist a bank in meeting these statutory and regulatory obligations, industry guidance has been prepared in the form of the Joint Money Laundering Steering Group's (JMLSG) Guidance Notes. The guidance notes provide extensive information on how and when to identify customers. The guidance notes are not mandatory but the FSA will take them into consideration in evaluating whether a bank has proper customer identification procedures. Neither the FSA's Rules nor the Regulations explicitly require banks to have formal procedures in place to recognize suspicious transactions. However, the practices recommended in the JMLSG Guidance Notes cover many of the elements that might be incorporated in formal procedures. The Guidance Notes set out that appropriate 'know your customer' procedures, combined with adequate staff training, are the key to recognizing transactions or patterns of activity that are inconsistent with a customer's known legitimate business, or with the normal business for that type of account. Accordingly, many banks routinely monitor cash deposits/withdrawals, and wire transfers over a certain monetary threshold (typically a few thousand pounds) and some major banks have developed or purchased sophisticated anti-fraud and money laundering monitoring systems. FSA Rules and Regulations require all bank staff to report (to the MLRO) any information that gives rise to knowledge or suspicion of money laundering. Further, the bank is required to take reasonable steps to insure that staff who handle or have responsibility for transactions that may involve money laundering report promptly. Reporting the suspicion or knowledge to the MLRO discharges the individual's statutory and regulatory responsibilities. The MLRO, as an Approved Person, has the designated responsibility to receive internal reports of suspicious activities, to report suspicious activities to NCIS, to insure adequate awareness and training, to monitor day-to-day compliance with anti-money laundering policies and to prepare an annual report to management. The purpose of the annual report is to highlight any compliance problems, which it is the responsibility of the bank's senior management to remedy. FSA supervisors can request a copy of the report to assist in assessing the bank's level of compliance with its statutory and regulatory obligations. A bank is not specifically required to report to FSA suspicions of money laundering; the obligation is to report to NCIS. But banks do have a regulatory obligation to notify the FSA of significant incidences of fraud. In determining whether a fraud incident is significant, the firm must consider (i) size of loss in relation either to the bank itself or to customers; (ii) risk of reputational loss; and (iii) whether the incident reflects weaknesses in the bank's internal controls. The FSA operates a risk-based approach to verifying that banks have the necessary controls to

	comply with anti-money laundering rules and regulations. The approach is designed to allocate resources in the most efficient manner to ensure that supervisory attention is directed at those areas that pose the greatest threat to the FSA's regulatory objectives, with deterrence of financial crime being one of those objectives. To assess the vulnerability of a bank to money laundering, FSA identifies key risk criteria drawn from money laundering typologies. These criteria are scored against the business profile of individual banks. Taking into account the robustness of a bank's control regime, FSA makes an evaluation of the extent to which the business of the bank exposes it to money laundering risk and the probability that risk will materialize. A further judgment is made about the impact if such risks do materialize and the threat this would pose to FSA's ability to meet its statutory objectives. For banks, size is a major factor in scaling the risks to FSA's objectives. Based on this analysis FSA arrives at a judgment about the supervisory tools and resources to be devoted to the supervision of money laundering and the intensity and focus of oversight on individual firms. In a July 2001 report, "The Money Laundering Theme," FSA announced that it had identified six "clusters" of activities which were particularly vulnerable to money laundering and on which regulatory attention would focus. Two of these clusters concerned banks. Theme supervision provides FSA with a tool for horizontal review of practices across banks without regard to the risk profile of the bank in other business areas. Thematic work includes on-site testing of anti-money laundering procedures. Theme reviews, however, are also targeted based on risk assessments. To assist line supervisors assess the level of a bank's compliance with the FSA's Rules and Regulations the FSA has: • a Money Laundering Review Team (supervisors with expertise in the area of money laundering); • the power to appoint "skilled persons" to investigate money laundering compliance issues; • an Intelligence and Records Department, which liaises with national and international law enforcement agencies; and • the Financial Crime Policy Unit, which provides guidance on the Rules Line supervision includes periodic meetings with senior management responsible for fraud prevention to discuss current issues that may be of concern. MLRO reports may be copied to the FSA and followed-up as necessary. They will also be used in horizontal reviews. FSA has a broad range of tools to compel banks to comply with its rules. These include powers to impose financial penalties, public censure, and to vary and even cancel permissions. FSA is also a criminal prosecuting authority under the Regulations. FSA cannot disclose confidential information (as defined under relevant legislation) unless a gateway exists. The FSA may disclose information to its international equivalents, i.e., bodies with equivalent functions, to assist them in carrying out those functions. In the case of information covered by the EU single market directives, disclosure can only be made under a co-operation agreement and where equivalent confidentiality restrictions apply under the laws applying to the other regulator. Banks are required to comply with the FSA's Principles for Businesses, which are a general statement of fundamental obligations under the regulatory system. Breaching a Principle makes a bank liable to disciplinary sanctions. Principle 1 states that 'a firm must conduct its business with integrity and Principle 2 states that it "must conduct its business with due skill, care and diligence." There is no specific FSA requirement that these Principles be communicated to all members of a bank's staff. ***Additional Criteria*** U.K. laws and regulations embody international sound practices and are largely compliant with the

	FATF recommendations. FSA Rules require relevant staff to receive training at least every 24 months. Validation follows supervisory practices outlined above. FSA Regulations require an FSA supervisor to report knowledge or suspicion of money laundering in the same way as a member of staff employed by a bank. Criminal law gateways allow for the sharing of information for the purpose of criminal proceedings and criminal investigation in the U.K. or elsewhere. The FSA has in-house specialist expertise in financial crime matters, as outlined above.
Assessment	Largely compliant
Comments	FSA has strong powers and a comprehensive program for supervising the U.K. anti-money laundering practices and procedures of banks. The regime has been reinforced and energized within the last two years, notably by the implementation of FSMA with the additional responsibility and powers it provides to FSA in the area of financial crime. The regime will be further reinforced with passage of the Proceeds of Crime Act which is expected to be approved by Parliament in 2002. Increased FSA authority has been paralleled by intensified supervisory effort in the area of money laundering. The intensification of FSA supervision was confirmed in numerous contacts across the banking industry. ***Essential Criteria 3*** requires that " banks have formal procedures to recognize potentially suspicious transactions." Although FSA does not make such procedures a formal requirement of its AML/CFT rules and regulations, other elements of the supervisory regime effectively require banks to have structured procedures and practices that address the requirement to recognize potentially suspicious transactions. The JMLSG Guidance Notes cover many of the elements that might be incorporated in formal procedures, including "know your customer" guidance. For example, JMLSG Note 5.9 outlines tests to apply for determining whether suspicion of money laundering arises. These include: is the size of the transaction consistent with the normal activity of the customer? is the transaction rational in the context of the customer's business or personal activities? etc. Guidance Notes 5.62-5.64 identify issues to be considered with respect to wire transfers. AML training requirements established in the Handbook require bank staff to be familiar with the Guidance Notes. Although the Guidance Notes are advisory, not mandatory, FSA takes them into account in determining compliance with its rules and regulations. In addition, the FSA Handbook requires all staff to report (to the MLRO) any information that gives rise to knowledge or suspicion of money laundering. Under the Regulations and under the Handbook FSA has authority to impose sanctions if firms fail to report suspicious transactions. While the substance of Essential Criteria 3 is satisfied, the FSAP team believes bank's internal governance would be strengthened by a requirement for a formal policy on recognition of potentially suspicious transactions. ***Essential Criteria 11*** calls for the supervisor to determine that banks have a policy statement on ethics and professional behavior that is clearly communicated to all staff. Although FSA does not explicitly require banks to have such a policy statement, the substance of Criteria 11 is achieved in other ways. Requirements for ethical and professional behavior animate FSA's approach to financial supervision. For example, such behavior is required under FSA's Principles for Business. Principle 1, *Integrity*, states that a firm must conduct its business with integrity. Principle 6, *Customer's interest,* states that a firm must pay due regard to the interests of its customers and treat them fairly. The FSA's Statements of Principle for Approved Persons require bank's Approved Persons to act with integrity and due skill, care and diligence in carrying out controlled functions. Furthermore, under Regulation 5(1)(a) of the 1993 Money Laundering Regulations FSA may find a firm to be in breach of the Regulations if a business relationship is formed, or a one-off transaction takes place, without the required ethical and professional procedures being applied to that particular relationship.

	The FSA risk based approach to supervision allows for considerable selectivity in the firms and risks that attract close supervision, with high risk/high impact firms being the primary focus of attention. The FSAP team considered the possibility that the selectivity of this approach posed a hazard that anti-money laundering compliance in smaller, low impact firms might not be sufficiently disciplined by the supervisory process. The FSAP team satisfied itself that, at least with respect to banks, this is not the case. In the last year one-third of the small number of banks classified as low impact have been subject to theme visits for compliance with anti-money laundering requirements and all are expected to be visited over a three-year cycle. Also, in practice, money laundering theme reviews of banks cover the full scope of money laundering risks and are not limited to the two risk clusters identified in "The Money Laundering Theme" report.
Principle 16.	**On-Site and Off-Site Supervision** An effective banking supervisory system should consist of some form of both on-site and off-site supervision.
Description	The FSA utilizes a combination of on-site examinations and desk-based analysis to acquire a thorough understanding of banks' safety and soundness. The regular supervisory staff is supported by risk review teams with specialized expertise in areas such as corporate governance, risk management, internal audit, IT, anti-money laundering controls and quantitative modeling techniques. To assist in the supervision of financial firms the FSA has the power to appoint so-called skilled persons (section 166 of the FSMA). In the case of banks, these are usually auditors from the big five accountancy firms. The number of skilled persons reports commissioned has been greatly reduced as they are no longer used to perform routine validation of supervisory returns. The skilled persons' reports are discussed generically with the accountancy firms to ensure consistency of standards and the FSA forms its own judgment on the materiality of the issues raised in the reports. Through these mechanisms the FSA is able to examine any aspect of a bank's operations, including compliance with legal requirements and prudential regulations. In addition, the FSA carries out sector-wide statistical analysis of prudential returns, financial statements, share price movements, credit ratings and other quantitative information to monitor industry trends and to identify outliers. The FSA has developed a risk-focused assessment model, covering all regulated entities in the financial industry. The model is designed to identify the key risks that institutions pose to the FSA's statutory objectives, which in turn determine the degree of attention that the FSA devotes to individual institutions. This risk assessment is based on a view of the impact and the probability of a problem occurring at a particular institution. For prudential issues in banks, the impact is seen as being determined mostly by the size of the bank, while the judgment on probability depends on the FSA's view of the business and control risks at a particular bank. Banks are rated either as high impact, medium high impact, medium low impact, or low impact. The risk based approach, in combination with the FSMA's philosophy that it is neither possible nor desirable to remove all risk of failure from the financial system, has led the FSA to concentrate its supervisory activities with regard to banks on the larger institutions. In addition to the industry-wide risk assessment model, the FSA uses a firm-specific model to assess risks in individual institutions. This assessment is based on a detailed breakdown of business and control risks in individual banks. For a large bank, up to about 35 different business lines may be distinguished. Inputs into the firm-specific risk assessment model may include information from on-site work, interviews with management, prudential returns, firms' annual AML report, external auditors' management letters, special information requests and publicly available information. Findings of a bank's internal auditors may be taken into account if the FSA is satisfied that the audit work has been independently and competently performed. The FSA encourages internal auditors to devote attention to issues of interest to the supervisor in their work. On-site and off-site work are thus integrated through the firm-specific risk assessment model. The firm-specific risk assessment process will take three to six months to complete and, for large banks, is carried out on a one and a half to two year cycle. The process results in a risk mitigation program that details the supervisory work with regard to the institution over the period until the next risk assessment cycle

	as well as actions to be undertaken by the institution itself. The supervisory work planned in this manner leaves room to undertake event-driven work as the need arises. On-site supervision is most active in high impact firms, including regular visits by the dedicated supervisory team, focused reviews by experts drawn from the FSA's risk review department, as well as frequent contacts with high and middle level managers. Low impact banks, on the other hand, are largely supervised through off-site baseline monitoring supplemented occasionally by on-site visits in the context of the FSA's thematic work, to deal with issues that have arisen from the off-site monitoring, or on the occasion of events such as the bank entering into new activities or the appointment of a new director. On-site visits at low impact banks will be held at least once every three years, but on average they are held more often in practice. Under the new regime, low impact banks no longer have a dedicated relationship manager within the supervisory authority. As of June 2002, 44 banks had been graded by the FSA as low impact (excluding 7 EEA branches and 9 banks which are part of a wider group). Sixteen of these were branches of overseas banks and the other 28 included small retail banks as well as some banks specializing in wholesale operations. Six low impact banks were subject to intensive supervision because risks had crystallized. Total deposit liabilities of the low impact banks amounted to 0.03 percent of total deposit liabilities of all U.K. banks. On-site visits are designed to provide a focused review of well specified topics. They typically require around three days extending up to one week in some cases. The scope of visits and the intended outcomes are detailed in the risk mitigation program generated by the firm-specific risk assessment. On-site visits by a bank's dedicated supervisory team consist of extensive discussions with various managers supplemented by some file reviews. Topics addressed may cut across the full range of supervisory interests, including all significant business and control risks as well as compliance issues. The dedicated teams are guided by methodological aide-mémoires outlining specific points for attention in particular risk areas. For international firms, the FSA has a regular program of on-site visits to the overseas parents of the branches and subsidiaries of foreign firms operating in the U.K. and to the affiliates of U.K. banks operating overseas. The FSA has recently begun development of so-called thematic regulation, which is aimed at analyzing industry or sector wide issues by focusing on a sample of institutions. This has been assisted by the establishment of Risk Management Units throughout the FSA, including one devoted to banking issues, which have responsibility for monitoring industry-wide risk. The sample of institutions usually includes some low impact firms. Themes that have been covered so far in the banking sector include credit risk, systems and controls, anti-money laundering measures as well as other topics. The thematic work helps inform the FSA's views on particular risk areas and may lead to follow-up work at individual institutions. The outcome of the thematic work may be rule changes, guidance letters to bank directors, seminars or speeches to draw banks' attention to particular issues. The thematic work may also lead to enforcement action against a firm that was included in the sample. Such action would be publicized to set an example for other banks. If significant issues have been uncovered, the FSA may decide to extend the thematic work to banks outside the initial sample. The effectiveness of on-site and off-site functions is reviewed by a panel of senior and independent supervisors as part of the FSA's formal risk assessment process. The panel focuses on the risk mitigation programs for individual banks, particularly the ones assessed as high impact or medium high impact, assessing the priorities set for supervisory work and giving advice on the proposed deployment of supervisory tools. In case of disagreement with a bank's relationship manager, a decision is taken at a higher level within the FSA. This work is supplemented by an internal Quality Assurance Department, which is in the Chairman's Office, that focuses on supervisory processes generically. The FSMA (Part XXIII) sets out restrictions that apply to the disclosure of supervisory information which is confidential under the Act. However, the FSMA and secondary legislation do allow the FSA to provide confidential information to other regulators, on condition that the information

	continues to be subject to restrictions on disclosure equivalent to those in the FSMA. In case another regulator requests the FSA to provide it with confidential information, the FSA will satisfy itself that this condition is met. The FSA is able to refuse requests for confidential information except in limited cases relating to court orders in criminal proceedings or Parliamentary enquiries.
Assessment	Largely compliant
Comments	The FSA's supervisory process for banks consists of a combination of on-site visits, desk-based analysis and formal firm-specific risk assessment. Information from a variety of sources feeds into the process, including skilled persons' and internal and external auditors' reports. In addition, the FSA has begun developing thematic regulation. The FSA's risk based supervisory approach implies that it focuses its resources on those firms that pose the highest potential risks to its objectives. Thus, banks that are considered to have a high potential impact on the objectives receive extensive supervisory attention. They are assigned a dedicated supervisory team, consisting of up to seven staff members, that will maintain frequent management contact and conduct on-site visits. The dedicated teams may request focused investigations into specific risk areas by specialized risk review teams or skilled persons. Banks graded as medium high or medium low impact will have a less intensive supervisory relationship with the FSA than the high impact banks but will nevertheless receive regular on-site visits. For some banks, however, in particular those that are considered to pose a low potential risk to the FSA's objectives, the risk-based approach implies that they will not have a close and continuous interaction with the FSA. No on-site examinations will normally be held at these banks to verify adherence to legal and prudential requirements, and management contact will be relatively infrequent. Unless specific risks have crystallized, reliance is placed primarily on off-site monitoring of prudential returns and external auditors reports, occasionally supplemented by work conducted in the context of thematic regulation or event-driven work. In terms of protecting consumers and safeguarding market confidence, and obviously also simply because of size, it is clearly justified to concentrate scarce supervisory resources on the larger banks. However, as Essential Criterion 1, requiring an in-depth understanding of individual banks' operations, does not distinguish between large and small banks, it applies to smaller banks' operations as well. Undue reliance on off-site monitoring makes it difficult to achieve this level of understanding, particularly with respect to control arrangements and compliance requirements in, for example, the area of anti-money laundering. The FSA recognizes this and is considering refining its risk assessment methodology to take more explicit account of all four of its statutory objectives, including the one on combating financial crime. In fact, in the period from January 2000 to July 2002, it has already conducted anti-money laundering visits to 14 of the 44 low impact banks. To the extent that risk based supervision will continue to entail less reliance on direct oversight of lower impact banks and more reliance on baseline monitoring, consideration should be given to more frequent reporting of audited returns and more regular disclosures by all banks, along the lines recommended in the comments on Principle 19 below. Audited returns would to some extent provide indirect confirmation of the integrity of the bank's internal systems and controls in view of the auditors' duty to report to the supervisor any material shortcomings revealed in the audit. They would also provide stronger underpinning for offsite monitoring. Some concern was expressed by industry sources that the turnover rate of supervisory staff in the dedicated teams was too high to enable the FSA to build up thorough firm-specific knowledge. However, it is the mission's view that this is a relatively minor issue of a transitory nature as it appears to be related to the changeover to the new supervisory regime (see also Principle 1(2)). The number of staff in the risk review teams (46 budgeted as of May 2002) appears to be somewhat small considering that they are not exclusively devoted to the banking sector but are also contributing to the supervision of the other sectors regulated by the FSA. Skilled persons reports may be commissioned to augment specialist supervisory capacity. However, skilled persons

	investigations are expensive relative to the FSA's own on-site work and the FSA strives to keep the costs of supervision proportionate with the risks to its objectives. The FSA should take care to ensure that sufficient supervisory attention is devoted to specific risk areas that require highly specialized expertise, such as credit risk classification systems, market risk management and IT security.
Principle 17.	**Bank Management Contact** Banking supervisors must have regular contact with bank management and a thorough understanding of the institution's operations.
Description	The intensity of the FSA's supervisory relationship with individual banks is influenced by the assessment of the bank's risk management procedures and practice and by the FSA's assessment of the risks that banks pose to its statutory objectives. The FSA considers that well-managed banks whose own risk management is sophisticated and effective will require less supervisory attention than banks conducting similar business but with controls of lesser quality. Banks deemed to be high impact will have a close supervisory relationship with the FSA. Thus, for large banks, there will be frequent other contacts with directors and senior management, as well as bank specific on-site visits and thematic visits involving contacts with middle management and various other bank employees. Banks considered to be low-impact will receive occasional thematic visits on cross-industry issues, together with less frequent meetings with directors and senior management to discuss bank specific issues. The FSA nevertheless feels that it has a good understanding of smaller banks' operations, in part because these are usually relatively straightforward. The FSA has a full range of supervisory tools available to achieve a thorough understanding of banks' operations. In addition to meetings with management and other representatives of a bank, this includes on-site visits, desk based reviews, liaison with other regulators and analysis of periodic returns and notifications. The FSA has access to internal auditors' reports and external auditors' management letters. Furthermore, the FSA may commission so-called skilled persons to conduct investigations of special topics at institutions under its supervision. Banks and other supervised firms are required to provide the FSA with a wide range of information. Principle 11 of the FSA's Principles for Business require firms to deal with their regulator in an open and cooperative way, and to disclose to the FSA anything of which the FSA could reasonably expect to receive notice. This includes any significant failures in the bank's systems and controls, any action which would result in a significant change in its capital adequacy, and any proposed change in the bank's operations which could have a significant impact on its risk profile. These requirements imply that banks have to notify the FSA of any significant new activities, which they would have to do in any case if a variation of the bank's permission would be required. SUP Section 15.3 requires specifically that the FSA must be notified immediately if a firm becomes aware that any of the following has occurred or may occur in the foreseeable future: • The firm's failing to satisfy one or more of the threshold conditions • Any matter which could have a significant adverse impact on the firm's reputation • Any matter in respect of the firm that could result in serious financial consequences to the financial system or to other firms • Any offences and breaches of the FSMA or rules established under the FSMA. The quality of a bank's management is considered on application for regulated status and thereafter during the normal supervisory process. Banks have to meet the threshold conditions for authorization on an on-going basis and key individuals within the bank have to be vetted and approved to carry out their particular functions. An individual that does not meet the FSA's fit and proper standards can be disapproved for carrying out particular functions or banned from employment in the regulated financial sector altogether.
Assessment	Compliant

Comments	The FSA has frequent contacts, both through face-to-face meetings and other means, with various levels of management at the larger banks. Any issue relevant to a bank's operations may be covered in the course of these contacts. Meetings with managers of small banks, however, appear to be rare. This is a reflection of the FSA's risk based approach to supervision which implies that scarce supervisory resources should be allocated primarily to those areas where the potential risks to the FSA's objectives are highest, i.e., to the larger banks (in the context of banking supervision). For low impact banks, the FSA relies mostly on desk based review of prudential returns, written material such as external auditors' management letters and other quantitative and qualitative material, except for occasional visits to some of these banks in the course of thematic reviews. Management contact with these banks takes place once every three years at a minimum but in practice usually more often, especially after risks have crystallized (see also Principle 16). The FSA expects to be notified if a low impact bank were to experience safety or soundness problems or to enter risky new business. It would be useful to identify criteria that would require low impact banks (as well as other banks) to notify the FSA of emerging problems at an earlier stage. The mission welcomes the FSA's intention to establish clearer guidelines for offsite monitoring triggers that would prompt it to initiate contact with low impact firms. Such triggers are also useful for medium-low impact firms, and, in general, would be useful for all firms.
Principle 18.	**Off-Site Supervision** Banking supervisors must have a means of collecting, reviewing, and analyzing prudential reports and statistical returns from banks on a solo and consolidated basis.
Description	Banks are required to submit a variety of statistical and prudential returns either directly to the FSA or via the Bank of England. Requirements for banks to report regularly to FSA are laid out in Chapter 16 of the Supervision (SUP) chapter of the Handbook. The requirements relate to a firm's financial condition and to its compliance with other rules and requirements which apply to the firm. Under Principle 11 banks are required to deal with their regulators in an open and cooperative way, and to tell the FSA appropriately anything of which the FSA would reasonably expect notice. The required compliance reports include an annual report on controllers (SUP 16.4.), an annual close links report (SUP 16.5), an annual report listing all overseas regulators for each legal entity of a firm's group and an annual organogram showing the authorized entities in the firm's group (SUP 16.6.5). Beyond this SUP 16.7.7 identifies eleven separate reports that banks are required to submit with varying frequency over the course of the year. Standardized forms address capital adequacy, large exposures and liquidity. The standardized BSD3 Capital Adequacy Return filed semi-annually provides detailed information on both a solo and consolidated basis for both on-balance sheet and off-balance sheet assets and liabilities, divided between the banking book and the traded book, profits and losses, counterparty exposure on derivative contracts, repos and similar transactions, large exposures, provisions against bad and doubtful debts and investments, deposit sources and market risk in the trading book. The return provides supporting details for on and off balance sheet activities and provides a step-by-step calculation of capital adequacy on both a solo and consolidated basis. IPRU (Chapter CS) sets out the basis on which consolidation will be required and the consolidation techniques that are to be applied for U.K. incorporated banks and banking groups with U.K. non-bank parents only. For banks subject to the liquidity mismatch requirements, quarterly reporting is required using Form LR. For firms subject to the stock liquidity regime, monthly reports are required, using Form SL R1. The Liquidity Management (LM) chapter of the Handbook provides detailed guidance on the information to be provided in the liquidity reports. U.K. banking groups are required to report quarterly on large exposures, on both a solo and a consolidated basis, using Form LE 2. The Large Exposures (LE) chapter of the Handbook provided

	detailed guidance on the information to be provided in the large exposure reports. U.K. branches of non-EEA banks are required to report on profits, large exposures, balance sheet, off-balance sheet items, and bad and doubtful debt provisions using the half-yearly Form B7. They are also required to provide liquidity information quarterly, using Form LR. To insure the consistency and reliability of prudential returns, FSA policies regarding valuation of assets and liabilities are spelled out in considerable detail in the Valuation (VA) chapter of the Handbook. FSA has strong powers to enforce compliance with reporting requirements. Knowingly or recklessly giving information which is false or misleading in a material particular may be a criminal offence under sections 398 and 400 of FSMA. The handbook (SUP 15.6.1R and SUP 15.6.3R) requires an authorized person to take reasonable steps to ensure the accuracy and completeness of returns and to notify FSA immediately if material or inaccurate information has been provided. Failure to do so may result in fines or other disciplinary sanctions (ENF 13.5). FSMA (Section 165) gives the FSA statutory powers to require the provision of information.
Assessment	Largely compliant
Comments	FSA has a well structured system of prudential reporting requirements for banking groups that covers both financial and compliance information. For U.K. banking groups standardized reports are required on capital adequacy, large exposures and liquidity. Reports are required to be on both a solo and a consolidated basis, where appropriate. U.K. branches of overseas banks are required to provide liquidity and large exposure reports. The scope of reporting and the policies with respect to valuation of assets and liabilities are spelled out in detail in the handbook. Essential Criteria 4 of Principle 18, dealing with information required to be submitted for statistical and prudential reporting, states: ***"Inclusion of data on loan classification and provisioning is also required."*** FSA does not routinely collect standardized data on classified or non-performing loans. As a matter of policy, FSA has not established regulatory loan classification or loan delinquency systems, preferring instead to emphasize that proper loan classification and asset valuation are responsibilities of bank management based on the circumstances of the individual institutions. While an entirely legitimate supervisory strategy, the FSAP team believes the absence of reporting on classified loans and non-performing loans handicaps the ability of FSA to verify the credit risk environment of banks, particularly on an offsite basis. This is a particularly important gap given the importance of baseline monitoring in the risk based supervisory regime, (See comments on Principle 19 below.) Peer group analysis would be strengthened if standardized information were available on classified and non-performing assets. Forthcoming adoption of Basel II and IAS 39 will require changes in firm practices with respect to provisioning and loan classification so now would be opportune time to close this gap in FSA's reporting regime. IAS 39 will require a more rigorous approach to recognition of impaired assets and loan loss provisioning and Basel II will emphasize more rigorous internal loan classification systems.
Principle 19.	**Validation of Supervisory Information** Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.
Description	Section 165 of the FSMA gives the FSA the authority to obtain information from banks. These powers extend to providing the FSA with access to a bank's directors, senior management, and key personnel. The FSA uses on-site visits to most banks as part of its formal risk assessment process; however, a small number of small banks considered to be "low impact" do not receive a formal risk

	assessment. The low impact banks are reviewed primarily using desktop baseline monitoring, with on-site visits being event driven. The risk assessment visits for the high, medium-high, and medium-low impact banks take the form of on-site high-level reviews by the supervisory team. Results of the risk assessment are used to develop a risk mitigation program (RMP) which establishes to supervisory objectives for the bank for the forthcoming period, including identifying areas for further on-site review. Such on-site reviews may be conducted by frontline supervision, by the FSA's internal risk review teams, or by engaging skilled persons, e.g., external auditors, to validate supervisory information provided by banks. The FSA Handbook (SUP 3) provides rules and guidance on the role auditors play in the FSA's monitoring of a bank's compliance with its rules and standards. This chapter addresses the auditors' qualifications, independence, reporting, and the duty to notify the FSA of any significant matters raised by the auditor. The FSA rules place the duty on the bank to ensure the auditor is qualified and independent; however they prohibit a bank from appointing an auditor the FSA has disqualified. The FSA rules establish specific areas to be covered in the auditor's report, and require a copy of all reports be provided to the FSA. In addition, SUP 3.8.2R requires the auditor to co-operate with the FSA. While the rules in SUP 3 do not provide for FSA's monitoring of the quality of the auditor's work, there are provisions in SUP 5 relating to skilled persons reports that provide for monitoring of work related to skilled persons reports. The FSA meets periodically with the bank's external auditors, on a bilateral basis. In addition to periodic meetings, external auditors have a statutory duty to inform the FSA of any concerns arising during the course of their work. Section 166 of the FSMA gives the FSA the authority to require the bank to obtain a skilled persons report. The FSMA section 166(4) requires that the skilled person must be nominated or approved by the FSA, and that the skilled person must appear to the FSA to have the skills necessary to make a report on the matter concerned. Additional rules and guidance relating to the use of skilled persons is found in the FSA Handbook (SUP 5). The large international accountancy firms produce the vast majority of skilled persons reports. The FSA will direct the scope of the review using a commissioning letter, and the nature of work to be completed may be discussed by the FSA in advance. The rules pertaining to reporting and notification in SUP 3 also apply to skilled person's reports. The FSA may hold bilateral meetings with individual partners within these firms to provide feedback from the supervisory teams on the scope and quality of their work. Trilateral meetings are held to discuss the findings of skilled person's reports. The FSA has a formal, structured process in place for skilled persons reports (SUP 5). The process includes preliminary discussions about scope, the engagement/scoping letter to the skilled person, and the objectives to be accomplished by the review. Procedures for internal risk review visits carried out by FSA's Risk Review Division are less formalized. These procedures typically involve a detailed scoping paper prepared by frontline supervisors. The firm is typically asked to provide supporting information which is analyzed prior to the visit. The visit itself builds on the information supplied and involves interviews with management and staff as well as an examination of files. For certain areas (money laundering, credit) aide-mémoires have been prepared that guide the procedures performed in the review. Supervisory returns are reviewed by supervisors for consistency and plausibility. An initial check is required within 2 days of receipt and a more detailed check is required to be completed within ten days of receipt. These reviews consist of trend analysis and plausibility checks involving comparisons with previous returns and checks against audited accounts for capital adequacy and large exposures capital base. These reviews are supplemented by peer group analysis. Validation checks completed by one supervisor must be checked and signed off by another supervisor. Follow-up with the bank will take place to reconcile outlier data and inconsistencies. Banks are subject to fines for late returns. The FSA does not require that the auditors examine certain key supervisory returns, such as capital adequacy, at least annually nor do FSA examiners routinely validate the returns to bank records.

	FSA has a variety of powers to ensure the validity of supervisory returns, including authority under S165 of FSMA to request additional information from the bank at any time, the authority under S166 to require skilled persons report to verify the accuracy of information provided, and the ability to request supplementary information from the bank's auditors under the provisions of SUP 3.8.2R which covers an Auditor's duty to cooperate with FSA. The FSA does have the means to independently validate supervisory returns, through supervisory visits, risk review division visits, or skilled person's reports. Supervisory visits (during the risk assessment process) are used to review the bank's process for completing the reports, and do not include validating key returns. The use of the internal risk review or skilled persons report tools depends on whether an issue was raised during the supervisory visit, the impact rating of the firm and the availability of these resources. FSA has identified validation of supervisory returns as a topic for theme supervision over the next year. There is no requirement that the FSA meets with the management or board each year. The FSA may hold meetings with a bank's board, or hold separate meetings with non-executive directors, when it is deemed appropriate. The FSA determines the level of supervision based on its assessment of the risk a bank poses to the FSA's regulatory objectives, and this assessment will drive whether a meeting with a bank's board is required.
Assessment	Largely Compliant
Comments	The FSA has the means to independently validate supervisory information, through supervisory visits, risk review division visits, or by commissioning skilled person's reports. However, costs and resource constraints limit the use that is made of skilled persons reports or on-site risk review visits to validate supervisory information. The FSAP team was told that, partly because of their expense, FSA has discontinued the routine use of skilled persons reports to validate regulatory returns, but they may be used on an exceptional basis. Going forward, use of skilled persons reports will focus on situations where remedial work is needed quickly or the FSA does not have the resources and/or expertise to conduct the review internally. The Major Financial Groups Division (MFGD) estimated that 70-120 skilled persons reports would be ordered per year across the 52 largest bank, securities and insurance groups firms that are supervised by the division. The Deposit Takers Division (DTD) estimated that they would order about 15-20 skilled persons reports, across about 200 banks. Internal risk review is a scarce resource, with an approved head count of 46 (including administrative support) to support work across all of FSA. MFGD supervisors indicated that risk review currently is unable to fill all requests for their services, so requests are prioritized, and some reviews may be negotiated or deferred. ***Essential criteria 5*** provides that the supervisor should require that certain key supervisory returns, such as capital adequacy, be examined at least annually by the auditors and a report submitted to the supervisor. The FSA has no explicit requirement that supervisory returns be validated in the manner called for by ***criteria 5***, although elements of this criteria are met through the requirement for an annual audit of the statutory accounts and FSA's ability to consult with and request information from auditors. **Recommendation**. The FSA relies on the supervisory returns as a key part of its risk based approach to supervision and particularly for its baseline-monitoring program., so it is very important that the FSA is able to place reliance on the accuracy of that information. In addition, greater disclosure of such information would add to market discipline. Given the resource constraints on the ability of FSA itself to comprehensively validate supervisory returns, the FSAP team recommends that FSA should consider going beyond the literal requirements of ***Essential Criteria 5*** and consider requiring all banking groups to provide annual

	audits of key supervisory returns. It would be useful if validation of supervision were made a regular topic for theme supervision. In addition it would be desirable for all U.K. banks be required to publish audited financial reports on an annual basis, coupled with a continuous disclosure requirement – currently these requirements apply only to listed companies. There does not appear to be a compelling reason to limit market disciplines that arise from financial disclosures to only banks (public issuers) that are listed.
Principle 20.	**Consolidated Supervision** An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.
Description	The FSA approach to consolidated supervision is set out in IPRU (CS Chapter) which is the principle vehicle for implementing the EU Banking Consolidation Directive(*date*) and the EU Post-BCCI Directive (*date*) The FSA's consolidation policy addresses three main areas of concern arising from group membership: • losses in another group entity that could lead to financial pressure on the bank because of financial or reputational linkages; • capital that is subject to double-gearing or leveraging: that is, a solo assessment of a firm over-estimates the quantity of capital which is available to support the bank's risks, because of the way the capital has been raised or accounted for within the group; and • business that is booked in an unauthorized group entity to avoid regulatory requirements. The FSA views its consolidated supervision as a complement to individual firm requirements rather than as a substitute. The objective is to enhance the overall effectiveness of the prudential supervision of the bank by ensuring that risks related to the bank's membership of a group are taken into account in the supervision of the bank. Consolidated supervision does not, however, constitute supervision of undertakings within the group which are not authorized. The FSA is required to undertake supervision on a consolidated basis by EU legislation, in particular the Banking Consolidation Directive. The FSA's consolidated supervision framework consists of two main elements: • A qualitative assessment of the group as a whole. This is made in relation to the group's significant business units and their potential material bearing on the bank. It focuses on the group's business, controls, organization and management. • A quantitative, consolidated assessment of relevant financial companies within the group that establishes prudential requirements, for instance with respect to capital adequacy and large exposures. The FSA approach identifies where group risk arises, sets systems and controls requirements for managing that risk, and establishes a methodology for the calculation of consolidated capital (Principle 18). The scope of the FSA's consolidated supervision includes all parents and subsidiaries of the bank, any of their parents or subsidiaries; or any undertaking in which those parents or subsidiaries or the bank have a participation. In addition, the FSA may require a bank to include within its group consolidation an undertaking that is not a member of group as defined but which has links to the group that would make its omission from the scope of the consolidation assessment misleading. (CS 3.1.3) requires that the bank have adequate controls to produce any data required to supervise on a consolidated basis. (CS 3.3.19) requires adequate controls to identify and monitor large exposures. Consolidated returns are required twice annually and large exposures must be reported quarterly. (CS 3.3.7) requires a detailed organization chart and identification of subsidiaries supervised by others. Section 166 exams may be required to cover internal control systems used to generate consolidated accounts. Consolidation usually applies to financial subsidiaries. For purpose

	of consolidated supervision, insurance and insurance broking are not defined as financial activities and are therefore not normally consolidated (CS 4.3). For activities undertaken within the U.K. coordination among functional regulators of a group takes place within FSA. A variety of arrangements are in place with home and host supervisors overseas to allow exchanges of information on the financial condition and adequacy of risk management and controls of overseas undertakings. Where FSA is unable to satisfy itself that the overseas parent of a branch or subsidiary in the U.K. is subject to adequate home country consolidated supervision FSA may require solo consolidation at the U.K. level. Fit and proper tests may be applied to senior management of parent companies under the FSA's authorized persons regime. Consolidated supervision encompasses the activities of U.K. banks in offshore centers through several mechanisms. Exposures in offshore centers are included in the quantitative requirements for consolidation and the capital adequacy ratio and the controls on large exposures. Where FSA is concerned about such exposures it may impose additional capital requirements, require deconsolidation of the capital and assets in the offshore jurisdiction, and restrict transactions with the jurisdiction. U.K. financial institutions are required to be able to provide FSA all the information it requires to carry out effective consolidated supervision wherever their business is conducted, including in jurisdictions with strict secrecy provisions. Under the qualitative element of its consolidated supervision, FSA requires that banks have the ability to measure, monitor, manage and control the risks in all their significant business lines, wherever that business is conducted. This will apply to business lines such as private banking, asset management, insurance, and capital markets operations, all of which can have links to offshore centers. FSA anti-money laundering policies include an expectation that the practices of overseas affiliates of U.K. banks will conform to the higher of U.K. or local standards. Compliance with this policy is one of the duties the bank's MLRO, an individual who must be authorized by FSA. In evaluating the risks in business lines, FSA places a strong emphasis on the quality of counterpart financial supervision in the jurisdictions where the business is conducted. This is also a key consideration in granting permission for U.K. banks to establish or operate in those jurisdictions or in granting FSA authorizations to firms from those jurisdictions. For FSA an important factor in evaluating the practices of other supervisors is their willingness to share information. In this regard FSA takes into account the FATF NCCT classifications as well as its own experience. FSA has an active involvement with numerous offshore centers, particularly in the U.K. overseas territories and dependencies. This includes participation in regional organizations and regular liaison with offshore supervisors.
Assessment	Compliant
Comments	FSA has comprehensive arrangements to be able to supervise U.K. banking groups on a consolidated basis, both quantitatively and qualitatively, regardless of where their business is carried out. Capital requirements set out clearly the procedures to be followed in consolidating group accounts to insure that the U.K. banking activities of a group are adequately capitalized, both on a solo and a consolidated basis. Large exposure limits are governed by clear policies with limits enforced on both a solo and a consolidated basis. Management systems and controls are required so that risks arising from the bank's dealing with other parts of the group are properly identified, measured, monitored and controlled. A variety of arrangements are in place for coordinating and cooperating with other regulators, both at home and overseas, who have responsibility for other legal entities within the group.
Principle 21.	**Accounting Standards** Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.
Description	The threshold conditions require that banks must have adequate resources, including high level systems and controls. SYSC 3.1.1R and 3.2.20R require that a bank's directors and management

	ensure that the bank maintains adequate records (including accounting records) that are appropriate to the scale, nature and complexity of its business. IPRU (Banks) Chapter AR provides further guidance on adequate accounting (and other) records and internal control systems. The FSA does not publish a comprehensive list of the accounting and other records which a bank should maintain; however, banks are required to capture and record accurately and on a timely basis every transaction and commitment which the bank enters into and record details as appropriate for each transaction and commitment (IPRU Chapter AR 3.2.2). These provisions apply for all U.K. banks and branches of non-EEA banks. [For U.K. incorporated banks further accounting record requirements are set out in the Companies Act 1985.] The FSA has powers to enforce the records requirements, and may fine banks for late and inaccurate supervisory returns. The FSA has the authority under FSMA Section 166 to commission a skilled persons report to verify bank records in particular areas. In addition, the FSA's internal risk review division may be used for verification of a bank's records. These tools would be employed as part of a risk mitigation program if the supervisors identified a concern during their risk assessment process. Regulatory reporting forms are accompanied by detailed guidance notes that include information on accounting treatment. Banks are required to use generally accepted accounting principles when valuing assets. FSA reports should be prepared using book value of assets and liabilities, and the banking and trading books should be valued on an accrual basis, unless a different practice has been agreed in writing with the FSA. CAD banks should value trading books on a mark-to-market basis, and banking books on an accrual basis. IPRU (Banks), Chapter GN 3.3.17R requires all U.K. banks and non-EEA overseas branches to maintain adequate provisions for depreciation or diminution in the value of assets (including loan loss provisions), for liabilities which will or may fail to be met by the bank and for losses which it may incur. IPRU (Banks), Chapters VA and PN discuss the valuation and provisioning policies that banks should adopt. The Companies Act 1985 requires all U.K. banks to prepare accounts that give a true and fair view of the results and financial position of the bank and/or group. The accounts are subject to public filing requirements. Detailed provisions on the form and content of the accounts of banks and banking groups are contained in Schedule 9 to the Act. There is a general presumption that compliance with U.K. Financial Reporting Standards (FRS) and Statements of Standard Accounting Practice (SSAP) is necessary in order for the accounts to give a true and fair view. Banks accounts must state whether they have been prepared in accordance with these standards, and give details of any departure from the standards and the reasons. Banks are also expected to comply with the five industry-specific Statements of Recommended accounting Practice (SORP), and are required to state in their accounts whether they have complied, and if not, explain why they have not complied with them. All U.K.-incorporated banks must appoint an external auditor (SUP 3.3.2R) and the bank's published accounts must bear an opinion by the external auditor as to the completeness and accuracy of the financial statements (SUP 16.7.8R). Auditors are required under the rules of their professional bodies to comply with Statements of Auditing Standards issued by the U.K. Auditing Practices Board. If the bank failed to comply with the relevant accounting standards, the external auditor would qualify the opinion. The FSA has periodic contact with external auditors to discuss annual accounts and skilled persons reviews. Auditors have a legal duty to report to the FSA breaches or possible breaches of laws or rules, and other matters that they reasonably believe are, or may be, significant. The FSMA Section 342 and the SUP 3.8.10R require that the external auditors inform the FSA if they have any material concerns as a result of their work. Sections 342 and 343 of the FSMA also provide protections for

	auditors that report in good faith matters that are, or are likely to be, of material significance to the FSA. Guidance regarding an auditor's duty to report is provided in SUP 3.8. The FSMA gives the FSA the authority to disqualify auditors if they have failed to comply with a duty imposed on them under the FSMA. Banks are prohibited from using disqualified auditor under SUP 3.4.5R. If the FSA had concerns over the abilities of a bank's external auditors, it may request management to change the audit firm. Under Section 166 of the FSMA, the FSA may appoint a skilled person to do onsite work on its behalf. The skilled person process includes a determination by the FSA that the skilled person has appropriate expertise to carry out the review. In practice, the large international firms perform the majority of banks' external audits and skilled persons reports. SUP Chapter 3 provides rules and guidance governing the FSA's relationship with external auditors, and SUP Chapter 5 addresses skilled persons reports. The FSA has a procedure in place for skilled persons reports to establish the scope of the engagement and the objectives to be accomplished by the review (SUP 5). The FSA does not have specific guidelines addressing the scope and conduct of internal audits. However, the FSA does look at the audit universe, and may guide the scope of an internal audit when it meets supervisory needs. The FSA would expect that internal audit would have a risk based approach to its audit Chapter 349 of the FSMA imposes confidentiality requirements on the FSA. Refer to CP 1(6) for further details on confidentiality. The FSA supports Basel and EU proposals to promote public disclosure by banks as a means of strengthening market discipline as a complement to other regulatory efforts.
Assessment	Compliant
Comments	A comprehensive accounting and reporting structure is in place to provide for financial statements on a regular basis. A bank's annual accounts are required by the Companies Act to be prepared in a way that gives a true and fair view of the results and financial position of the bank and follow the detailed provisions of the Act on form and content of the accounts. The accounts are also expected to comply with other accounting standards such as FRS and SORP, and are subject to public filing requirements. Banks are also required to file regulatory reports with the FSA. These reports have detailed guidance notes to assist in preparation. The FSA requires banks to use generally accepted accounting principles when valuing assets.
Principle 22.	**Remedial Measures** Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking license or recommend its revocation.
Description	The FSA has a broad range of supervisory measures available address such problems as failure to meet the FSMA threshold conditions and non-compliance with the FSA's rules. The range of possible actions available is broad, as the FSA is able to use its powers under FSMA Section 43 to place requirements or restrictions in a bank's permission. The power can be used to require a bank to take specified action or to require it to refrain from taking specified action. The FSA may also vary or cancel a bank's permission under Section 45, and also has the authority to take disciplinary measures against a bank or individual, including fines (Section 206) and public censure (Section 205). The FSMA Section 53(3) provides that FSA may take Section 45 actions that have immediate effect if the FSA reasonably determines that immediate effect is necessary. The FSA may require that any actions or requirements imposed under its Section 45 powers be taken within a specified time period. Injunctive relief is also available to the FSA under Section 380, and restitution orders

	are available under Section 382. These remedies are commonly used against unauthorized firms where the other disciplinary powers are not available. The FSMA Section 61 requires the FSA to exercise control over individuals performing "controlled functions" by requiring that they be approved by the FSA. Controlled functions are functions involving key responsibility and are typically director and senior management level positions. A list of controlled functions is in the SUP chapter of the FSA Handbook (Section 10, Approved Persons). In order to be an "approved person", the FSA must be satisfied that the person is fit and proper to perform those functions. If the FSA no longer considers a person fit and proper, they may withdraw their approval under FSMA section 63. The FSA may also take action against an approved person if it appears to the FSA that the person is guilty of misconduct under FSMA Section 66. The FSA also has the power to prohibit a person from performing functions in relation to a regulated activity if the FSA finds the person is not fit and proper. If a prohibition order is made, the FSA is required to follow the procedures in FSMA section 347 regarding publication of information about the prohibited person. The FSA's Regulatory Decisions Committee (RDC, a committee of practitioners and public interest members appointed by the Board, but independent of the FSA's executive staff) may take major regulatory decisions. The RDC exercises regulatory powers on behalf of, and is answerable to, the FSA's Board. The FSM Tribunal, an independent body, will consider major regulatory decisions made by the FSA if the firm or individual concerned decides to refer the matter on. The FSMA contains no express requirement that the FSA take action within any particular time frame, with the exception of representations or referrals to the FSM Tribunal. Nor is there guidance or formal voluntary commitment by the FSA to any timeframe. If the FSA does not take action in a timely manner, firms or individuals may raise this in proceedings against them under the general jurisdiction of the courts and Tribunal, and the ordinary principles of fairness that must apply in such proceedings. In addition, the FSA must comply with Article 6 of the European Declaration of Human Rights that requires there to be a right to an independent determination of civil rights and liabilities within a reasonable time frame. For these reasons, and as a matter of general good regulatory practice, the FSA does ensure that remedial actions are in practice taken in a timely manner. Once the FSA has initiated formal supervisory or disciplinary action by service of a notice, a statutory a time frame applies to the completion of the process for making representations or referring the matter to the Tribunal. There are however no constraints on the initiation of action. FSMA Part XXVI requires compliance with formal written notice procedures when the FSA exercises any of the formal disciplinary or supervisory powers.
Assessment	Compliant
Comments	The FSMA provides the FSA with broad powers to take remedial and enforcement actions, and also provides for sanctions against individuals and firms. Adequate protections, in the form of referral to the Tribunal, are in place to protect against abusive enforcement or disciplinary actions. The new enforcement powers granted under the FSMA are very recent, and have only been used in a handful of actions to date, so it is difficult to make a proper assessment of the effectiveness of the FSA's use of its powers.
Principle 23.	**Globally Consolidated Supervision** Banking supervisors must practice global consolidated supervision over their internationally active banking organizations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organizations worldwide, primarily at their foreign branches, joint ventures, and subsidiaries.
Description	Authority to supervise the overseas activities of U.K. incorporated banks is provided for in Threshold Condition 3: (Close Links), based on Paragraph 3, schedule 6 of FSMA. The close links provisions implement and expand on the requirements of the EU Post BCCI Directive. For U.K. based banking groups, FSA carries out global consolidated supervision covering all

	aspects of supervision, specifically including non-U.K. group companies. Foreign branches of U.K. banks, not being separate legal entities, are considered to be an integral part of the U.K. bank itself, and are supervised on that basis. Quantitative consolidation (see Principle 18) is applied to the global undertakings of U.K.-based banking groups. Under FSA's risk based approach to supervision the supervisory effort concentrates on significant business units. These may be identifiable on a geographical, legal or business basis. Consistent with the qualitative element of FSA's general approach to consolidated supervision, supervisory effort is directed at ensuring that banks have information systems and controls adequate to manage risks in all business units, wherever they are located. Heads of significant business units will be seen during the risk assessment stage or during the following supervisory period. In conducting reviews of high level controls at the center, the FSA considers the quality of the control system both centrally and locally. Supervisors periodically visit major overseas operations to supplement reviews made at the center. If circumstances require the FSA will impose limitations on the activities of overseas operations of U.K. banks through liaison with home country senior management. The FSA may impose limitations on the activities of overseas operations in order to ensure that the close links/supervisability of group structures requirement in the Threshold Conditions is met in particular cases. In addition to regular contact with senior management based in the U.K. responsible for the international operations of internationally active groups, FSA is also in periodic contact with the locally based management responsible for significant business units overseas. Direct supervision of significant international operations is supplemented by close co-operation and liaison with the banking supervisors of the host country. If necessary, plans for remedial action are discussed and agreed with the host supervisor. If, as part of the risk assessment process, the FSA determines that an overseas operation of a U.K. banking group is presenting significant unmitigated risks the FSA would initiate discussions with the bank's senior management. These discussions could ultimately require the closure of a bank's overseas operation. FSA has the power to conduct on-site examinations of overseas branches and subsidiaries of U.K. banking groups. The FSA conducts periodic on-site examinations of a sample of the more significant overseas offices of U.K. banks, usually in conjunction with the host country supervisor. Following FSA's risk based approach to supervision, oversight of the foreign operations of U.K. banks focuses on significant activities with higher risk profiles and those that are subject to weaker host country supervision. FSA routinely undertakes assessments of the extent of supervision undertaken by other supervisors relevant to the U.K. In particular, it forms its own judgment as to their compliance with the Basel Core Principles.
Assessment	Compliant
Comments	FSA supervises internationally active U.K. banking organizations on a globally consolidated basis, both quantitatively and qualitatively. The international dimension places particular emphasis on ensuring that banks have information systems and controls to manage risks in all business units, wherever they are located. FSA insures that overseas activities are structured in a way that can be properly supervised and, where it is not satisfied, imposes restrictions or limits activities. Overseas visits and cooperation with foreign supervisors are important aspects of FSA's supervision on a globally consolidated basis.
Principle 24.	**Host Country Supervision** A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.
Description	The FSA has established an extensive network of formal and informal contacts with overseas

	banking supervisors to provide for the exchange of information necessary for effective global consolidated supervision. These contacts are both multilateral and bilateral. At the level of international organizations, FSA is an active participant in supervisory groups such the Basel committee and EU groupings such as the Banking Advisory Committee and the Groupe de Contact. Bilateral memoranda of understandings with numerous countries provide for information exchanges and on-site examinations of branches and subsidiaries of U.K. banks. FSA maintains a very active dialogue with supervisors in offshore centers particularly those that are in overseas territories and crown dependencies. Information exchanges are both formal and informal and range across the full spectrum of supervisory information, from written documentation in support of authorizations to oral sharing of supervisory judgments about individuals and institutions. In line with its risk based approach to supervision FSA, in consultation with local supervisors, regularly visits the major overseas offices of U.K. banking groups and on such visits frequently conducts joint examinations with the host country supervisors. The readiness of an overseas supervisor to provide information is a consideration for the FSA in determining the extent to which it can take into account the work of the overseas supervisory in its supervision of the overseas subsidiaries of U.K. banks. Threshold Condition 3 (Close Links) would be breached if the regulations or administrative provisions of a territory, which is not an EEA state, would prevent the FSA's effective supervision of a bank or affiliate. COND 2.3.3G also notes that the FSA considers branches when assessing whether a firm meets Threshold Condition 3. Restrictions on information flows also impact on Principle for Business (PRIN) which provides that a firm must deal with its regulators in an open and cooperative way and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice. This principle is enforced in Rule 2.1.1 in SUP. COND 2.3.3G also indicates that restrictions on information flow could stop a firm complying with the rules in SUP on information gathering. In discussions with host country supervisors FSA will focus on the local banking group and the group as a whole.
Assessment	Compliant
Comments	FSA has a very broad network of contacts and arrangements with foreign supervisors whereby it exchanges supervisory information necessary to carry out globally consolidated supervision. This includes participation in numerous international and bilateral supervisory groups, as well as formal and informal bilateral contacts with other supervisors responsible for affiliates of banking organizations in the U.K. Where practical, the FSA will consult with an overseas supervisor providing information before taking action in relation to a bank that it supervises (and more widely where any action could have consequences for its supervision of other banks or financial companies). The FSA must consult a firm's EEA home state regulator before taking actions in certain specified cases. The FSA discloses information to host country supervisors in a wide variety of circumstances whether or not at the specific request of the host supervisor.
Principle 25.	**Supervision Over Foreign Banks' Establishments** Banking supervisors must require the local operations of foreign banks to be conducted with the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.
Description	All banks, whether U.K. incorporated or branches of foreign banks, are required to satisfy and continue to satisfy the Threshold Conditions set out in FSMA. The Principles for Business likewise are applicable to all banks whether U.K. incorporated or branches of foreign banks. FSA's risk based approach to supervision does not differentiate between foreign and domestic banks. Foreign

	banks are subject to the same risk assessment and risk mitigation process as domestic banks. Reporting requirements are similar for all banks, although there are differences in the prudential returns relating to capital and large exposures. These differences apply mainly to branches of foreign banks and the differences are spelled out in SUP 16 of the Handbook. Prudential supervision of branches of EEA banks operating in the U.K. under the EU passport arrangements are primarily the responsibility of the home country supervisor and, hence, prudential returns to FSA are limited. For branches of non-EEA banks the FSA relies on the home country supervisor for capital adequacy and large exposures. Although FSA has responsibility for supervising the liquidity of foreign branches on a case-by-case bases it may agree to defer to the home country supervisor for the oversight of branch liquidity. In both its licensing and ongoing supervision of branches and subsidiaries of foreign banks, FSA takes into account the extent to which home country supervisors carry out effective global consolidated supervision. Before authorizing deposit taking activities of a foreign branch of a non-EEA bank the FSA confirms both that the bank is subject to consolidated supervision and that the home country supervisor approves the proposal. Similar procedures do not apply to approval of branches of EEA banks operating under EU passport arrangements. If, on a continuing basis, FSA is unable to rely on the home country supervisor, it is FSA policy that branches of non-EEA banks close or the branch should subsidiarise. This policy has been enforced in individual cases. For U.K. subsidiaries of overseas banks the FSA seeks confirmation that the home country supervisor practices effective consolidated supervision. If FSA is not satisfied on this point then it will require that the corporate governance and risk management policies of the subsidiary be sufficiently robust to provide adequate ring-fencing from the parent bank. This policy has been enforced in individual cases. FSMA provides authority for the FSA to share supervisory information with foreign supervisors subject to confidentiality safeguards. All home country supervisors are permitted to conduct on-site visits and examinations of U.K. branches and subsidiaries and FSA encourages this practice. FSA informs home country supervisors of risk assessments and supervisory actions that it is taking in relation to the operations of banks from their countries. Urgent remedial actions are promptly communicated. FSA systematically informs itself of business strategies and risk and control regimes of parent banking groups in order to provide the context necessary for supervision of branches and subsidiaries of foreign banks operating in the U.K. This done through contacts with the banking group supplemented by information provided by the home country supervisor.
Assessment	Compliant
Comments	The U.K. operations of foreign banks are subject to the same high level standards and principles the FSA applies to U.K. banking organizations and FSA applies the same risk based supervisory tools to both foreign and domestic banks. Reporting requirements are similar for all banks, taking into account differences applicable to branches of foreign banks and the special legal arrangements for EEA branches established under the EU passport regime. FSA licensing and ongoing supervision of U.K. branches and subsidiaries of foreign banks takes into account the reliance FSA believes it can place on home country consolidated supervision. FSA has wide authority to share supervisory information with home country supervisors and, as a matter of policy, FSA encourages home country supervisors to carry out on-site visits of the U.K. operations of their banks.

Table 2. Summary Compliance of the Basel Core Principles

Core Principle	C[1/]	LC[2/]	MNC[3/]	NC[4/]	NA[5/]
1. Objectives, Autonomy, Powers, and Resources	**C**				
1.1 Objectives	**C**				
1.2 Independence	**C**				
1.3 Legal framework	**C**				
1.4 Enforcement powers	**C**				
1.5 Legal protection	**C**				
1.6 Information sharing	**C**				
2. Permissible Activities	**C**				
3. Licensing Criteria	**C**				
4. Ownership	**C**				
5. Investment Criteria	**C**				
6. Capital Adequacy	**C**				
7. Credit Policies	**C**				
8. Loan Evaluation and Loan-Loss Provisioning	**C**				
9. Large Exposure Limits	**C**				
10. Connected Lending	**C**				
11. Country Risk	**C**				
12. Market Risks	**C**				
13. Other Risks	**C**				
14. Internal Control and Audit	**C**				
15. Money Laundering		**LC**			
16. On-Site and Off-Site Supervision		**LC**			
17. Bank Management Contact	**C**				
18. Off-Site Supervision		**LC**			
19. Validation of Supervisory Information		**LC**			
20. Consolidated Supervision	**C**				
21. Accounting Standards	**C**				
22. Remedial Measures	**C**				
23. Globally Consolidated Supervision	**C**				
24. Host Country Supervision	**C**				
25. Supervision Over Foreign Banks' Establishments	**C**				

[1/] C: Compliant.
[2/] LC: Largely compliant.
[3/] MNC: Materially non-compliant.
[4/] NC: Non-compliant.
[5/] NA: Not applicable.

E. Recommended Action Plan and Authorities' Response to the Assessment

Recommended action plan

14. Table 3 sets out the actions recommended by the mission with respect to Bank supervision. Note that the recommendations related to principles 15, 16, 18, and 19 are to improve compliance with the Core Principles, while the other recommendations are more technical ones for Principles already complied with. The mission considers the latter

desirable measures for further refining bank supervision given, in particular, the role of London as a major international financial center.

Table 3. Recommended Action Plan with Respect to the Basel Core Principles

Reference Principle	Recommended Action
CP 8 Loan evaluation and provisioning	Introduce periodic reports on asset quality.
CP 12 Market risks	Consider expanding the supervisory staff responsible for testing banks' market risks controls.
CP 13 Other risks	Develop a new approach to liquidity monitoring that will be more aligned to banks' own techniques for liquidity management.
CP 15 Money laundering	FSA to monitor annually a sample of anti-money laundering reports from banks that have not been subject to on-site review.
CP 16 On-Site and Off-Site Supervision	See recommended actions under CPs 17, 18 and 19
CP 17 Bank management contact	Identify criteria for banks to notify the FSA of emerging problems at an early stage. Establish off-site monitoring triggers for the FSA to contact banks with emerging problems.
CP 18 Off-site supervision	Introduce regular reporting requirement for data on classified and non-performing loans.
CP 19 Validation of supervisory information	Introduce a requirement for key supervisory returns to be examined at least annually by external auditors. Extend listed banks' disclosure requirements to non-listed banks.

Authorities' response to the assessment

15. The U.K. authorities consider that the FSAP assessment is valuable and clearly demonstrates the U.K.'s very high degree of compliance with the Basel Core Principles. They support the broad thrust of the FSAP mission's findings and recommendations and find them helpful in taking forward some existing strands of work. In particular, they agree with the usefulness of developing a new approach to liquidity monitoring, and changes to their existing approach are in train. There are a small number of recommendations where they believe the current regime effectively fulfils the IMF's requirements. There are also some recommendations where further consideration will be required to effectively account for the costs of implementing them relative to the benefit. Specific comments from the authorities on the recommendations in the table above, are as follows:

- On *CP 8*, in line with their risk based approach to regulation, and the principle of proportionality, the FSA indicated that it currently operates a selective process to reporting asset quality, i.e., if they have concerns about an institution's asset quality, or the possible deterioration of that asset quality, they may ask the bank to provide regular info on asset quality. Their approach to this issue is being considered under the currently ongoing data needs project, and would be considered in the same context as CP 18.

- On *CP 12*, they noted that the FSAP team has rightly recognized their need to focus most of their resources, which are of course finite, on the institutions that have the largest combination of impact and risk.

- On *CP 13*, the authorities agreed with the usefulness of developing a new approach to liquidity monitoring, and changes to their existing approach are in train. They have already consulted on systems and controls requirements and it is planned to introduce these in summer 2004. They will also consult on a framework of quantitative requirements for liquidity risk in summer 2003.

- On *CP 15*, the authorities noted that they already monitor the reports of Money Laundering Reporting Officers and have undertaken a specific study of reports from 75 banks. This program of work will continue.

- On *CPs 16-19*, in the context of a risk based approach, the authorities were of the view that, while valid, some of the recommendations about the supervisory process in relation to these Principles relating to on/off site supervision, management contact and validation of information, could be overly prescriptive and less relevant to low impact banks (which account for only 0.02 percent of deposit liabilities). They felt that, by and large their tools are adequate and it is doubtful whether the value of extra reports on asset quality would outweigh the cost. Nonetheless, they are reviewing their data needs requirements generally and exploring ways of strengthening baseline monitoring, including the quality of data they receive from firms and the timeliness of notifications. (See also comment on BCP 8). The recommendations will be considered in this context.

  With respect to D firms [all low impact and low risk/medium low impact firms], in the authorities' view, their new systems and processes deliver a robust, and appropriate supervisory regime for these firms, which have a low RTO and they do not wish to overburden this sector with unnecessary or disproportionate regulatory obligations.

  Regarding CP 17, they noted that block one of the FSA handbook sets out senior management responsibilities and the Principles for Businesses. These have the status of rules and apply to all firms. One of these Principles requires firms to disclose appropriately anything that the FSA could reasonably expect to be notified of. The authorities felt that providing detailed criteria and triggers for when firms should contact or notify the FSA is unlikely to make firms more open. They already have a list of basic events that must be notified and moving beyond this minimum could perversely restrict the issues on which a firm feels it has to consider communicating, and also weaken senior management's responsibility to make considered judgments.

  On CP 19, the authorities noted that the FSA checks the plausibility of comparisons and trend analysis on financial returns from banks. Where there are concerns supervisors can request further information or appoint a skilled person (under S 166 of FSMA) to verify the accuracy of information. Auditors have a statutory duty to report to the FSA. Again, they are reviewing the recommended CP 19 requirement under the data needs project.

II. IAIS Insurance Core Principles

A. General

16. This is an assessment of the observance of the core principles of the International Association of Insurance Supervisors (IAIS) in the United Kingdom (U.K.). Insurance is supervised in the United Kingdom by the Financial Services Authority, an independent non-governmental incorporated body limited by guarantee and operating under powers granted by the Financial Services and Markets Act 2000. The assessment was conducted by Carl Hiralal, Senior Director, Office of the Superintendent of Financial Institutions Canada, Conglomerates Group, and Rodney Lester, Lead Specialist and head of the Insurance and Contractual Savings practice in the Financial Sector Development Department of the World Bank. Frank Engels , U.K. desk officer for the IMF provided early commentary on the assessment and participated in the feedback sessions.

B. Information and Methodology Used for Assessment

17. This assessment has been based on the Insurance Core Principles Methodology (ICP) of the IAIS dated October 2000, as modified by the joint IMF/World Bank assessment template.

18. Given the highly developed nature of the U.K. insurance market, the current lack of stability in certain segments of the market and the large exposure to international financial activities, this assessment has been carried out on the basis of both the essential and supplementary criteria underpinning each Core Principle. In addition the assessors relied on the override provisions in the Methodology,[1] and applied standards appropriate to a leading industrial country.[2] The United Kingdom is the first insurance market of global significance to be assessed and provided special challenges. In particular it would have been possible to provide observed ratings on most of the CPs if just the law and FSA model (especially once rolled out) had been considered. The assessors view has been that this would not have added value given the current transition stage in the evolution in FSA, particularly with regard to supervision,[3] and would not have done justice to the importance of the U.K. insurance sector,

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[1] The key override provision comes under the heading ‘Comprehensiveness’ and states that ‘the assessment must be conducted in sufficient depth to allow a judgment of whether criteria are fulfilled in practice, not just in concept’.

[2] It has been difficult to apply one set of (somewhat general) CPs to insurance and contractual savings markets that vary from almost nonexistent to being comparable to the banking sector by some key measures. The Fund and Bank have been considering options to deal with this variability, however, in the interim assessors have had to use their own judgment in interpreting and assessing the standards.

[3] The regulatory model rests on a very explicit risk-based philosophy (or, more precisely, a framework focusing on risk to the statutory objectives under FSMA); as discussed further below, the Tiner Report reflects the application of this framework to insurance sector supervision.

both domestically and internationally. Thus the assessment is based on the FSA as it was at the date of the assessment when supervisory practices were still being developed and resourced. In addition it needs to be explicitly stated that demanding benchmarks were applied and this will need to be acknowledged in any comparison with other industrial countries.

19. Major sources of information used for the assessment included the answers to the questionnaire submitted by the IMF prior to the mission, a comprehensive self assessment carried out by the Insurance Firms Division, information available from the FSA web site including numerous consultation papers, comprehensive CD-ROM databases provided by FSA, presentation material provided by FSA officers, statistical information provided by the Association of British Insurers (ABI) and S&P Thesys, and background information available from various professional firms and international industry intelligence services. In addition extensive interviews were conducted with numerous officers in FSA and the various governmental and regulatory bodies concerned with private pensions, senior management of ABI and the National Association of Pension Funds (NAPF), members of relevant boards of the Institute of Actuaries, senior chartered accountants and rating agency personnel, and a wide range of senior management from the insurance sector, including Lloyds. All concerned gave willingly of their time and were cooperative, and this added significantly to the effectiveness of the insurance assessment team.

C. Institutional and Macroprudential Setting—Overview

20. The British insurance industry is venerable and large. With net premium income in 2000 of £174 billion or approximately 10 percent of the world market, it is the third largest after the U.S. and Japan (although considerably smaller than either). See following table for premiums data. It includes the most important cross-border non-life insurance markets in Lloyds and the London Market, which together account for 65 percent of approximately US$20 billion of annual global cross border general insurance premium flows (Source-Sigma No. 6, 2001), and is a significant source of life insurance products for people resident in other EU countries. Insurance penetration[4] at 15.8 percent is the highest in the world, South Africa excepted. This penetration is driven largely by a strong imperative to save for retirement in the U.K. given a relatively low (and declining) social security replacement ratio.

21. The insurance industry also makes a significant contribution to the economy. It employs in excess of 220,000 people directly and another 115,000 indirectly, accounting for 1.5 percent of total U.K. employment. It is an important contributor to the balance of payments, with overseas earnings in 2000 approaching £7 billion (£8.7 billion in 1999), of which the major element is insurance 'exports' (off shore insurance accepted or intermediated by a U.K.-based insurer or broker). U.K. insurers are also active in foreign

[4] Premiums as a percentage of GDP, a widely accepted basis of comparison.

markets; however this represents a relatively minor and reducing component of foreign earnings. Net assets of overseas operations have fallen for three years in a row with the main declines occurring in the U.S. and Europe, and only the few leading players continue to have global ambitions.

Table 4. Gross Direct U.K. Sourced Premium Revenues
(in £ billions)

	Life – Ordinary	Life - Industrial	Non life
1990	32.8	1.4	18.3
2000	118.0	0.7	28.7

Source : ABI.

22. The U.K.-based insurers are, with self-administered pension funds, the most important repositories of individual financial sector wealth. Of total FY 2000 financial assets of households and related non-profits of £3 trillion, more than 50 percent is represented by insurance policyholder related liabilities (Source National Statistics, Financial Statistics, Table 12.1N). Total investment assets under management at the end of 1999 amounted to slightly over £1 trillion and the life and pensions sectors were easily the major providers of finance to government and private borrowers. When examined over time the long term insurance sector has also been the most consistent source of new investment funds in the economy, although given the stresses the industry is now experiencing (see below), this is not guaranteed to be the case in the future. While a figure for 'other' company securities on issue is not readily available, life insurers appear to account for a major part of the Sterling commercial paper on issue.

23. U.K. insurance companies and pension funds are under considerable stress given that their income has been eroded by market risk. While balance sheet concerns remain, the insurance sector is not likely to pose a systemic threat to the financial system. Owing to their investment profile, U.K. insurers, most notably life insurers and pension funds, have been specifically affected by the fall in stock prices and exceptionally low bond yields. Coupled with long-term non-life claims, substantial losses related to September 11, and in some cases mounting liabilities based on guaranteed annuities or defined-benefit schemes, the sector constitutes a potential source of market risk, as insurers hold around a fifth of total U.K.-quoted equities and could resort to asset sales to safeguard profitability and regulatory capital. Growing balance sheet concerns in the insurance industry have been reflected in increased supervisory activity, including suspensions and modifications to the FSA's resilience tests and enhanced monitoring of the financial modeling of insurers.

Table 5. Insurance Sector Asset Allocation, end-1999

	Cash & Equities	Gilts	U.K. Corporate Securities	Foreign Corporate Securities	Foreign Gilts	U.K. Loans	Unit Trusts	Other	Property	Total
Long Term (£bill)	50.1	123.6	467.3	81.3	21.8	9.3	83.7	28.5	51.0	916.6
%	5.5	13.5	51.1	8.9	2.3	1.0	9.1	3.1	5.5	100
General (£bill)	6.0	13.9	18.8	10.3	14.0	1.4	1.3	22.9	1.7	90.3
%	6.6	15.4	20.9	11.4	15.6	1.5	1.4	25.3	1.9	100

Source: ABI [1/]

1/ ABI is one good source of summary information on insurance industry developments but this is oriented to turnover and assets rather than detailed financial analysis. S&P Thesys is one good source of financial analysis. The U.K. regulatory returns tend to be liability oriented and insurers have traditionally been given considerable leeway in terms of submission time, although this has recently been tightened. Although most regulatory returns are still filed in paper form, firms now have the option to file electronically. Returns for individual companies are publicly available from Companies House.

Table 6. Holdings of U.K. Securities 1998
(% of outstanding value)

	Life Insurers	Non Life Insurers	Pension Funds
U.K. Gilts	43.0	5.5	30.6
U.K. company shares	20.3	0.9	22.3

Source: ONS

D. General Preconditions for Effective Insurance Supervision

24. The United Kingdom has a well developed judicial system with a reputation for probity and professionalism. Civil commercial matters are normally heard in one of the divisions of the High Court, with appeal processes available through the Court of Appeal and, if accepted, the House of Lords. The senior EU Court is the European Court of Justice and it has similar professional standing to the English upper courts. The legal system is based on case law and domestic and EU legislation. As the United Kingdom has no written constitution, Parliament is the supreme domestic law making body, however as a general principle EU law overrides domestic law under the Treaty of Rome. EU directives agreed by the Council of Ministers and the European Parliament must usually be implemented into national law by member states. International Insurance Law can in many ways be said to be based on U.K. case law given the jurisdiction's long history of insurance actions and

settlements. Many insurance contracts around the world continue to be subject to English law and from a regulatory point of view the legal and judicial precondition could hardly be better satisfied.

25. The professions important to the financial sector are also well developed in the U.K. and are subject to full liability for breach of duty. There are in excess of 65,000 practicing chartered accountants in the U.K. many of which are insurance specialists. In addition there are approximately 3,000 actuaries active in the United Kingdom, all of which are expected to maintain minimum levels of continuing professional training. Both professions have world class qualification and accreditation requirements and are seen as best practice resources by educators and professionals in many other countries. Again it is hard to imagine a better level of satisfaction of a precondition for effective regulation and supervision.

26. One idiosyncratic feature of the U.K. environment is that there is no insurance accounting standard. Instead there is a Statement of Reporting Principles (SORP), largely worked out by the insurance sector on a modified regulatory reporting basis, but informed by general company reporting requirements, and with no objection from the Accounting Standards Board (which in the U.K. has the right to issue standards on its own authority, although under the guidance of the Financial Reporting Council). As a general rule the ASB has taken a limited interest in the financial sector allegedly because of the major scope for disagreement over reporting principles: the assessors were advised that the imposition of IAS in the EU in 2005 will to a large extent supplant the ASB role and that the U.K. will then be in a position to enforce an appropriate modern approach, which is still evolving. The IASB is still engaged in resolving the contentious issue of the valuation of liabilities arising from insurance contracts. In the interim there is ongoing scope for there to be up to three different sets of accounts struck within the United Kingdom for a long-term insurer (regulatory, modified regulatory, and assessed value).

27. The auditing profession is also well established. External auditors need to be members of recognized supervisory organizations and remain eligible to be a member under the rules of that organization (leading to a practicing certificate). Recognized organizations have to ensure that all their members are 'fit and proper' and that audit processes are carried out in a professional manner and with integrity. The role of the external auditor is increasingly taking on a prevention and detection role and the FSA's regulatory model seeks to build on this. The main coordinating body for the six U.K. accounting bodies, the CCAB, is a recognized supervisory body. The assessment team was not able to determine the level of performance of the internal audit function within the insurance sector; however, anecdotal evidence pointed to considerable variation in levels of competence and awareness of the risk based approach. A number of large insurers now employ distinct full time compliance teams with high level reporting lines.

28. A relatively unique aspect of the FSA model is its rejection of the twin peaks model where market conduct and prudential supervision fall under different regulators and/or supervisors. Thus many officers in FSA have a joint responsibility to consider the financial strength of an institution at the same time as they are ensuring that its customers are being

treated fairly. This integrated role can potentially place substantial demands on FSA supervisors if other parts of government also make decisions which affect this trade off.

29. The regulatory environment is in a process of rapid transition with the consolidation of at least nine former regulators into an independent FSA. While the reasons for this are well known and well founded there is a need to ensure that the circumstances which have made the U.K., and London in particular, the insurance center of the world, are not fundamentally altered. Prior to the formation of FSA the key formal insurance regulators was DTI and subsequently HMT, in both cases advised by the Government Actuary's Department (GAD). These were seen to have a light regulatory touch (although the informal rules were well understood by the market) and in practice the role of rating agencies formed a third, market based form of regulation, providing an additional effective influence on governance in the general insurance segment.[5] This has been supplemented by the central role of the appointed actuary in the long term sector. Overriding all of this has been the growing governance roles of directors and managers, supported by the internal and external audit functions.

30. The U.K. authorities are in the process of strengthening their approach to insurance regulation along the lines of their risk-based approach to supervision. The creation of the FSA as a single regulator revealed significant differences between the supervision of insurance and other financial sectors regarding similar types of risk. The so-called Tiner project has been initiated to implement and take forward a risked-based approach to insurance supervision where regulatory attention focuses on firms and activities likely to pose the greatest risk to the achievement of the regulator's statutory objectives. This has already been reflected in the inclusion of major life and non-life offices in the Major Financial Groups Division (MFGD) of the FSA which conducts integrated regulation and supervision of the most important market participants. The Tiner project also aims at improving the prudential and conduct of business regimes for insurers, notably an increased focus on the firms' strategies, quality of management and systems and controls; an improved disclosure and financial reporting regime; and a more proactive prudential regime with less reliance on desk-based analysis of financial returns.

31. The U.K. easily satisfies the preconditions for a full assessment.

E. Principle-by-Principle Assessment

32. As to the main findings of the mission regarding insurance supervision, the key issue is that FSA's interim regime presently lacks a sufficient degree of experienced on site examination capacity. In addition greater precision in defining what is required of management and boards is desirable as many smaller institutions in particular will not be

[5] Private agencies are the best source of detailed financial performance data and analysis on the insurance sector, although at a substantial cost for the average consumer. Individual company information is available but this is likely to be opaque to most consumers.

familiar with modern risk management concepts. Thus, while the assessors agree that the FSA's objective of placing more governance and internal control responsibilities on insurance firms' boards and management is highly desirable, they strongly feel that more independent assessment of the effectiveness of firms' systems and controls is warranted.

33. At present there is no guarantee that a sufficiently comprehensive review of the appropriateness of firms' risk management systems, asset allocation limits, internal controls, capital and reserves, and reinsurance programs will take place in light of the nature and amount of business underwritten: this is particularly the case where bank based large groups containing significant insurers are involved, or bank supervisors have been given very large insurance based groups to supervise and assimilate. This skills requirement will become even more evident when the envisaged risk-based approach to supervision (together with fair value accounting) is introduced, as this will inevitably require the ability to review complex simulations using model offices. As a consequence, the FSA should take steps to ensure that the risk review team, on which the large group supervisors draw, formally contains (either as establishment or through a solid line matrix) specialist insurance expertise in areas such as reinsurance, actuarial modeling and long-tail non-life claims, in addition to generalist insurance people. Some of these skills are scarce (for example non life actuarial skills) and long term consulting or staff exchange programs may be appropriate.

34. In terms of the current interim supervisory model, the present desk-based analysis of returns does not appear to adequately capture the risks of underlying exposures, again largely because of the availability and disposition of the requisite skills. Consequently, the assessors are of the view that the IAIS CPs 5, 6, 7, and 12 are broadly rather than fully observed. The mission also confirms the authorities' self-assessment that CP 13, as formulated, is materially non-observed, given the limited reliance on onsite inspections under the current practice, while the core principles call for detailed onsite reviews of books, records, accounts and other documents. By contrast the assessors feel that the standards achieved in the U.K. under the governance and market conduct CPs constitute very good examples of international best practice.

35. It is the assessors' understanding that the FSA is currently in the process of rolling out new risked-based modalities for prudential supervision (and related market conduct supervision in the case of with profits contracts) of insurance markets and building the available insurance skills base. These actions are based on the findings of the Tiner report and will operate within the overarching risk based philosophy and methodology which has been developed in the last three years. This program is expected to remedy most of the noted shortcomings on the prudential side. As a consequence, the recommendations which appear below are intended to work within this new framework, while emphasizing the unique (and in many cases highly indeterminate) nature of many insurance balance sheet risks.

Table 7. Detailed Assessment of Observance of the IAIS Insurance Core Principles

Principle 1.	**Organization of an Insurance Supervisor** The insurance supervisor of a jurisdiction must be organized so that it is able to accomplish its primary task, i.e., to maintain efficient, fair, safe, and stable insurance markets for the benefit and protection of policyholders. It should, at any time, be able to carry out this task efficiently in accordance with the Insurance Core Principles. In particular, the insurance supervisor should: – be operationally independent and accountable in the exercise of its functions and powers; – have adequate powers, legal protection, and financial resources to perform its functions and exercise its powers; – adopt a clear, transparent, and consistent regulatory and supervisory process; – clearly define the responsibility for decision-making; and – hire, train, and maintain sufficient staff with high professional standards who follow the appropriate standards of confidentiality.
Description	The responsibilities and objectives of the Financial Services Authority (FSA) as the regulator and supervisor of insurers are set out in the Financial Services and Markets Act 2000 (FSMA). In discharging its general functions, the FSA is required to act in a way that is compatible with the regulatory objectives. The regulatory objectives are: (a) maintaining confidence in the financial system; (b) promoting public understanding of the financial system; (c) securing the appropriate degree of protection for consumers; and (d) reducing the extent to which it is possible for an authorized business to be used for a purpose connected with financial crime. The FSA functions as a public authority by virtue of statutory powers granted by the FSMA, but is operationally independent having been established as a private company limited by guarantee. It is responsible for its own budget and is financed by direct levies on the industry. The FSA has the ability to hire and maintain staff with the appropriate skills and is responsible for its own staff remuneration policy. It is also required to have regard to the principles of good regulation specified in the FSMA, such as the need to use its resources in the most efficient and economic way. The FSA's Handbook of rules and guidance ("the Handbook") is publicly available: changes in the rules are subject to consultation. A decision-making manual forms part of the Handbook. The FSA makes and maintains effective arrangements with consulting practitioners and consumers on the extent to which its general policies and practices are consistent with its general duties. It also maintains separate practitioner and consumer panels. The FSMA grants the FSA wide powers to take action against insurance firms which do not comply with the requirements set out in the Act, secondary legislation under the FSMA and the rules set out in the Handbook. Under the powers of intervention of the FSMA, actuarial or general investigations into insurers may be ordered. These may be undertaken by third parties with the required skills. The FSA is able to recruit expert assistance when needed. The FSA Code of Conduct sets out clear rules on dealing with insurance companies and conflicts of interest. When staff are appointed to the FSA, they are required to provide details to an Ethics Officer of all significant relationships that may be relevant to their work. Changes in this information must be notified. Similarly, direct holdings of shares in regulated firms need to be notified to the Ethics Officer and the information updated. Staff cannot themselves hold or deal in shares and related investments of the institutions they supervise. Nor can they accept gifts other than of a token kind, or excessive hospitality.

	The FSMA provides that the FSA and any person who is, or is acting as, a member officer or member of staff of the FSA, is not to be liable for damages regarding anything done or omitted in the discharge, or purported discharge, of the FSA's functions. However, this protection does not apply if the act or omission is shown to have been in bad faith, or unlawful.
Assessment	Observed
Comments	Officially, the FSA became an integrated regulator on December 1, 2001. Consistent with the powers granted under the FSMA, the FSA is organized and operates in a manner that ensures that it is able to comply with its regulatory mandate. The essential elements of this core principle have been met but the competitive pressures faced by insurers are increasing. The resulting supervisory challenges the FSA faces in the insurance sector will no doubt require increased emphasis on resource needs and staff training and development. The FSA should consider strengthening its core insurance expertise to include individuals with significant experience in reinsurance, actuarial science and long tail, non life claims. The addition of these individuals would likely be organized in a matrix structure. The availability of their technical skills to all supervisors, particularly those working within MFGD, should be actively promoted within the FSA. The inclusion of the larger insurance firms within MFGD promotes consistent, consolidated supervision. However, since some of these insurance firms are supervised by staff whose background is in banking, the FSA runs the risk—at least transitionally--that these supervisors may not always recognize when staff, with the insurance expertise described above, may be required. The fundamental importance of the insurance risk liabilities for balance sheet and profit/loss accounting purposes (both statutory and published) underlines the seriousness of this point. Since the initial assessment was undertaken, further insurance experience has been gained in the MFGD teams, and the overall availability of insurance skills and expertise within the FSA has been enhanced.
Principle 2.	**Licensing** Companies wishing to underwrite insurance in the domestic insurance market should be licensed. Where the insurance supervisor has authority to grant a license, the insurance supervisor: – in granting a license, should assess the suitability of owners, directors, and/or senior management, and the soundness of the business plan, which could include proforma financial statements, a capital plan, and projected solvency margins; and – in permitting access to the domestic market, may choose to rely on the work carried out by an insurance supervisor in another jurisdiction if the prudential rules of the two jurisdictions are broadly equivalent.
Description	The effecting and carrying out of contracts of insurance as a principal is a regulated activity in the U.K. and requires authorization. The FSA must ensure that applicants satisfy and will continue to satisfy the "threshold conditions" set out in the FSMA in relation to all of the regulated activities for which they will have permission. There are five general Threshold conditions, covering legal status, location of offices, close links, adequate resources and suitability. The threshold conditions represent a framework against which an applicant can be thoroughly assessed on all relevant criteria. In that framework, an assessment is made of appropriate financial resources and projected solvency, adequate systems and controls, integrity and competence of senior management, directors and controllers, and the applicant's regulatory history. As part of the assessment of whether an applicant satisfies and will continue to satisfy the threshold conditions, the FSA considers whether the applicant is ready, willing and organized to comply with the regulatory requirements to which it will be subject if it is granted permission. Permission to carry on regulated activities may be accompanied by specific requirements placed

	on the insurer. Insurers appropriately authorized in another EEA Member State may operate in the U.K. through a branch or on a cross-border services basis under a passport arrangement, based on the common standards of supervision established under the EU Insurance Directives.
Assessment	Observed
Comments	The FSA has well developed policies and procedures in place to ensure that any insurer wishing to operate in the U.K. meets the stated regulatory requirements.
Principle 3.	**Changes in Control** The insurance supervisor should review changes in the control of companies that are licensed in the jurisdiction. The insurance supervisor should establish clear requirements to be met when a change in control occurs. These may be the same as, or similar to, the requirements which apply in granting a license. In particular, the insurance supervisor should: – require the purchaser or the licensed insurance company to provide notification of the change in control and/or seek approval of the proposed change; and – establish criteria to assess the appropriateness of the change, which could include the assessment of the suitability of the new owners as well as any new directors and senior managers, and the soundness of any new business plan.
Description	Under existing legislation, a person proposing to take control of or vary its existing control over an insurance firm must notify the FSA. The insurance firms are also required to notify the FSA of any changes in control. The FSA has the power to object to changes in control. The specific documents that the insurers have to submit depend on the licensing requirements of the jurisdiction and are consistent with the documentation required for new license applications. When a change in control occurs, the suitability of the new owners, directors and senior managers, and the soundness of any new business plan are checked. Where changes to business strategy are proposed these too will be assessed. The normal process would involve the consideration of the proposed business strategy against the existing business strategy and the assessment of the likely benefits/drawbacks. In the case of life insurers the actuarial advice provided by the FSA's actuarial department would be a critical consideration. In deciding whether the approval requirements are met, the FSA must ensure that the insurance firm satisfies and will continue to satisfy the Threshold conditions which are the same standards that apply to those who seek to obtain permission to carry on insurance business for the first time.
Assessment	Observed
Comments	The FSA has well-developed systems and procedures in place to address issues relating to changes in control.
Principle 4.	**Corporate Governance** It is desirable that standards be established in the jurisdictions which deal with corporate governance. Where the insurance supervisor has responsibility for setting requirements for corporate governance, the insurance supervisor should set requirements with respect to: – the roles and responsibilities of the board of directors; – reliance on other supervisors for companies licensed in another jurisdiction; and – the distinction between the standards to be met by companies incorporated in his jurisdiction and branch operations of companies incorporated in another jurisdiction.
Description	In respect of firms regulated by the FSA, there is a range of rules relevant to corporate governance. These rules are elaborated in Principles (eleven in total) which are fundamental obligations placed on firms, and derive from the FSA's general rule-making power in the FSMA. However, they do not apply where the matter in question falls under the firm's Home State regulator under EC Directives.

	A firm is also required to satisfy, and continue to satisfy threshold conditions in order to be given and to retain its permissions under the Act. The FSA must ensure that a firm satisfies and will continue to satisfy the Threshold conditions in relation to each regulated activity for which it has, or will have, permission. In addition to conditions governing the legal form of insurance companies, the threshold conditions require that the resources of the person concerned must, in the opinion of the FSA, be adequate in relation to the regulated activities that he/she seeks to carry on, or carries on. In reaching its opinion, the FSA may take into account the person's membership of a group and the effect which that membership may have. If it appears that an authorized person is failing, or likely to fail, to satisfy the Threshold conditions, the FSA may take action to vary or revoke the firm's permissions. The threshold conditions are complemented by high level systems and control requirements, which include the encouragement of firms' directors and senior managers to take appropriate practical responsibility for their firms' arrangements on matters that impinge on the FSA's functions under the FSMA. The FSA is not primarily concerned with risks that threaten only the owners of a financial business except, in so far as those risks may have an impact on the FSA's mandate. The FSA, however, does recognize the need to balance the unique interests of shareholders and consumers alike. In addition to the high level systems and controls noted above, the FSA has in place an Approved Persons' Regime, which requires certain individuals within all financial services companies, including the directors and many senior managers, to remain fit and proper (FIT) and to comply with certain standards of behavior set out in Statements of Principle for Approved Persons and a Code of Practice (APER). The tone and layout of APER is similar to the Principles for Businesses and it describes seven Principles that govern the performance of the director's or senior manager's role. These include personal elements like due skill, care and integrity as well as the organization and control of the areas of business under the individual's direct control.
Assessment	Observed
Comments	The FSA, which has considerable rule-making power under the FSMA, has in place a comprehensive set of rules and guidelines for use by its supervised firms and its own staff and these are consistent with the requirements of this core principle. Nevertheless, two recommendations are presented below. The FSA should consider making it mandatory for a Financial Condition Report (FCR) to be signed off by the Board and subsequently made available to the FSA. The Board should take responsibility for the analysis of the FCR and ensure that the level of resilience/scenario testing is appropriate to the complexity and size of the organization. The FSA may wish to work closely with the appropriate professional bodies and develop guidance for use by supervised firms when preparing the FCR. At the conclusion of every review of high impact firms, senior officials from the FSA should meet formally with the audit committees to review and present the management letter points. At these meetings, it is good practice to request an *in camera* meeting with only the non-executive members of the audit committee.
Principle 5.	**Internal Controls** The insurance supervisor should be able to: – review the internal controls that the board of directors and management approve and apply, and request strengthening of the controls where necessary; and – require the board of directors to provide suitable prudential oversight, such as setting standards for underwriting risks and setting qualitative and quantitative standards for investment and liquidity management.
Description	The FSA's eleven Principles for Businesses apply to some aspects of internal control. These

	principles cover a wide array of topics and are fundamental obligations placed on firms, deriving from the FSA's general rule-making power in the FSMA. In addition, threshold conditions represent the minimum conditions which a firm is required to satisfy, and continue to satisfy, in order to be given and to retain their permissions under the Act. The FSA must ensure that a firm satisfies and will continue to satisfy, the Threshold conditions in relation to each regulated activity for which it has, or will have, permission. Assessment of a firm's internal controls is through a combination of off-site and on-site monitoring; however, the emphasis is on off-site monitoring. This assessment process determines whether the firm has taken reasonable steps to identify all risks of regulatory concern that it may encounter in conducting its business, and has installed appropriate systems and controls and appointed appropriate human resources to manage them prudently at all times. Firms are required to notify the FSA of any proposed restructuring, reorganization or business expansion which could have a significant impact on the firm's risk profile, and any significant failure in the firm's systems or controls, including those reported to the firm by the firm's external auditor.
Assessment	Broadly Observed
Comments	Based on current practices, this core principle is rated Broadly Observed; however, when the new risk-based methodology is implemented in the insurance sector, the requirements of this principle will be met. Essential Criteria # 1 is the primary reason for the assigned rating. The completeness, appropriateness and effectiveness of a firm's internal controls and systems are fundamental to its on-going viability and competitive position in the industry. The FSA's requirements on systems and controls provide good guidance for the industry and, when implemented effectively, should foster a strong internal control discipline by senior management and the Board. However, the effectiveness of these controls and systems need to be independently reviewed and tested from time to time. Currently, only limited independent, on-site reviews are carried out. Again, the level of review needs to be enhanced, in order to ensure that systems and controls are effective. One way to accomplish this is to consider more effective use of external checks and balances. This could include the use of auditors, skilled persons and supervisors. Operational risk, in particular, is most effectively assessed in the field, and working in the field also affords a unique opportunity for supervisors to develop a better understanding of the firm's operations. The FSA is strongly encouraged to devote more attention to this aspect of supervision in the future. The increasing pressures on insurance firms require management to pay more attention to risk management practices. In the current environment, most firms, particularly those in MFGD, are strengthening their risk management practices; however, where this is not true, the FSA should consider encouraging those firms to do so. Possible actions that could be taken by such firms include the establishment of a risk management function and a risk committee of the Board. Management letters issued by the FSA to a firm are important pieces of correspondence that usually deal with prudential issues which are also of interest to a firm's auditors. Many firms routinely provide copies of management letters to their auditors, but this is not done consistently. The FSA may wish to standardize its procedures for management letters by including a requirement that firms provide a copy to their auditors on a timely basis.

<table>
<tr><td>Principle 6.</td><td>Assets
Standards should be established with respect to the assets of companies licensed to operate in the jurisdiction. Where insurance supervisors have the authority to establish the standards, these should apply at least to an amount of assets equal to the total of the technical provisions, and should address:
– diversification by type;
– any limits, or restrictions, on the amount that may be held in financial instruments, property, and receivables;
– the basis for valuing assets which are included in the financial reports;
– the safekeeping of assets;
– appropriate matching of assets and liabilities; and
– liquidity.</td></tr>
<tr><td>Description</td><td>The FSA’s Principles for Business include that a firm must maintain adequate financial resources. Rules also provide comprehensive guidance for firms to follow when dealing with important issues such as asset diversification, matching of liabilities in any particular currency by assets in that currency, provisions relating to the location of assets, adequate spread, the separation of the assets and liabilities, method of valuing assets, and the extent to which an asset may be taken into account for prudential purposes.

The FSA requires firms to have in place suitable control and management information systems to enable the company to implement an appropriate investment strategy. The investment strategy should be reflected in clear terms of reference by the company to its investment managers, who must be qualified and competent to carry out their assigned task and whose remuneration package should be consistent with that strategy. The work of the investment managers should be monitored sufficiently closely to ensure that the company's strategy is being followed.

Also, a life insurance company must at all times identify the assets held by it which it considers to be the most suitable to cover its obligations; and make prudent provision for the effect on the amount of its excess assets of adverse variations between the value of the assets identified and the value of the assets which it may be obliged to deliver to meet its obligations. Life insurers must apply resilience tests for which guidance is laid down by the FSA. The Integrated Prudential Sourcebook that the FSA intends to bring in will introduce similar controls for non-life insurers.

In the case of life insurers, the appointed actuary plays a significant role in ensuring that the insurer has made proper provision in respect of its liabilities, and in monitoring the risks the firm runs where these are material to the firm’s ability to meet its liabilities to policyholders.

Each year, as part of the annual returns, Directors are expected to certify that the company’s systems and controls comply with the FSA’s requirements. The ‘reasonableness’ of the Directors’ certification of compliance is subject to external audit opinion. These reports are reviewed by the FSA, and supervisors may also seek to verify directly with the firm that adequate controls exist.</td></tr>
<tr><td>Assessment</td><td>Broadly Observed</td></tr>
<tr><td>Comments</td><td>Based on current practices, this core principle is rated as Broadly Observed; however, the implementation of the proposed risk-based methodology will result in this principle rated as Observed. Essential Criteria 4, 5 and 7 are the primary reasons for the assigned rating.
As described above, the FSA has strong standards and rules governing the assets held by a firm to cover its liabilities. These rules cover the essential elements of asset management, such as the establishment of investment policy, valuation, safe keeping, matching of assets and liabilities and the existence of adequate internal controls. Tightly controlling risks (market, credit, liquidity operational and legal) associated with investment activities is of particular significance in an</td></tr>
</table>

	insurance firm as they could affect the determination and on–going sufficiency of the technical provisions. The review of a firm's risk management policies and systems, internal controls and internal audit programs usually requires specialized expertise and is best assessed in the field. More balance between desk review and independent testing on site is required in order to meet the requirements of this core principle which are demanding. The new risk-based methodology, which is currently being developed, will meet this objective but, at present, it is not being achieved in a consistent manner.
Principle 7.	**Liabilities** Insurance supervisors should establish standards with respect to the liabilities of companies licensed to operate in their jurisdiction. In developing the standards, the insurance supervisor should consider: – what is to be included as a liability of the company, for example, claims incurred but not paid, claims incurred but not reported, amounts owed to others, amounts owed that are in dispute, premiums received in advance, as well as the provision for policy liabilities or technical provisions that may be set by an actuary; – the standards for establishing policy liabilities or technical provisions; and – the amount of credit allowed to reduce liabilities for amounts recoverable under reinsurance arrangements with a given reinsurer, making provision for the ultimate collectability.
Description	The FSA's power to prescribe standards for establishing technical provisions and other liabilities derives from its rule making powers under the FSMA. Insurers must maintain such accounting and other records as are necessary for identifying the liabilities attributable to each kind of business it carries on. The Interim Prudential Sourcebook for Insurers covers the identification and application of assets and liabilities relating to long-term business. Long-term liabilities must be determined on the basis of actuarial principles, having regard to the reasonable expectations of policyholders and relevant actuarial guidance, and make proper provision for all liabilities using prudent assumptions that include appropriate margins for adverse deviation of the relevant factors. In the case of non-life insurance, the responsibility for establishing prudent technical provisions and provisions for other liabilities rests first and foremost on the management of the insurance company and its advisers. The U.K. legislation does not generally lay down precise rules on how non-life liabilities are to be calculated. The accounting profession has developed statements of recommended practice, and independent auditors must certify that the reserves have been established in accordance with regulatory requirements and professional standards. The core requirement is that the reserves should be sufficient to meet liabilities in all reasonably foreseeable circumstances. The various sorts of technical reserves that a non-life insurance company should establish are defined in the Companies Act 1985. Discounting of outstanding long tail claims is allowed within a clearly defined framework. The annual return provided by insurers, including information on technical provisions and an abstract of the appointed actuary's valuation report, are examined by the FSA. Where there are concerns that the technical provisions have not been appropriately calculated, the supervisory authority can use its powers of intervention to require an actuarial or general investigation. The FSA may assess the adequacy of the technical provisions through on or off-site monitoring or a combination of the two. It also has the power to require reports by skilled persons into the adequacy of the technical provisions granted by the FSMA. Regarding reinsurance use, insurers may take credit for reinsurance recoveries up to the amounts reasonably expected to be recovered. However, in the solvency margin calculation, insurers are

	only allowed to take credit for reinsurance recoverables up to a maximum of 50 percent.
Assessment	Broadly Observed
Comments	This core principle is rated as Observed for the life firms and Broadly Observed for the non-life firms. While the FSA's supervisors are likely to identify problems related to long-tail, non-life claims, the scarcity of qualified non life personnel makes it difficult to perform the required follow up. The U.K. is assessed as not being fully compliant with Essential Criteria # 3. The nature of the non-life liabilities makes it increasingly important to establish rules and guidance for use by supervised firms. Long-tail non-life liabilities should be subject to a rigorous overview by the appropriate mix of professional bodies at the insurer level. Input from this multi-discipline professional team should be considered in the development of the Financial Condition Report. The determination of policy liabilities in life firms is a highly specialized task and involves the use of considerable judgment by the appointed actuary. Judgment is required even though the appointed actuary is required to calculate the policy reserves within the guidelines set out by the professional body. Judgment is particularly critical for some products as results are highly sensitive to certain assumptions and slight variations can result in material differences in reserve balances. For these reasons the assessors believe it would be good practice to require the implementation of a peer review process and the FSA may want to work with the Institute of Actuaries or other relevant professional bodies to implement such a review. Depending on the company-specific situation, a multi-discipline team may be required to do the review.
Principle 8.	**Capital Adequacy and Solvency** The requirements regarding the capital to be maintained by companies which are licensed, or seeking a license, in the jurisdiction should be clearly defined and should address the minimum levels of capital or the levels of deposits that should be maintained. Capital adequacy requirements should reflect the size, complexity, and business risks of the company in the jurisdiction.
Description	FSA rules require both life and non-life insurers to maintain a margin of solvency. The basic obligations reflect the EU solvency and minimum capital requirements. Whilst larger companies are clearly required to have larger solvency margins in absolute terms under these provisions, different levels of complexity or business risks are not currently reflected in specific EU or U.K. solvency requirements - except to a very limited extent in the fixed minimum capital requirements. The FSA nevertheless seeks to ensure, and has the powers to require and enforce, that individual companies maintain solvency margins appropriate to the nature of their business, which in many cases are several multiples of the EU requirements. The powers under the FSMA may be used to set an individual requirement for an insurer necessitating that they maintain a particular level of financial resources. The financial returns made to the FSA, provide the necessary information to allow the supervisor to monitor assets, liabilities and compliance with the solvency margin requirements. The FSA reviews and analyses the returns, and investigates any problems identified with the firms concerned. The FSA may also examine these areas through on-site inspections. The directors of an insurance company have to certify in respect of the annual return to the FSA that the company has maintained the required margin of solvency throughout the financial year in question. The auditor, in the report they are obliged to produce, is required to provide their opinion whether it was reasonable for the directors to have made the statement. Given the international nature of the U.K. insurance market, the ability to share prudential information with other regulators is of critical importance. The Financial Services and Markets

	Act 2000 (Disclosure of Confidential Information) Regulations 2001, contains gateways permitting the exchange of supervisory information with other insurance supervisory authorities.
Assessment	Observed
Comments	In May 2002 the FSA issued consultation paper 136 "Individual Capital Adequacy Standards" which will result in a comprehensive review of the capital requirements for all firms, including the informal rules currently used by non-life firms. For non-life firms, the capital requirement is a combination of formal and informal requirements. The formal requirements are set out in the EU Directives. There are adjustments for reinsurance, based on actual recoveries and subject to a maximum reduction of 50 percent. The informal requirement is determined based on "rules of thumb" which have emerged such as 200 percent of minimum requirements for less risky lines of business while for more risky lines, the norm is about 300 percent to 400 percent of minimum requirements. More formalized risk-based capital rules are clearly required and this is recognized by the FSA.
Principle 9.	**Derivatives and 'Off-Balance Sheet' Items** The insurance supervisor should be able to set requirements with respect to the use of financial instruments that may not form a part of the financial report of a company licensed in the jurisdiction. In setting these requirements, the insurance supervisor should address: – restrictions in the use of derivatives and other off-balance sheet items; – disclosure requirements for derivatives and other off-balance sheet items; and – the establishment of adequate internal controls and monitoring of derivative positions.
Description	FSA rules set out the principles governing the use of derivatives by insurers, and these are supplemented by guidance dealing with systems and controls over investments with particular reference to the use of derivatives. The U.K. approach seeks to ensure that derivatives are not used in a way that is speculative or which might have the effect of weakening the company materially. Guidance issued by FSA covers the standards to be achieved by companies' systems and controls. This includes the requirement for insurers to have in place written guidelines on the use of derivatives which must be approved by the Board, and must be consistent with the company's agreed investment strategy. The following must be addressed in the guidelines: objectives and policies for use of derivatives, types of instrument, the establishment of prudent limits, exposures and volumes, competence and qualifications of staff, and the segregation of functions. Directors are required to ensure derivatives use is monitored and in line with the objectives and policy contained in the guideline. Directors must also ensure that risk management and control systems are capable of analyzing and monitoring the risk of all transactions undertaken by the organization individually and in aggregate. Each year, as part of the annual returns, Directors are expected to certify that the company's systems and controls comply with the FSA's requirements. The 'reasonableness' of the Directors' certification of compliance is subject to external audit opinion. The annual returns provide the basis for off-site monitoring of the adequacy of the internal controls over derivatives. The controls may also be checked on-site, and in this respect the FSA expects to make increasing use of its market risk review team. Every insurer must attach to the annual return covering their balance sheet, profit and loss account and revenue account a statement comprising a brief description of any investment guidelines followed by the insurer for the use of derivative contracts and of other matters

	concerning the use of derivatives.
Assessment	Observed
Comments	FSA rules set out the principles governing the use of derivatives by insurers, and these are supplemented by guidance dealing with systems and controls over investments with particular reference to the use of derivatives. The U.K. approach seeks to ensure that derivatives are not used in a way that is speculative or which might have the effect of weakening the company materially.
Principle 10.	**Reinsurance** Insurance companies use reinsurance as a means of risk containment. The insurance supervisor must be able to review reinsurance arrangements, to assess the degree of reliance placed on these arrangements and to determine the appropriateness of such reliance. Insurance companies would be expected to assess the financial positions of their reinsurers in determining an appropriate level of exposure to them. The insurance supervisor should set requirements with respect to reinsurance contracts or reinsurance companies addressing: – the amount of the credit taken for reinsurance ceded. The amount of credit taken should reflect an assessment of the ultimate collectability of the reinsurance recoverable and may take into account the supervisory control over the reinsurer; and – the amount of reliance placed on the insurance supervisor of the reinsurance business of a company which is incorporated in another jurisdiction.
Description	FSA's rules require insurers to report to the supervisory authority on their reinsurance arrangements. This information is analyzed with respect to the appropriateness of the programme and the security provided. Non-life insurers have to provide statements covering their major reinsurers, both treaty and facultative. These statements include information on any connections the insurer might have with the reinsurer; the amount of reinsurance payments payable; and the amount of anticipated recoveries to the extent that these have been taken into account by the company in determining the reinsurers' share of the technical provisions in respect of claims outstanding. In addition, companies have to provide a detailed statement of the business ceded. Reinsurers are subject to direct regulation in the United Kingdom, in addition to the supervision applied through the review of the reinsurance cessions of direct insurers. Primary insurers that accept reinsurance risks are supervised in respect of the whole of their business. The supervision of reinsurers is carried out in broadly the same manner as the supervision of direct insurers, though with specific attention being paid to the potential for aggregation of risk within reinsurers which might, for example, make them particularly vulnerable to a specific event or chain of events. The full range of supervisory controls apply, including reporting requirements; on and off-site monitoring; the ability to intervene; authorization by class of business; fit and proper requirements; and systems and controls requirements. As noted earlier, insurers may take the credit for reinsurance recoveries up to the amounts reasonably expected to be recovered. However, in the solvency margin calculation, insurers are only allowed to take credit for reinsurance recoverables up to a maximum of 50 percent of claims. The FSA has powers to share confidential information with other supervisors in appropriate circumstances.
Assessment	Observed
Comments	Reinsurance usually requires specialized knowledge in order to conduct any meaningful review. Reinsurance contracts tend to be company-specific and the determination of whether there is a true transfer of risk, or lack thereof, can be elusive. The Board, however, is ultimately responsible for ensuring that the proper level of reserve credit is taken by the firm. The FSA has

	used reinsurance specialists in the past to assist with its supervisory work but only on an ad-hoc basis. The complexity of reinsurance arrangements – particularly financial reinsurance – makes it difficult for even skilled supervisors to assess the adequacy of the reinsurance program of insurance companies relative to their level of capital and the risk profile of the underwriting book. Moreover as a considerable share of reinsurance arrangements tends to be ceded offshore, it becomes increasingly difficult for U.K. regulators to assess the recoverability of claims held by domestic insurers on their reinsurers. For this reason, the assessors strongly support the rapid introduction of an EU reinsurance directive and international standards. A further challenge with respect to reinsurance is the limitation of the current data base system to capture meaningful data on reinsurance use within the insurance industry. This is a challenge for all regulators world-wide and does serve to make supervisors' job very difficult. The FSA may wish to consider implementing a thematic review of reinsurance operations across the firms for purposes of ensuring that, all firms and the industry in general, have put in place appropriate controls and systems to deal with this important risk.
Principle 11.	**Market Conduct** Insurance supervisors should ensure that insurers and intermediaries exercise the necessary knowledge, skills, and integrity in dealing with their customers. Insurers and intermediaries should: – at all times act honestly and in a straightforward manner; – act with due skill, care, and diligence in conducting their business activities; – conduct their business and organize their affairs with prudence; – pay due regard to the information needs of their customers and treat them fairly; – seek from their customers information which might reasonably be expected before giving advice or concluding a contract; – avoid conflicts of interest; – deal with their regulators in an open and cooperative way; – support a system of complaints handling, where applicable; and – organize and control their affairs effectively.
Description	The FSA is responsible for the supervision of the sale and marketing of life insurance with an investment element. Since the majority of life insurance sold within the U.K. has an investment element, the FSA effectively regulates the sale and marketing of all life insurance. The supervision of the sale and marketing of non-life insurance is in a period of transition. The Government recently announced that the sale of non-life insurance will in future be regulated by the FSA. This will require considerable preparatory work by the FSA before the transfer from the existing - non-statutory – regulatory regime can be effected in 2004. In the meantime the General Insurance Standards Council (GISC) will continue in its role as an independent, non-statutory organization to regulate the sales, advisory and service standards of its members (insurers and intermediaries - including brokers, agents, and anyone acting for them). Those insurers and intermediaries that are not members of the GISC will continue to be subject to the provisions contained in the Association of British Insurers' Code of Practice (ABI Code).[6]

[6] Full title is "General Insurance Business – Code of Practice for all Intermediaries (Including Employees of Insurance Companies) Other than Registered Insurance Brokers". The reference to registered insurance brokers is to those brokers previously registered with the Insurance Brokers Registration Council – now abolished.

	There is a continuing and enforceable requirement throughout the lifetime of all financial services firms authorized by the FSA, that all approved persons are fit and proper to hold their office. Persons requiring approval are those who exercise controlled functions within the firm. Controlled functions as defined in the Handbook include governing functions, such as director or chief executive; required functions, such as compliance oversight; and significant management functions such as financial resources or insurance underwriting. Certain customer functions, such as the investment adviser function, are also controlled functions. The FSA's Supervision Manual notes that on-site inspection is one of the tools that may be used to monitor whether a firm, once authorized, remains in compliance with regulatory requirements. The FSA also has rules in place relating to the internal handling of complaints, including the procedures which a firm must put in place; the time limits within which a firm must deal with a complaint; the records of a complaint which a firm must make and retain, and the requirements on a firm to report information about complaints to the FSA. Complaints that cannot be resolved between insurers and private customers can be referred to the Financial Services Ombudsman.
Assessment	Observed
Comments	The FSA requires supervised firms to have well-developed systems and controls in place to deal with issues relating to market conduct. The FSA follows up in an appropriate manner to ensure that firms are distributing their products appropriately and that customers are treated fairly.

Principle 12.	**Financial Reporting** It is important that insurance supervisors get the information they need to properly form an opinion on the financial strength of the operations of each insurance company in their jurisdiction. The information needed to carry out this review and analysis is obtained from the financial and statistical reports that are filed on a regular basis, supported by information obtained through special information requests, on-site inspections, and communication with actuaries and external auditors. A process should be established for: – setting the scope and frequency of reports requested and received from all companies licensed in the jurisdiction, including financial reports, statistical reports, actuarial reports, and other information; – setting the accounting requirements for the preparation of financial reports in the jurisdiction; – ensuring that external audits of insurance companies operating in the jurisdiction are acceptable; and – setting the standards for the establishment of technical provisions or policy and other liabilities to be included in the financial reports in the jurisdiction. In so doing, a distinction may be made: – between the standards that apply to reports and calculations prepared for disclosure to policyholders and investors, and those prepared for the insurance supervisor; and – between the financial reports and calculations prepared for companies incorporated in the jurisdiction, and branch operations of companies incorporated in another jurisdiction.
Description	The FSA's rule-making powers under the FSMA enables the Authority to prescribe rules for financial reporting. Insurers are required to produce an annual return for the FSA in addition to their statutory accounts for shareholders or members. The outline contents of returns laid down in the rules are: • profit and loss account, revenue account and balance sheet, together • with notes, statements and reports and directors' certificates annexed thereto; • an abstract of the annual investigation of the appointed actuary; and • an auditor's report. The accounts and balance sheets of every insurer must be audited by a person qualified in accordance with rules set out in the FSA's Handbook. Assets generally have to be valued at either net asset value or current market value, although there are some specific rules as to the valuation of individual assets, such as real estate. For both long-term and general insurance business the amount of the liabilities must be determined in accordance with generally accepted accounting concepts, bases, policies and other generally accepted methods appropriate to insurers. Long-term liabilities must be determined on the basis of actuarial principles having regard to the reasonable expectations of policyholders and relevant actuarial guidance and include proper provision for all liabilities using prudent assumptions that include appropriate margins for adverse deviation of the relevant factors. Companies carrying on life assurance business are required to conduct a periodic actuarial investigation by the appointed actuary. The appointed actuary must certify, amongst other things, that proper records have been kept, that proper provisions have been made, and that assets and liabilities have been assessed in accordance with the prescribed rules. Non-EEA insurers operating in the U.K. through a branch, are required to maintain both a U.K. and global solvency margin and report accordingly. The provisions of the EU Insurance Groups Directive, requiring amongst other things a parent undertaking a solvency margin calculation, have also been reflected in reporting requirements. Reporting of material connected-party transactions is required.

	The annual returns of insurers are entered into FSA's database and various ratios generated, which might indicate if the insurer is running into financial difficulties or if its performance is deteriorating. The ratio analysis helps determine the priority for a more detailed desk analysis of the returns. Problems identified as a result of this analysis, and/or as a result of other information available to the supervisor, are discussed with the insurer's management and appropriate action taken. The FSA has powers to require companies to report more frequently, or to accelerate reports. The annual return is available to the public, but the more frequent reports are usually confidential between the insurer and the FSA.
Assessment	Broadly Observed
Comments	This core principle is rated as Broadly Observed based on current practices, which need enhancing to cope with the rapidly changing risk profile in the industry; however, the proposed implementation of the risk-based methodology for insurance firms will move the rating to Observed. The risk level of the insurance industry is increasing due to pressure points from several fronts including on-going underwriting losses (non-life); reduced returns on investment activities coupled with high expense pressures; and the uncertainty of long-tail liabilities. Currently, firms are required to file regulatory returns annually and may still use a paper medium. Given the rapidity with which an insurance firm's risk profile can change, a move towards quarterly reporting, at least for the higher priority firms, would significantly enhance a supervisor's ability to closely monitor his or her assigned firm(s). Firms that fall under the purview of MFGD, particularly listed firms, should be encouraged to file their MIS reports prior to public release. To accommodate this increased information flow, FSA may need to review its financial reporting data base and systems capability. Furthermore, it is necessary to carry out a review of the nature of the existing data being received as some data may no longer be relevant. Consequently, changes to the regulatory returns may be required. Public disclosure of relevant information on a timely basis is one element of the three-pillar approach proposed by the Basel Committee for banking supervision, but is equally applicable to insurance firms. There is an increasing need for all firms to disclose more relevant information in their published financial reports. For example, there is need for firms to include more information on risk management practices, risk exposures and sources of gains and losses. In this connection, the FSA has an important role to play in encouraging firms to adopt more appropriate disclosure practices.
Principle 13.	**On-Site Inspection** The insurance supervisor should be able to: – carry out on-site inspections to review the business and affairs of the company, including the inspection of books, records, accounts, and other documents. This may be limited to the operation of the company in the jurisdiction or, subject to the agreement of the respective supervisors, include other jurisdictions in which the company operates; and – request and receive any information from companies licensed in its jurisdiction, whether this information be specific to a company or be requested of all companies.
Description	The FSA's approach to supervision involves a risk assessment of firms, based on the extent to which they pose risks to the FSA's regulatory objectives. The risk assessment process applies to all firms, although the detail required may vary from firm to firm, and is subject to continuing review. In the case of firms in which risks have been identified which could have a material bearing on the FSA meeting its regulatory objectives, the FSA will also outline a programme

	intended to address these risks. The FSA's use of on-site inspection for prudential purposes in relation to insurers is considered against the background of other reporting requirements and controls. The FSA places considerable reliance on the validity of the information provided in the annual returns, and in particular sees no need routinely to duplicate the work of the auditor and appointed actuary. Onsite inspections have not been a regular feature of supervisory activities to date, particularly with respect to non-life insurance firms. Nevertheless, the figures provided are carefully analyzed off-site. In the case of life insurers especially, specialist actuarial analysis is undertaken. If it seems to the FSA that an auditor or actuary has not performed their role appropriately, the FSA has the authority to disqualify that auditor or actuary. The FSA also has the ability to request further information, as the need arises, for assessment off-site, or to require reports by skilled persons. The policy with regard to on-site inspections of insurance companies is currently evolving. The FSA has announced in its Plan and Budget its intention that risk specialists and supervisors will, in future, spend more time on-site at insurance firms – with a greater proportion of that time spent at higher impact firms, in line with the Authority's risk-based approach to supervision. On-site inspection will address suspected areas of deficiency within an individual company or specific risk/risk management factors. It is not intended to inspect smaller, low risk insurers that represent a small minority of insurance business written in the U.K. on a routine basis. Smaller insurers may, however, be inspected as part of the FSA's examination of particular supervisory themes. The purpose of these inspections will not be routinely to analyze all insurance companies on a rotational basis, or – when an on-site inspection is initiated - all of an individual company's activities. The FSA's risk based approach to supervision requires the Authority's on-site inspections, as its other activities, to be appropriately targeted. The FSA does, however, have the authority to conduct a full on-site inspection covering the elements set out in the criterion. A full-scale on-site inspection would be undertaken if the risk assessment suggested that it would be the right thing to do. In respect of life insurers conducting investment business, appointed representatives and independent financial advisers, the FSA carries out on-site inspections to determine compliance with conduct of business rules. These inspections regularly focus on the sufficiency and adequacy of the information sought from, and given to, customers. It is also the FSA's intention to use the information on complaints and enquiries provided by the Financial Services Ombudsman to identify potential problem areas for follow-up with regulated firms.
Assessment	Materially Non-Observed
Comments	While the FSA has full authority to carry out on-site supervision of supervised firms, on-site reviews are not routine. The FSA does conduct an on-site review when a firm comes under stress, or when prudential concerns arise. The review is tailor-made to fit company-specific circumstances. The FSA is currently undertaking a major review of its approach to insurance regulation, led by John Tiner (Managing Director, Consumer, Investment & Insurance Directorate). The review is not primarily about the legal powers that apply in this area, but concerns various practical aspects of supervision and the way in which the FSA exercises its powers. It is expected that the results will place greater emphasis on on-site inspection in assessing risk exposures. In order to comply with this CP, the FSA will also need to increase the resources and skill set of supervisors who are responsible for supervising the insurance industry. Core insurance expertise should be strengthened by including individuals with experience in reinsurance, risk

	management, actuarial science and long-tail, non-life claims. It is expected that the results of the Tiner project will address these issues.
Principle 14.	**Sanctions** Insurance supervisors must have the power to take remedial action where problems involving licensed companies are identified. The insurance supervisor must have a range of actions available in order to apply appropriate sanctions to problems encountered. The legislation should set out the powers available to the insurance supervisor and may include: – the power to restrict the business activities of a company, for example, by withholding approval for new activities or acquisitions; – the power to direct a company to stop practices that are unsafe or unsound, or to take action to remedy an unsafe or unsound business practice; and – the option to invoke other sanctions on a company or its business operation in the jurisdiction, for example, by revoking the license of a company or imposing remedial measures where a company violates the insurance laws of the jurisdiction.
Description	The FSA has powers under the FSMA to take remedial action against and/or impose penalties on insurers. depending on the severity of the situation. Examples of measures that the FSA can impose include fines, public censure, imposition of requirements or limitations on permission to carry on a regulated activity, and—in extreme cases—cancellation of a permission. Approval for new activities can also be withheld where appropriate. The Regulatory Decisions Committee, which is an FSA committee outside the FSA's management structure, normally takes major regulatory decisions. The FSA can, where necessary, ensure that these actions have immediate effect. It also has criminal prosecution powers in certain circumstances (e.g., breaches of the money laundering regulations). Additionally, the FSA can withdraw an individual's approval to perform controlled functions, if it considers that the person in respect of whom approval was given is not a fit and proper person to perform the function to which the approval relates.
Assessment	Observed
Comments	The FSA has powers under the FSMA to require firms to take remedial action when threats to the solvency of the institutions are noted. Although there are well developed processes within the FSA for dealing with firms when prudential concerns are noted, firms which are placed on a watch list are not formally notified when such action is taken.
Principle 15.	**Cross-Border Business Operations** Insurance companies are becoming increasingly international in scope, establishing branches and subsidiaries outside their home jurisdiction, and sometimes conducting cross-border business on a services basis only. The insurance supervisor should ensure that: – no foreign insurance establishment escapes supervision; – all insurance establishments of international insurance groups and international insurers are subject to effective supervision; – the creation of a cross-border insurance establishment is subject to consultation between host and home supervisors; and – foreign insurers providing insurance cover on a cross-border services basis are subject to effective supervision.
Description	The FSMA includes a general prohibition on carrying on regulated activities in the U.K. without authorization or specific exemption. An EEA insurer subject to prudential supervision in its home state may operate in the U.K. via a branch or on a cross-border services basis, subject to a notification procedure. With this exception, the FSA has sole responsibility for authorizing and supervising foreign insurers wishing to carry on insurance business in the United Kingdom, including U.K. subsidiaries of foreign companies, joint ventures with one or more foreign parents, and branches of companies with a head office outside the EEA (subject to the possibility

	of limited lead supervision by one Member State of branches situated in more than one EEA state, which is provided for by the EC Directives). The FSA has a duty to take such steps as it considers appropriate to co-operate with other regulators. In considering an application for authorization, the FSA may discuss the application with other regulators as appropriate. In the case of branches, where an applicant has its principal place of business in a country or territory outside the EEA, the FSA will, in assessing an application for Part IV permission, have regard to the applicant as a whole and not just the proposed U.K. branch. As part of the process the FSA may, if reasonable in the circumstances, take into consideration information supplied by the relevant overseas regulator in that country or territory. The promotion of contracts of life insurance in the U.K. by non-EEA companies not authorized in the U.K. is not normally permitted where the rights under the contract constitute an investment. The exception is where the company is established in a designated territory affording adequate protection to policyholders and potential policyholders against the risk that the company may be unable to meet its liabilities. The promotion of non-life contracts on a cross-border basis is permitted, subject to disclosure requirements that apply other than in respect of large risks and reinsurance.
Assessment	Observed
Comments	The FSA has well-developed systems and controls in place to ensure that no firms escapes supervision. In carrying out this responsibility, it seeks to co-operate with other regulators as necessary.
Principle 16.	**Coordination and Cooperation** Increasingly, insurance supervisors liaise with each other to ensure that each is aware of the other's concerns with respect to an insurance company that operates in more than one jurisdiction, either directly or through a separate corporate entity. In order to share relevant information with other insurance supervisors, adequate and effective communication should be developed and maintained. In developing or implementing a regulatory framework, consideration should be given to whether the insurance supervisor: – is able to enter into an agreement or understanding with any other supervisor both in other jurisdictions and in other sectors of the industry (i.e., insurance, banking, or securities) to share information or otherwise work together; – is permitted to share information, or otherwise work together, with an insurance supervisor in another jurisdiction. This may be limited to insurance supervisors who have agreed, and are legally able, to treat the information as confidential; – should be informed of findings of investigations where power to investigate fraud, money laundering, and other such activities rests with a body other than the insurance supervisor; and – is permitted to set out the types of information and the basis on which information obtained by the insurance supervisor may be shared.
Description	The FSA's legislation permits the disclosure of information for the purpose of enabling or assisting an authority in a country or territory outside the U.K. to exercise functions corresponding to those of the FSA under the FSMA, in effect to other supervisors of insurance, banking and investment business, subject to equivalent professional secrecy/confidentiality requirements being in place. Procedures relating to the collaboration of the insurance supervisory authorities in the EEA, in particular in the application of the EC Directives on life assurance and non-life insurance, are contained in a specific Protocol agreed between the authorities. This includes provisions on the exchange of information. A further Protocol covers collaboration and information exchange in

	respect to the supervision of insurance groups. The FSA has to date had little experience of regular liaison and co-operation with insurance supervisory authorities outside the EEA. The contacts that have taken place have in most cases been in response to particular problems that have arisen. This situation is expected to change with the emergence of insurance groups and conglomerates. The enhancement of information exchange is being actively pursued. There are agreed guidelines in place between the FSA and key criminal investigators and prosecutors in the U.K. (Serious Fraud Office, Department of Trade and Industry, Criminal Prosecution Service, Policy and their Scottish/Northern Irish counterparts). These guidelines provide that the parties should alert each other to cases of mutual interest and that they should communicate with each other when initiating investigations and proceedings. In addition, the guidelines provide that it is best practice for agencies to notify each other on the outcome of investigations or proceedings.
Assessment	Observed
Comments	The FSA maintains close relations with overseas financial supervisors. The Authority is able to exchange information with the competent authorities in other EEA Member States relatively freely, and may conclude co-operation agreements providing for the exchange of information with competent authorities of other countries if the information disclosed is subject to equivalent guarantees of professional secrecy.
Principle 17.	**Confidentiality** All insurance supervisors should be subject to professional secrecy constraints in respect of information obtained in the course of their activities, including during the conduct of on-site inspections. The insurance supervisor is required to hold confidential any information received from other insurance supervisors, except where constrained by law or in situations where the insurance supervisor who provided the information provides authorization for its release. Jurisdictions whose confidentiality requirements continue to constrain or prevent the sharing of information for supervisory purposes with insurance supervisors in other jurisdictions, and jurisdictions where information received from another insurance supervisor cannot be kept confidential, are urged to review their requirements.
Description	The FSMA contains general restrictions on disclosure of information, which would apply to information received from another supervisory authority. Gateways provided for in the regulations under the Act allow the FSA to pass confidential information to other supervisors or law enforcement bodies in specified circumstances. The confidentiality requirements are not overridden by freedom of information provisions.
Assessment	Observed
Comments	The treatment of confidential information is tightly controlled and well managed by the FSA.

Table 8. Summary Observance of IAIS Insurance Core Principles

Assessment Grade	Principles Grouped by Assessment Grade	
	Count	List
Observed	12	CP 1,2,3,4,8,9,10,11,14,15,16,17.
Broadly observed	4	5,6,7,12.
Materially non-observed	1	13
Non-observed	0	
Not applicable	0	

F. Recommended Action Plan and Authorities' Response to the Assessment

Recommended action plan

36. Table 9 sets out the actions recommended by the mission with respect to insurance supervision. Note that the recommendations related to principles 5, 6, 7, 12, and 13 are to improve compliance with the Core Principles, while the other recommendations are more technical ones for Principles already complied with. The mission considers the latter desirable measures for further refining insurance supervision given, in particular, the role of London as a major international financial center.

Table 9. Recommended Action Plan to Improve Observance of IAIS Insurance Core Principles

Reference Principle	Recommended Action
Organization of an Insurance Supervisor **CP 1.** The insurance supervisor of a jurisdiction must be organized so that it is able to accomplish its primary task, i.e., to maintain efficient, fair, safe, and stable insurance markets for the benefit and protection of policyholders. It should, at any time, be able to carry out this task efficiently in accordance with the Insurance Core Principles	The FSA should consider building its core insurance expertise to include individuals with significant experience in reinsurance, actuarial practice, and long tail, non life claims. These resources should be made available to all supervisors who are responsible for supervising insurance firms regardless of where they work within the FSA. Because the addition of these individuals would likely be organized in a matrix set up, the availability of their technical skills to all supervisors should be actively promoted within the FSA.

Corporate Governance and Internal Controls **CP 4 Corporate Governance** It is desirable that standards be established in the jurisdictions which deal with corporate governance. Where the insurance supervisor has responsibility for setting requirements for corporate governance, the insurance supervisor should set requirements with respect to: – the roles and responsibilities of the board of directors; – reliance on other supervisors for companies licensed in another jurisdiction; and the distinction between the standards to be met by companies incorporated in his jurisdiction and branch operations of companies incorporated in another jurisdiction	The FSA should consider making it mandatory for a Financial Condition Report (FCR) to be signed off by the Board and to be available to the FSA. The Board should take responsibility for the analysis of the FCR and ensure that the level of stress/scenario testing is appropriate to the complexity and size of the organization. The FSA may wish to work closely with the appropriate professional bodies to develop guidance for use by supervised firms when preparing the FCR. At the conclusion of every review of high impact firms, senior officials from the FSA should formally meet with the audit committees to review and present the management letter points. At each of these meetings it is also good practice to request an *in camera* meeting with only the non-executive members of the audit committees.
CP 5 Internal Controls The insurance supervisor should be able to: – review the internal controls that the board of directors and management approve and apply, and request strengthening of the controls where necessary; and – require the board of directors to provide suitable prudential oversight, such as setting standards for underwriting risks and setting qualitative and quantitative standards for investment and liquidity management require the board of directors to provide suitable prudential oversight, such as setting standards for underwriting risks and setting qualitative and quantitative standards for investment and liquidity management	The increasing pressures on insurance firms require management to pay to more attention to risk management practices. In the current environment, most firms, particularly those in MFGD, are increasingly strengthening their risk management practices; however, where this is not true, the FSA should consider encouraging those firms to do so. Possible actions that could be taken by firms include the establishment of a risk management function and a risk committee of the board. This would also largely deal with concerns expressed under CP 6 (Assets). Management letters from the regulator are important pieces of correspondence that usually deals with prudential issues which are also of interest to a firms' auditors. Firms routinely provide copies of management letters to their auditors but this is not done consistently. The FSA may wish to standardize its procedures for processing management letters by including a requirement that firms provide a copy to their auditors on a timely basis.
Prudential Rules **CPs 6–10 Liabilities** **CP 6**	See comments under CP 5.
CP 7 Liabilities Insurance supervisors should establish standards with respect to the liabilities of companies licensed to operate in their jurisdiction. In developing the standards, the insurance supervisor should consider: – what is to be included as a liability of the	The determination of policy liabilities in life firms is a highly specialized task and involves the use of considerable judgment by the appointed actuary. Judgment is required even though the appointed actuary is required to calculate the policy reserves

company, for example, claims incurred but not paid, claims incurred but not reported, amounts owed to others, amounts owed that are in dispute, premiums received in advance, as well as the provision for policy liabilities or technical provisions that may be set by an actuary; – the standards for establishing policy liabilities or technical provisions; and – the amount of credit allowed to reduce liabilities for amounts recoverable under reinsurance arrangements with a given reinsurer, making provision for the ultimate collectability	within the guidelines set out by the professional body. Judgment is particularly critical for some products as certain assumptions are highly sensitive and slight variations usually result in material differences in reserve balances. It would be good practice to require the implementation of a peer review process and the FSA may want to work with the institute of actuaries or other relevant professional bodies to implement such a review. Depending on the company-specific situation, a multi-discipline team may be required to do the review.
CP 10 Reinsurance Insurance companies use reinsurance as a means of risk containment. The insurance supervisor must be able to review reinsurance arrangements, to assess the degree of reliance placed on these arrangements and to determine the appropriateness of such reliance. Insurance companies would be expected to assess the financial positions of their reinsurers in determining an appropriate level of exposure to them. The insurance supervisor should set requirements with respect to reinsurance contracts or reinsurance companies addressing: – the amount of the credit taken for reinsurance ceded. The amount of credit taken should reflect an assessment of the ultimate collectability of the reinsurance recoverable and may take into account the supervisory control over the reinsurer; and – the amount of reliance placed on the insurance supervisor of the reinsurance business of a company which is incorporated in another jurisdiction.	The FSA may wish to consider implementing a thematic review of reinsurance operations across the firms for purposes of ensuring that appropriate controls and systems are in place.

CP 12 Financial Reporting It is important that insurance supervisors get the information they need to properly form an opinion on the financial strength of the operations of each insurance company in their jurisdiction. The information needed to carry out this review and analysis is obtained from the financial and statistical reports that are filed on a regular basis, supported by information obtained through special information requests, on-site inspections, and communication with actuaries and external auditors.	The risk profile of the insurance industry is increasing due to pressure points from several fronts including on-going underwriting losses (non-life); reduced returns on investment activities coupled with high expense pressures and uncertainty about long-tail liabilities. Currently, firms are required to file statutory returns annually. Given the rapidity with which an insurance firm's risk profile can change, a move towards quarterly reporting, at least for higher priority firms, would significantly enhance a supervisor's ability to closely monitor his or her assigned firm(s). Firms that fall under the purview of MFGD, particularly listed firms, should provide their MIS reports prior to public release. To accommodate this increased information flow, FSA may need to review its financial reporting data base and systems capability, and require electronic returns from insurers. Furthermore, it is necessary to carry out a review of the nature of the existing data being received as it may no longer be relevant. Consequently, changes to the statutory returns may be required. Public disclosure of relevant information on a timely basis is one element of the three-pillar approach proposed by the Basel Committee for banking supervision but is equally applicable to insurance firms. There is an increasing need for all firms to disclose more relevant information in their published financial reports. For example, there is need for firms to include more information on risk management practices, risk exposures and sources of gains and losses, etc. In this connection, the FSA has an important role to play in encouraging firms to adopt more appropriate disclosure practices.
CP 13 On-Site Inspection The insurance supervisor should be able to: – carry out on-site inspections to review the business and affairs of the company, including the inspection of books, records, accounts, and other documents. This may be limited to the operation of the company in the jurisdiction or, subject to the agreement of the respective supervisors, include other jurisdictions in which the company operates; and – request and receive any information from companies licensed in its jurisdiction, whether this information be specific to a company or be requested of all companies.	In order to comply with this CP, the FSA will need to increase the resources and skill set of supervisors who are responsible for supervising the insurance industry. Core insurance expertise should be strengthened to include individuals with experience in reinsurance, risk management, actuarial science and long-tail, non-life claims.

CP 14 Sanctions Insurance supervisors must have the power to take remedial action where problems involving licensed companies are identified. The insurance supervisor must have a range of actions available in order to apply appropriate sanctions to problems encountered	The FSA has powers under the FSMA to require firms to take remedial action when threats to the solvency of the institutions are noted. Although there are well developed processes within the FSA for dealing with firms when prudential concerns are noted, firms which are placed on a watch list are not formally notified when such action is taken. The FSA may way wish to consider notifying firms when, for prudential reasons, they are placed on a watch list.

Authorities' response to the assessment

37. The authorities noted that the FSA is carrying out a major program to reform insurance regulation (the Tiner project). This work was in train during the IMF's mission and has now progressed further. The reforms are having a significant and far-reaching impact on the FSA's approach to insurance regulation and on the industry. The program of reform was triggered by a number of factors. First, the insurance industry is operating in a significantly more challenging environment. This has underlined the importance of ensuring that insurance firms have sound management structures and adequate financial resources. Second, the creation of the FSA as a single regulator has highlighted significant differences between the regulation of insurance and of other sectors, not evidently justified by sectoral specifics. Third, an independent report commissioned by the FSA into the FSA's regulation of Equitable Life made several recommendations about the regulation of the sector.

38. The reform program was established in September 2001 and the FSA set out the work that has been completed, or is underway, in a progress report published in October 2002. The reform program is focused on strengthening the prudential regime, including corporate governance, ensuring that insurance firms take proper account of the nature, diversity and scale of risks they face. It also aims at delivering a more proactive and challenging risk-based approach to regulating insurance, including significantly more on-site work.

39. As a result of the changes from the Tiner project insurance firms are facing a fundamental change in the way they are regulated, including a more proactive and challenging regulatory relationship. In line with the FSA's risk-based approach, some firms will have started to notice the increased contact with supervisors at senior management and working levels. This reflects the explicit responsibility the FSA places on management for ensuring that systems and controls are adequate and that they are treating their customers fairly. The FSA uses a range of tools including on site work and reports by external auditors, actuaries and other professionals to test the controls that management have put in place.

40. The FSA has already begun to address the need for more insurance specialists. Over the last year the FSA has recruited in total 35 new insurance supervisors, the majority from insurance firms. These new recruits have brought with them a wide range of skills. In addition the Risk Review Department set up an insurance risk review team at the beginning

of the year which includes secondees with strong technical skills and knowledge of the insurance market.

41. The FSA has already made good progress in addressing some of the points raised by the IMF. In particular, it has given guidance on improving risk management in insurance firms (see Consultation Paper 140 and feedback statement). This is also being addressed in the work to prepare an integrated prudential sourcebook. The FSA has developed proposals on the role of actuaries in life assurance companies on which it has already undertaken an initial consultation with the industry and other interested parties. More detailed proposals were published for consultation on January 24, 2003. The FSA has also published proposals to strengthen the regulation of insurance firms in the area of financial engineering, and has developed proposals on regulatory reporting, which specifically address the type of reporting required from insurance companies under risk-based supervision. These proposals also consider the issues about frequency of reporting by firms more generally.

42. The authorities welcomed the IMF's recognition of the importance of the Tiner project in strengthening insurance regulation and in meeting much of the IMF's proposed action plan. They had the following specific comments on the assessors' recommendations:

- On *CP1*, they agreed that having a range of expert skills in the FSA is important. The FSA's risk review team includes insurance specialists, as well as specialists in credit risk, operational risk and traded risk. This is a valuable resource for the FSA, which it intends to maximize. The FSA's actuarial and other specialist skills are already available to all those responsible for insurance firms.

- On *CP4*, the authorities noted that the requirement for the Board of an insurance firm to receive and review financial information that provides a true reflection of the health of the business under a number of different scenarios, is clearly recognized. The FSA will place increasing emphasis on appropriate stress and scenario testing within insurance firms. The precise nature of any future requirements in this area, and any link to reporting by insurance firms to the FSA, are under consideration.

  There is presently no clearly defined financial condition report for non-life insurers and the FSA would like the life one to be more clearly focused. Since the FCR includes an analysis of the financial impact of possible future scenarios, a report of this nature will be needed to support firms' individual capital requirements, on which the FSA will be consulting shortly. At present the FCR does not give rise to a capital requirement as such. On that basis it would be premature to replace the existing resilience test.

  It is not standard practice for FSA supervisors to see the Board or Audit Committee after a visit, but the FSA does write to the main Board to present the conclusions of its risk assessment. If there were significant issues arising that it was best to address through a meeting then the FSA would certainly pursue this option.

  If the FSA wanted to see non-executive directors separately, it would probably involve them all rather than those represented in a particular committee. The FSA would only consider focusing on a select group of directors where it felt there were real problems that it was necessary to deal with through this route.

- On *CP 5*, the FSA has made clear through the Tiner Reports on the future regulation of insurance (November 2001, progress report of October 2002) the importance it attaches to the need for firms to strengthen their risk management practices. This has been given further substance by the Guidance on

Systems and controls published in a Policy statement issued in December 2002, which sets out for firms the FSA's expectations that they will have proper risk management functions appropriate to the size and nature of their business. The FSA's supervisors cover this area as an integral aspect of the FSA's risk assessment framework. In addition the whole emphasis of the prudential source book is on the need for proper risk management practices. The Board should be responsible for the appropriate governance for risk management functions. Risk assessment letters and risk mitigation programmes are already copied to the auditors as standard practice.

- On *CP7*, the authorities indicated that the FSA is proposing changes to the role of actuaries in the governance of life insurers. It published a consultation paper on these matters (CP167) in January 2003. The intention is that the policy reserves will be calculated by an actuary. The actuary will advise the board on the methods, bases and results of the calculations. The FSA will also require an independent review of the calculation of policy reserves by the auditor. The auditor will be required to take actuarial advice independent of the regulated firm's actuary in forming the audit opinion. The FSA is working with the professional bodies to achieve appropriate guidance to professionals working in this area.

  For non-life liabilities, the FSA will keep under review whether to introduce actuarial overview of the provisions as part of its review of insurance regulation. The FSA is preparing rules and guidance on stress and scenario testing and on individual capital adequacy standards as part of its work on the integrated prudential sourcebook. The FSA is also developing proposals for better regulatory reporting, which will take into consideration the appropriate format for reporting to the FSA risks to non-life insurers.

- On *CP 10*, since the IMF visit the FSA has published a consultation paper with proposals to strengthen controls on financial engineering in insurance companies, which tackles reinsurance and other issues. The possibility of a wider thematic review of reinsurance arrangements will be considered alongside other priorities for such reviews.

- On *CP 12*, the authorities fully recognized that insurance firms are operating in an increasingly challenging environment. Against this background, the FSA is examining how it can reform regulatory reporting to ensure that it receives the key information it requires for supervisory purposes while keeping the burden on industry to the minimum necessary. Issues such as public disclosure versus private reporting, quantity versus quality of information submitted, and capturing more forward-looking information are all being looked at.

  Specifically in the insurance area, the FSA published a Discussion Paper on a new approach to regulatory reporting as part of the Tiner project. After analyzing the feedback on this, the FSA proposes to launch a consultation paper in mid-2003. Any proposals on the timeliness and frequency of information submitted by insurance firms will be dealt with then. The FSA recognizes that deciding on what, if any, information is required more frequently than annually, and what firms any additional reporting requirements should apply to, is a critical issue. Account will also have to be taken of international developments in planning changes in this area. The proposal that listed firms should provide any reports to the market to the FSA prior to public release will be considered.

  The FSA is enhancing its IT capabilities to facilitate anticipated changes, and is in the early stages of developing electronic reporting. Initially it is looking at areas such as Authorization and Listing where there are potential efficiencies from the use of technology, but this will be expanded into new areas as appropriate.

  The FSA is participating actively in international discussions within the IAIS and Joint Forum on the need for enhanced public disclosure of key financial information. The role of public disclosure of relevant information is integral to the approach the FSA intends to take in its own development work. In the forthcoming negotiations on a new EU insurance solvency regime the U.K. will press for the

adoption of a three-pillar approach similar to that being proposed by the Basel Committee for the banking sector.

- For CP 13, the authorities indicated that on-site inspection needs to be considered in the context of the FSA's overall risk-based approach to insurance supervision. The FSA does not undertake on-site inspections of all insurance firms, but follows instead a risk-based approach. During 2002, the FSA began to assess insurance firms using the risk-based framework it has developed. The FSA intends to have a close and continuing relationship with high impact firms (judged by reference to the FSA's statutory objectives). Prudential supervision in relation to these firms, and those judged medium impact, will be more pro-active and less reliant on desk-based analysis of financial returns. At the other end of the spectrum, low impact firms will not be subject to specific risk assessments, but supervised mainly through an analysis of the data routinely submitted to the FSA. On-site work in relation to these firms will (exceptionally) be undertaken in response to any risks identified from the data submitted, together with visits to a sample of firms as part of sector-wide reviews.

  Over the last year the FSA has recruited in total 35 new insurance supervisors, the majority from insurance firms. These new recruits have brought with them a wide range of skills. In addition the Risk Review Department set up an insurance risk review team at the beginning of the year which includes secondees with strong technical skills and knowledge of the insurance market. This team is being used actively as part of the risk assessment process. The FSA has also begun to commission skilled persons reports from independent professional experts on specific aspects of a firm's operation, systems or controls.

- On CP14, the authorities did not believe the recommendation was appropriate. Where a firm is placed on the FSA watchlist the firm will already be well aware of the issues of concern to the FSA, on solvency or other matters, and remedial work will be underway. The FSA does not believe that telling firms that they are on the watchlist is appropriate, since it is essentially an internal tool.

III. IOSCO Objectives and Principles of Securities Regulation

A. General

43. The principal regulator of securities markets in the United Kingdom is the Financial Services Authority (FSA). There are other organizations involved in aspects of the regulation of securities markets and participants, as appears in the assessments below, but the FSA is the main subject of this assessment. This assessment was conducted as part of the Financial Sector Assessment Program of the International Monetary Fund (IMF) and the World Bank, between November 2001 and July 2002. The principal assessors with respect to securities were: Mr. Alan Cameron, A.M., lawyer and regulatory consultant, former chairman of the Australian Securities and Investments Commission, the Executive Committee of IOSCO, and the Joint Forum; and Mr. David Shillman, Counsel to the Director of the Division of Market Regulation at the U.S. Securities and Exchange Commission.

B. Information and Methodology used for Assessment

44. The assessment was conducted using the February 2002 version of the IOSCO Objectives and Principles of Effective Securities Regulation, and the guidance issued by the IMF and the World Bank prepared in conjunction with the Implementation Committee of IOSCO.

45. The main information sources in making the assessment were self-assessments prepared by the FSA using the Questionnaires developed by IOSCO, supplemented by: (a) documents furnished by the FSA, such as its Annual Reports, publications relating to its policies, and its handbook; (b) material obtained through the FSA's website, such as press releases and speeches by senior FSA officials; (c) the Financial Services and Markets Act 2000 (FSMA); (d) interviews organized through the good offices of the FSA with market participants, industry groups, financial journalists, the FSA's Consumer and Practitioner Panels, and others; and (e) lengthy discussions with senior staff of the FSA.

46. The team received full cooperation from the FSA in completing the assessment and expresses its appreciation for that assistance.

C. Institutional and Macroprudential Setting, Market Structure

47. The FSA was established by the U.K. Government in May 1997, and commenced operation in an interim or transitional way in June 1998. The relevant law, the FSMA, was passed in 2000, and took full legal effect on December 1, 2001, a date usually referred to in this context as N2. The FSA absorbed initially the activities of nine previous regulators or government departments, but has since taken on even more responsibilities. For present purposes, the relevant features were that the FSA is in legal terms the former Securities and Investments Board, and took on all of its roles, together with those of the Securities and Futures Authority and the Investment Management Regulatory Organization. Since then the FSA has also incorporated the U.K. Listing Authority (UKLA), formerly a division of the London Stock Exchange (LSE).

48. Trading of securities in the United Kingdom is conducted on securities exchanges, alternative trading systems, and in the over-the-counter (OTC) market. There are six securities exchanges in the United Kingdom: the LSE and Virt-X primarily trade equities; the London Metal Exchange for commodities; and the London International Financial Futures and Options Exchange (LIFFE), OM London, and the International Petroleum Exchange trade financial and commodity derivative products. Each of these exchanges is supervised by the FSA as a 'Recognised Investment Exchange,' and has certain self-regulatory responsibilities with respect to the conduct of business on its facilities. In addition, a number of firms, such as Instinet, E-Crossnet, ITG Europe (Posit) and BrokerTec, offer alternative trading systems to U.K. market participants. These 'market infrastructure providers' are supervised by the FSA in a manner similar to investment firms, with an emphasis on prudential and conduct of business rules. Finally, significant OTC markets exist in the U.K. for foreign exchange, bullion, money market and fixed income products, and interest rate derivatives. Participants in the OTC markets are supervised by the FSA as investment firms and, among other things, are required to comply with the FSA's Code of Market Conduct and Inter-Professional Code.

49. The majority of the U.K. securities industry consists of subsidiaries of overseas financial institutions. For example, all of the parent companies of the top ten securities houses trading European shares in London are foreign, and together these institutions account for approximately 75 percent of the U.K. equity market. The LSE is the dominant U.K. stock exchange and, at the end of 2001, traded 2,975 equities. The LSE trades more foreign companies than any other exchange and daily trading volumes for international equities in London are almost double those for domestic companies. Annual turnover of domestic and foreign equities on the LSE was £5.5 trillion in 2001. In that year, domestic and foreign issues traded on the LSE had an aggregate market capitalization of £4.1 trillion, and funds raised totaled £149 billion. LIFFE dominates the U.K. market for exchange-traded financial derivatives. In 2001, annual turnover on LIFFE was more than 200 million contracts with a notional value in excess of £90 trillion. In the United Kingdom, the vast majority of fixed income trading takes place in the OTC markets. In the international bond market, London-based bookrunners (including both branches of overseas institutions and U.K.-based institutions) are estimated to account for 60 percent of eurobonds issued, with 70 percent of secondary market trading. London also accounts for almost a third of world foreign exchange activity, with an average daily turnover of $504 billion, and is the world's most liquid spot market for gold and gold lending. Finally, London is the most active trading centre for OTC derivatives, with a market share of 36 percent.

D. General Preconditions for Effective Securities Regulation

50. London, of course, is one of the world's major financial centres, and has the largest share of trading among many international financial markets, including foreign equity trading. Reasons for that prominence include the openness and efficiency of its markets, the concentration of skills and expertise in one place, and the liquidity which is already there. There appear to be no significant barriers to entry or exit from markets or products.

51. With respect to regulatory policy, London's success in attracting overseas business can be attributed in part to the perception that the United Kingdom has a "proportionate" approach to regulation. IOSCO sets out three objectives that should form a basis for an effective system of securities regulation: (a) the protection of investors; (b) ensuring that markets are fair, efficient and transparent; and (c) the reduction of systemic risk. The U.K. regulatory system is broadly designed to address each of these objectives, albeit investor protection is to be delivered, at least in part, by requiring the provision of information to investors, and investor education, in addition to traditional means such as enforcement. Notably, the applicable objective under the FSMA charges the FSA with securing an "appropriate degree" of investor protection "while recognizing [investors'] own responsibilities." As discussed more fully in the assessment, the FSA has issued comprehensive rules and guidance to implement its new statutory objectives under the FSMA. The effectiveness of this new regime, however, and in particular the FSA's 'risk-based' approach to supervision, under which resources are allocated to those areas assessed as being of greater systemic importance, has yet to be tested in practice. Finally, the U.K. regulatory scheme will be affected, perhaps significantly, over the next several years by European Union legislation, as well as initiatives of the Committee of European Securities Regulators. It is already clear, for example, that the FSA's powers need to be used and interpreted in light of the European Convention on Human Rights, but that should not prevent the FSA being effective.

52. The United Kingdom has a developed and robust legal system and its accounting standards are of a high and internationally acceptable quality. As to the tax framework, there has been long-standing criticism of the Stamp Duty, a 0.5 percent tax on the buy side of each share transaction in the United Kingdom, and concerns regarding it have become heightened as spreads have narrowed and the impact of the Stamp Duty becomes proportionately more significant. Demand for share substitutes that are free from the Stamp Duty, such as derivative products like contracts for difference and spread betting systems, has increased, thereby creating some distortions in the securities markets, but is not perceived at this stage as being likely to create vulnerabilities or cause systemic risks.

E. Principle-by-Principle Assessment

Table 10. Detailed Assessment of Observance of the IOSCO Objectives and Principles of Securities Regulation

Principles Relating to the Regulator	
Principle 1.	The responsibilities of the regulator should be clear and objectively stated.
Description	The principal regulator with respect to the securities markets is the FSA, whose functions and objectives are set out in the FSMA. In discharging its general functions, the FSA is required to act in a way which is compatible with its regulatory objectives and to have regard to stated principles of good regulation, such as the need to use its resources in the most efficient and economic way and recognizing the responsibilities of regulated firms' own management. The objectives are: (a) maintaining confidence in the financial system; (b) promoting public understanding of the financial system; (c) securing the appropriate degree of protection for consumers while recognizing their own responsibilities; and (d) reducing the extent to which it is possible for an authorized business to be used for a purpose connected with financial crime. Other bodies which play a regulatory role in the markets include the various Recognised Investment Exchanges (RIEs) and Recognised Clearing Houses (RCHs), and the London Panel on Takeovers and Mergers (Takeover Panel), which each have defined roles and objectives within their constitutive documents.
Assessment	Implemented
Comments	The FSA is an integrated regulator with wide responsibilities across the financial sector. It has been given more responsibilities than originally proposed, such as insurance regulation (especially Lloyds) and supervision of mortgage brokers, and any further widening of its role may run the risk of dispersion of effort, or loss of focus, so that one or more of the separate functions is not undertaken effectively or at all. Further, the statutory objectives and the associated principles of good regulation are to some extent in tension with each other, requiring the FSA to exercise judgment in how it interprets its role. While inevitable to some extent, it can be argued that an integrated regulator like the FSA can address these tensions at least as effectively, if not more effectively, than separate sectoral or functional regulators; in any event, the FSA will need to retain a clear focus on its principal responsibilities as set out in the FSMA.
Principle 2.	The regulator should be operationally independent and accountable in the exercise of its functions and powers.
Description	The FSA is established as a private company, limited by guarantee and financed by direct levies on the industry, with responsibility for its own budget. The FSA board is appointed and may be removed by the Treasury. The FSMA enables the Government to direct the FSA to include particular matters in its Annual Report, establish whether the FSA is providing value for money, review the secondary legislation enacted by the FSA, and launch an inquiry into serious regulatory failure. The FSA exercises statutory powers as a financial services regulator under FSMA. The FSMA includes requirements to make an annual report to the Treasury, hold an annual open meeting, establish an independent investigator of complaints against the FSA, consult consumers and practitioners through representative panels, and consult publicly on regulatory rules and guidance.
Assessment	Implemented

Comments	It is clear from the exchange of letters between the FSA and the Chancellor in December 2001, that the FSA is intended to and will be permitted to operate independently, therefore satisfying CP 2. The direction powers do not affect the FSA's operational independence, but do enhance its accountability. While the chairman and other board members of the FSA are liable to be removed by the government without cause having to be shown, such action would be subject to the Nolan Rules, and would undoubtedly have political consequences. The courts would also have jurisdiction to review the grounds for dismissal, but the dismissal would stand unless it was found to be so "unreasonable" that no minister acting properly could have reached that decision.
Principle 3.	The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.
Description	The FSMA sets out the regime under which the FSA acts and the FSA's powers under it. These powers include rulemaking and guidance-giving powers, authorization powers, information gathering and investigation powers, intervention powers, the power to appoint skilled persons to report, and powers to impose financial penalties. The FSA has responsibility for its own budget, is financed by direct levies on the industry and has a budget in the vicinity of £221.1 million in the 2002/2003 year. The FSA has a permanent staff of approximately 2200, and the capacity to appoint skilled persons (including those with substantial industry experience) to supplement its staff.
Assessment	Implemented
Comments	The FSA has experienced significant staff turnover since it commenced operating in mid-1998, although there are signs that the turnover levels have abated recently, perhaps in response to market conditions. While some turnover is to be expected and indeed welcomed, there is a concern of loss of expertise. Turnover has been particularly high in the securities sector, leading many in the industry to express concern as to the FSA's ability to conduct effective supervision in this area. Further, the FSA has spoken frequently about the need to minimize the cost of regulation, as reflected in its fees charged to industry, but its fees are already, on its own calculations, low compared to some other countries.
Principle 4.	The regulator should adopt clear and consistent regulatory processes.
Description	In January 2000, the FSA published 'A New Regulator for the New Millennium', setting out a high-level translation of its regulatory objectives and other general duties into day-to-day regulation. Included in this publication was a description of the FSA's 'risk-based' approach to supervision, which was expanded upon in two Progress Reports published in December 2000 and February 2002. The FSA also has laid down its regulatory requirements in the FSA Handbook of Rules and Guidance. One 'block' of this Handbook is entitled 'Regulatory Processes,' and this includes the FSA's rules and guidance on authorization, supervision, enforcement of rules and decision making processes. These cover all aspects of the securities markets, including authorization of exchanges, brokers, and investment advisers.
Assessment	Implemented
Comments	The FSA has adopted procedures for wide consultation concerning its proposals to exercise its regulatory powers, and its Handbook is a comprehensive and readily-accessible statement of the procedures it uses to carry out its functions in the securities markets. At this early stage, whether the FSA's 'risk based' approach to supervision will result in practice in the consistent and transparent application of its regulatory processes, remains to be seen.

Principle 5.	The staff of the regulator should observe the highest professional standards, including appropriate standards of confidentiality.
Description	The FSA has recruited its staff both from the former regulators whose functions it has absorbed, and by recruitment from industry and directly from university. The staff are provided with comprehensive training and development, which includes induction, and for regulatory staff, technical training encompassing the whole range of its regulatory responsibilities, including their professional responsibilities and confidentiality requirements. The FSA has dedicated legal resources to advise regulatory staff on matters such as their confidentiality obligations and how they apply in particular circumstances. FSA staff are bound by the terms of the FSA's Code of Conduct – part of their employment contract with the FSA – which includes provisions concerning the maintenance of the confidentiality of information staff obtain in the course of their work. The FSA has its own Complaints Commissioner, which provides an opportunity for anyone concerned that its staff may have abused their powers or information given to them, to pursue such matters.
Assessment	Implemented
Comments	Given some loss of expertise due to turnover of staff in the initial stages of forming the FSA, and the need for a high degree of specialized expertise needed to monitor markets and trading systems, the FSA is encouraged to exercise special efforts to make its organization structure (in the context of the way it recognizes and rewards specialist skill and knowledge), and its remuneration system generally more attractive.
Principles of Self-Regulation	
Principle 6.	The regulatory regime should make appropriate use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence and to the extent appropriate to the size and complexity of the markets.
Description	As a result of the U.K. Government's recent restructuring of financial regulation, there are only limited areas within the financial sector in which the framework provides for any significant elements of self-regulation. In the area of securities markets, these are the RIEs, RCHs, and the Takeovers Panel (see CP 15). The FSMA has provided for entities that are recognized as RIEs or RCHs to set and enforce rules, to ensure that business effected by means of their facilities takes place in an orderly manner, and thereby provides proper protection to investors. These entities take the lead role in the real-time monitoring of trading on those markets. RIEs operate within a framework that must comply with the recognition requirements drawn up by HM Treasury issued in the form of Regulations by HM Treasury pursuant to s. 286 of the FSMA, and guidance on those requirements set by the FSA.
Assessment	Implemented
Comments	IOSCO principles affirm that there can be substantial benefits from self-regulation, in that SROs may (a) require the observance of ethical standards which go beyond government regulations, and (b) offer considerable depth and expertise regarding market operations and practices, and be able to respond more quickly and flexibly than the government authority to changing market conditions. The U.K.'s new regulatory structure makes only very limited use of SROs – with respect to the operation of the securities exchanges and clearing houses; the FSA itself regulates all market intermediaries, with direct responsibility for, among other things, prudential supervision and conduct of business regulation. This places additional pressure on the FSA to attract and retain skilled staff in sufficient number to effectively supervise market intermediaries.

Principle 7.	SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.
Description	The FSMA provides for the FSA to grant recognition orders to entities applying for recognition as RIEs or RCHs, and to oversee their continuing compliance with the recognition requirements for such bodies. The FSMA (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001 set out a number of requirements for recognized bodies, with a view to ensuring that they use their powers fairly. These state that the body must: (a) be a fit and proper person to perform its functions; (b) include consultation with users in its procedures for making and amending rules; and (c) make provision in its disciplinary processes for the fair, independent and impartial resolution of appeals against its decisions.
Assessment	Implemented
Comments	The FSMA regulations and related FSA guidance with respect to SROs are comprehensive and appear to address all areas deemed important by IOSCO.
Principles for the Enforcement of Securities Regulation	
Principle 8.	The regulator should have comprehensive inspection, investigation and surveillance powers.
Description	The FSMA gives the FSA powers of investigation and statutory responsibility for bringing civil and regulatory proceedings for contravention of FSA rules. Under its information gathering powers, the FSA may require a firm to produce information or documentation, and has the power to require the provision of a report on a firm by a skilled person. The FSA has the power to investigate and prosecute insider dealing and breaches of prescribed money laundering regulations. The FSA also has powers to investigate and bring civil penalty or disciplinary proceedings in cases of market abuse.
Assessment	Implemented
Comments	Primary surveillance of trading on recognized markets is carried out by the exchanges themselves, who report suspected breaches to the FSA for investigation. Matters to be pursued are identified using the ‘risk-based’ assessment framework adopted by the FSA, although at this early stage the effectiveness of this approach has yet to be tested in practice. The FSA’s powers will need to be used and interpreted in light of the European Convention on Human Rights, but that should not operate to prevent the FSA from being an effective regulator.
Principle 9.	The regulator should have comprehensive enforcement powers.
Description	Under the FSMA, the FSA has the power to initiate proceedings against those firms and individuals which offer or purport to offer financial services without authorization. The FSA also has a range of administrative, civil and criminal prosecution powers. The FSA's administrative powers include the power to impose fines and statements of public censure. The FSA also is able to cancel or vary a firm's permission to conduct financial services under the FSMA, or withdraw an individual’s approval to undertake functions in relation to regulated activities where breaches of the FSMA are particularly serious. The FSA also has an administrative power to seek restitution from firms or individuals where such persons have profited from, or avoided a loss, due to a breach of the requirements of the FSMA. The FSA's civil powers include the power to apply to a court for injunction and restitution orders against authorized firms and approved individuals, and the power to make insolvency petitions against authorized firms. Civil powers are available to the FSA to combat market abuse, including specific powers to impose fines and seek restitution and injunction orders. The civil offence of market abuse is designed to complement the existing offences of insider dealing and misleading

	statements and practices. Under the FSMA, the FSA also has the power to bring criminal proceedings in cases of insider dealing or breach of money laundering regulations, subject to the outcome of liaison with other prosecuting authorities.
Assessment	Implemented
Comments	The wide enforcement powers of the FSA clearly will need to be tested in appropriate cases at an early opportunity. The civil offence market abuse provisions are novel and as yet untested. The floating burden of proof (somewhere less than beyond reasonable doubt, but more than on the balance of probabilities) may mean that the perceived advantages of the so-called 'civil offence' are not fully-realized in practice. Further, the credibility of a securities regulatory regime depends on the credibility of the threat of enforcement action, and it remains to be seen how civil offence proceedings will be regarded by the regulated community. Finally, the only enforcement device which may be considered for addition to the FSA's toolkit is the court enforceable undertaking – the right to accept a detailed commitment as to future behavior which has the effect of binding the giver as if it were bound by a court order to the same effect.
Principle 10.	The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.
Description	The FSA receives routine financial reports from markets and intermediaries. The FSA also conducts periodic routine inspections and inspections for cause. On-site visits are used as part of the formal risk-assessment process, and inspection priorities are based on identified risks or complaints associated with the regulated entity. Where necessary, skilled persons such as external auditors are engaged to validate information. In certain cases, the FSA itself sets penalties, but in doing so involves a Regulatory Decisions Committee, which includes external participation, and its decision is subject to the direction of the Financial Services and Markets Tribunal. This committee was established by the FSA, and includes both FSA staff and external participants in order to address concerns that the FSA's own disciplinary decisions might be perceived to be too harsh. Its decisions have the same legal effects as those of the FSA itself.
Assessment	Implemented
Comments	The move to civil offences described above (proceedings for which can only be initiated by the FSA) should produce more evidence of effective enforcement action utilizing a range of enforcement tools. At present, the regime has been dominated by disciplinary findings against authorized persons and some minor criminal prosecutions. The FSA's 'risk-based' approach will determine what issues the FSA investigates, together with the resources available to the FSA from time to time.
Principles for Cooperation in Regulation	
Principle 11.	The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.
Description	The FSMA defines the 'primary recipients,' including the FSA, of confidential regulatory information who are bound by information sharing rules. Primary recipients are empowered to pass confidential information should there be an available 'gateway' set out in either the FSMA or the statutory instrument made under it. These gateways include the passing of such information between relevant U.K. bodies, and to overseas regulatory authorities for the purpose of enabling or assisting them to discharge their functions. It is, however, an offence under FSMA for a primary recipient or any person who obtains confidential information directly or indirectly from a primary recipient to disclose confidential information, except through statutory gateways or where the originator of the information has given consent.

Assessment	Implemented
Comments	The FSMA permits the FSA, when deciding issues of assistance to overseas regulators outside the European Community, to take into account: (a) whether the requesting jurisdiction would provide such assistance to the U.K.; (b) whether the matter concerns a breach of a law or other requirement with no close parallel in the United Kingdom, or the assertion of a jurisdiction not recognized by the U.K.; (c) the seriousness of the case and its importance to persons in the U.K.; and (d) whether it is otherwise appropriate in the public interest (presumably, of the U.K.) to give that assistance. The references to the necessity to take account of the U.K.'s own interest when assessing whether or not to provide assistance might be thought inconsistent with the priority a major international financial centre like the United Kingdom ought to place on securing effective enforcement across national borders. The FSA may wish to consider this issue the next time it is reviewing policy in this area.
Principle 12.	Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.
Description	The FSA has signed nearly 160 Memoranda of Understanding (MoUs) with regulatory counterparts overseas. These are not all of the same kind, but serve different purposes depending on the requirements they are designed to meet, such as licensing, supervisory and enforcement issues. The FSA is reviewing its range of MoUs and other co-operation mechanisms to ensure that they are in line with the FSMA regime.
Assessment	Implemented
Comments	The MoUs were largely signed by the FSA's predecessors, and need to be reviewed to reflect the many changes in the law and the role of the FSA in the intervening period. On the other hand, MoUs are usually practical devices rather than substantive legal instruments, and any delay in revising them is more likely to lead to delay or inconvenience, than to obstruction.
Principle 13.	The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.
Description	Under the FSMA, the FSA has a general duty to take such steps as it considers appropriate to cooperate with foreign authorities that have similar functions to the FSA or in relation to the prevention or detection of financial crime. This includes sharing information that the FSA is not prevented from disclosing. The FSA is able to exercise specific powers on behalf of an overseas regulator if that regulator has requested it to do so. The FSA may, on behalf of an overseas regulator, require authorized firms, RIEs and RCHs (as well as persons connected to all these entities) to produce documents or information.
Assessment	Implemented
Comments	The FSA has a good record of providing such assistance to many regulators around the world. This is so despite the fact that, like many others, the FSA does not have the power to compel sworn testimony for other regulators. Further, there are limits: confidential information can only be disclosed if the FSA is satisfied that (a) the requesting authority and the request are bona fide, (b) the purpose of the request is clear and (c) the specific requirements of the FSMA (noted in the comments to CP 11) are met.
Principles for Issuers	
Principle 14.	There should be full, accurate and timely disclosure of financial results and other information that is material to investors' decisions.

Description	Issuers of securities who wish to be admitted to the listed securities markets operated by the LSE must first be admitted to the Official List as maintained by the UKLA (a division of the FSA), in its role as competent authority. When an issuer applies to have securities admitted to listing it must publish a prospectus which complies with the detailed disclosure requirements set out in the UKLA's Listing Rules, together with the general obligation contained in the FSMA. A prospectus must contain all such information as investors and their professional advisers would reasonably require and expect to find in order to make an informed assessment of the issuer's assets and liabilities, financial position, profits and losses, and prospects, as well as the rights attaching to the securities. The UKLA reviews and approves all such material, and can intervene to stop the circulation of false or misleading information. Once securities have been admitted to listing, the Listing Rules impose general obligations on an issuer to disclose information that would be likely to lead to a substantial movement in the price of its listed securities. Those obligations do not apply when the information is confidential, such as when negotiations are continuing, or disclosure might otherwise prejudice the interests of the issuer, and the UKLA provides guidance or relief in such cases. The Listing Rules also contain the continuing obligations with which an issuer must comply and which cover the disclosure of financial information, significant transactions, certain corporate changes and information concerning the management of the company. Where securities are offered to the public but where they are not being admitted to the Official List, the Public Offers of Securities Regulations 1995 impose disclosure requirements similar to those for listed securities. Once these securities are issued, if they are admitted to a RIE and traded on a market regulated by that exchange, the Traded Securities (Disclosure) Regulations 1994 require the issuer to disclose information that would be likely to lead to a substantial movement in the price of its securities. The obligations with respect to the publication of annual and other periodic reports of financial results are contained in the Listing Rules and/or the Companies Act. The Companies Act allows 180 days for a public company to prepare and circulate its annual accounts, although the period allowed under the Listing Rules is less than that; and the Listing Rules allow 120 days to circulate a preliminary final statement of the results and dividends. Semi-annual and quarterly reports (where they are required) are due within 90 days.
Assessment	Implemented
Comments	The time periods for the release of preliminary final results, and for the circulation of annual financial reports, are too long. The continuous disclosure regime is not a substitute, but an adjunct, to the periodic reporting of results, including balance sheets, accounting treatments, and the like. There are plans announced by the Department of Trade and Industry to shorten the statutory period significantly. Further, the review of the UKLA listing requirements, already announced, will look at these issues, at least in part because a proposed EU Directive on Regular Reporting will require periods of 90 days for annual reports and 60 days for half yearly and quarterly reports. In the context of that review, consideration could be given as to whether all prospectuses need to be reviewed by the UKLA; this is presently required under an EU directive, but it would be more efficient and effective if the FSA's 'risk-based' assessment methodology could be applied in this context. That method is already used in deciding which periodic reports should be reviewed.
Principle 15.	Holders of securities in a company should be treated in a fair and equitable manner.
Description	If a company has listed securities it will be subject to the Listing Rules, which provide that the company must ensure equality of treatment for all holders of shares who are in the same position. In addition, the continuing obligations apply this general principle, for example, by

	requiring certain transactions – by virtue of their size or because they are with persons connected to the company – to be subject to shareholder approval. Finally, the City Code on Takeovers and Mergers (City Code), as administered by the Takeovers Panel, applies to all takeovers of public companies in the United Kingdom, and is based on the principle of fair and equitable treatment of all shareholders within a class. Thus, all ordinary shareholders would receive the same offer in a takeover bid unless the Panel agreed to any differential treatment.
Assessment	Implemented
Comments	The City Code and Takeover Panel in particular are seen as effective contributors to the quality of the markets in London, by virtue of the speed, flexibility and certainty they bring to takeovers, despite their informality.
Principle 16.	Accounting and auditing standards should be of a high and internationally acceptable quality.
Description	Every U.K. company registered under the Companies Act is required to prepare annual accounts to standards set or agreed by the Accounting Standards Board (ASB). Audits are undertaken to standards set or agreed by the Auditing Practice Board (APB). Certain categories of small companies are not required to appoint auditors, but all other companies must have their accounts reported on by an external auditor. Both the ASB and APB are independent bodies under Financial Reporting Council oversight.
Assessment	Implemented
Comments	U.K. accounting standards are of a high and internationally acceptable quality. While there presently are a number of differences between U.K. Accounting Standards and International Accounting Standards, the U.K. will (subject to an EU accounting regulation) require listed companies, from January 2005, to prepare their group financial statements using international standards. In addition, U.K. Accounting Standards applicable to unlisted companies and unconsolidated accounts of U.K. companies are being revised in a process of phased alignment with international standards, except where circumstances suggest this is not appropriate. U.K. auditing standards are also of a high and internationally acceptable quality. While there presently are a number of differences between U.K. Statements of Auditing Standards and International Standards on Auditing, these differences are in the process of being resolved in the context of an EU recommendation that all listed companies be required, by 2005, to have their group financial statements audited in accordance with international standards.
Principles for Collective Investment Schemes	
Principle 17.	The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.
Description	Under the FSMA, the FSA is responsible for the authorization of investment management firms (as well as trustees and depositories) generally, and granting authorized firms specific permission to market and operate collective investment schemes (CISs). The FSA's Handbook sets out the following factors to be considered at the authorization stage with respect to the operator: (a) fitness and propriety; (b) honesty and integrity; (c) financial capacity; (d) adequacy of its internal management procedures; (e) competence to carry out the functions and duties of the CIS; (f) available human and technical resources; and (g) the capacity to discharge operator powers and duties. The operator is subject to a general and continuing obligation to comply with the admissions requirements, an obligation to notify the FSA of significant changes, and rules governing the conduct of its business.
Assessment	Implemented

Comments	These obligations are comprehensive and accessible, and this may be reflected in the fact that the U.K. investment fund industry is among the largest and most successful in the world. However, consideration could be given to several refinements, such as: (a) A specific requirement for transactions with affiliated parties to be disclosed to investors and the FSA (such transactions are required to be on arm's length terms, but that is not always an easy test to apply, and the volume of transactions may be of relevance to investors to know; the present requirement is merely to inform the FSA of anything of which the FSA would reasonably expect prompt notice); (b) A requirement that delegates receiving delegations of functions such as portfolio management, investment advisory and other core functions be bound not only by contract with the operator, as at present, but by law or delegated legislation, to comply with the same regulatory standards imposed on the operator itself ; and (c) An extension of the regulatory framework applicable to delegates to sub-delegates, or at least to those located in the U.K. The latter two changes would, we understand, require legislation, but in certain circumstances, direct access by the regulator to such delegates may be of value. Finally, whether the application of the FSA's 'risk-based' approach to CISs results in effective regulation, particularly with respect to smaller CISs, has yet to be tested in practice.
Principle 18.	The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.
Description	There are two types of CISs in the U.K. that are capable of being promoted to the public: (a) authorized unit trusts (AUTs); and (b) investment companies with variable capital (ICVCs) (currently known as open-ended investment companies, or OEICS). AUTs are unincorporated bodies created under trust law and constituted by a trust deed made between the manager (the operator) and the trustee, both of whom must be authorized persons under FSMA. The CIS Sourcebook sets out the general powers and duties of the manager and the trustee in detail, and the regulations that apply to them. ICVCs are incorporated bodies established in accordance with the Open-Ended Investment Companies Regulations 2001. The FSA's product regulations for ICVCs (in the CIS Sourcebook) deal with the powers, duties and responsibilities of the directors of the company and the depository of the company.
Assessment	Implemented
Comments	These rules are straightforward and clear. Consideration could be given to requiring that all delegations be notified, in annual reports at least. At present, only delegation arrangements for custody are notified to the FSA. (We understand that such notification will be required by an EU directive, required to be implemented by the middle of 2003.)
Principle 19.	Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.
Description	The rules on financial promotion and disclosure require that an Independent Financial Adviser or a Company Representative establish the personal financial circumstances of the investor (the principle of 'know your customer'), and recommend only a product which is suitable, having regard to the investor's needs. Where CISs are offered through a direct offer advertisement, the product provider must provide a statement in that advertisement explaining that a customer who is unsure about whether the product might be suitable for his or her needs should seek independent financial advice. In either case, the investor must be provided with a Key Features

	Document (KFD), which is to set out all material information the investor needs to make a sound purchase decision.
Assessment	Implemented
Comments	The KFD requirement is to produce material in a user-friendly format, and there is a requirement for fair and clear communication with customers - but there is no explicit requirement for 'plain English,' or for research to be conducted to ensure that the material is in fact in a form which is readily comprehensible. Also, there is no continuous disclosure requirement as such for CISs, presumably on the basis that material information is factored into the price and the price adjusted accordingly. But investors would be assisted by direct access to such information, particularly where information is not publicly available concerning the securities held by the CIS. We understand that consideration is already being given to all of these issues.
Principle 20.	Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.
Description	The FSMA (for AUTs) and the Open-Ended Investment Companies (OEIC) Regulations 2001 (for ICVCs) give participants the right to have their holdings redeemed at a price not significantly different from the net value of the property, determined in accordance with the Trust Deed/Instrument of Incorporation and FSA rules. The FSA's product regulations for authorized CISs (found in the CIS Sourcebook) require that: (a) price(s) of units/shares bought or sold properly relate to the net value of the authorized fund; (b) the manager deals fairly with investors when they purchase or sell units; and (c) investors have access to pre-sale information. There are also separate disclosure regulations requiring information to be given about charges and/or expenses that investors will or may bear.
Assessment	Implemented
Comments	The FSA has been reviewing the single/dual pricing regimes for CISs. and is encouraged to continue its efforts to reduce the risk of possible investor confusion in this area.
Principles for Market Intermediaries	
Principle 21.	Regulation should provide for minimum entry standards for market intermediaries.
Description	The FSMA provides that no person may carry on a regulated activity in the United Kingdom, or purport to do so, unless he or she is an authorized person or an exempt person. The FSMA (Regulated Activities) Order 2001 sets out activities that are regulated activities for the purpose of the FSMA. These activities include: (a) managing investments; (b) arranging deals in investments; (c) dealing in investments as principal; (d) dealing in investments as agent; and (e) giving investment advice. Further, when an authorized person enters into an arrangement in relation to carrying on a regulated activity, any person performing a "controlled function" (also a defined term) under the arrangement must be "approved" by the FSA.
Assessment	Implemented
Comments	These obligations are comprehensive and accessible. The FSMA's 'threshold conditions,' such as the 'fit and proper' test and those dealing with 'close links' address many of the matters suggested for consideration by IOSCO in the discussion surrounding CP 21. The FSA has the power to refuse an application for authorization if any of the threshold conditions are not met. The FSMA also requires notice to the FSA of proposals to acquire a controlling interest in a market intermediary. In the discussion surrounding CP 21 [Section 12.3], IOSCO also suggests that, to enable investors to protect their own interests, the regulator should ensure that the public

	have access to relevant information concerning market intermediaries, such as the category of license held, the scope of authorized activities, the identity of senior management and those authorized to act in the name of the intermediary. Under the FSMA, the FSA is obliged to publish such information about approved persons as the FSA thinks appropriate, including what services they hold themselves out as able to provide, and their address.
Principle 22.	There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.
Description	At authorization, each firm is given permission(s) to undertake specified types of regulated activity. After authorization, if a firm wishes to undertake additional regulated activities, then it has to apply for a variation in its permission(s). The prudential requirements and other rules that apply to a firm depend on the permissions that it holds. These requirements relate to: (a) capital adequacy; (b) the holding of client money and assets; (c) maintenance of systems of internal control; and (d) reporting and notification requirements. Firms that are assessed as being other than 'low impact' firms under the FSA's 'risk-based' approach are also subject to individual risk assessments. Firm-specific risk mitigation programmes are then drawn up, in light of the risks identified in the assessments.
Assessment	Implemented
Comments	FSA rules require all market intermediaries, other than professional firms and service companies, to meet specified initial and ongoing capital requirements. Professional firms and service companies simply are required to be able to meet their liabilities as they become due. According to IOSCO, regulation should ensure that there is proper ongoing supervision with respect to market intermediaries. Under the FSA's 'risk-based' approach to supervision, approximately 80 percent of market intermediaries (the 'low impact' firms) are not automatically subject to regular examinations and are required to submit only annual financial reports to the FSA. Visits, and closer attention generally, to these firms comes about when there are complaints from customers, or reports from whistleblowers, or in the context of thematic or random samples. The effectiveness of this approach to the supervision of low impact firms, and ability nevertheless to ensure compliance with ongoing capital and other important prudential requirements of these firms, has yet to be determined. Separately, the FSA is to be commended for its efforts to develop a liquidity standard for market intermediaries.
Principle 23.	Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.
Description	The FSA Handbook of Rules and Guidance for firms contains 11 Principles for Businesses with which all regulated firms must comply. The Principles for Businesses are enforced by rules and guidance throughout the Handbook, especially in the sections on conduct of business and arrangements for senior management, systems and controls.
Assessment	Implemented
Comments	The FSA Handbook places a comprehensive set of high-level obligations on market intermediaries with respect to risk management and internal controls, as well as the proper conduct of business. In general, these obligations encompass the standards recommended by CP 23: integrity and diligence; terms of engagement; information from customers; disclosure to customers; protection of customer assets; market conduct; operational controls; avoidance/management of conflicts of interest; and oversight of proprietary trading. As

	previously noted, it is too soon to say whether the FSA's limited approach to the supervision of 'low impact' market intermediaries will, in practice, lead to a deterioration of compliance with important regulatory standards, such as those relating to the conduct of business and risk management/internal controls.
Principle 24.	There should be a procedure for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.
Description	The FSA has wide powers under the FSMA to take action in cases of insolvency. These include the FSA's right to apply to a court to wind up an authorized person or to apply for an administration order. The FSA also has the right to be heard in court proceedings relating to the insolvency of such persons. Furthermore, the FSA is able to take regulatory action against firms that are failing before they are the subject of court proceedings for winding up. For example, the FSA has the power to impose requirements in a firm's permission to carry on regulated activities in order to protect the interests of consumers, and to vary or cancel the firm's permission. All RIEs and RCHs are required to have default rules in respect of market contracts effected by means of their facilities. In addition, Part VII of the Companies Act modifies the law of insolvency to protect market default procedures, charges given to secure obligations in connection with transactions and margin held by RIEs and RCHs. (See also in this context, Assessment of IOSCO/CPSS Recommendations for Securities Settlement Systems.) The Financial Services Compensation Scheme (FSCS), is available for the compensation of persons in circumstances where a defaulter is unable, or is unlikely to be able, to satisfy claims against it.
Assessment	Implemented
Comments	The means by which FSA can deal with the failure of a market intermediary are many, and the FSA has the discretion to apply them in a flexible manner, either independently or in cooperation with other authorities. While many of these regulatory tools can be applied before an intermediary is the subject of formal insolvency proceedings, the FSA's 'risk-based' approach to supervision could prevent early diagnosis with respect to the large number of 'low impact' firms. Although these 'low impact' firms, by definition, do not pose systemic risks individually, sight should not be lost of the fact that individual customers risk losses in the event of a failure, at least to the extent they are not covered by the FSCS. However, it is too soon to say how this will play out in practice.
Principles for the Secondary Market	
Principle 25.	The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.
Description	The FSMA prohibits persons from carrying out a regulated activity in the U.K. without either being authorized by the FSA or exempt therefrom. Regulated activities, particularly those defined as arranging deals in investments, capture the activity of providing a trading system or exchange service. Once authorized, these trading systems (including securities exchanges) are subject to regulatory oversight by the FSA. Authorized persons operating trading systems are subject to FSA rules and guidance that are set out in the FSA Handbook.
Assessment	Implemented
Comments	Securities exchanges, as RIEs, are subject to a well-developed regime for regulatory authorization by the FSA, and oversight by the FSA and by the exchanges themselves acting as SROs. Although the regulatory scheme for alternative trading systems currently is under review, at present the FSA applies the authorization and oversight regime applicable to

	‘authorized persons’ to these systems. While this structure has the potential for regulatory gaps it does not appear to be a significant cause for concern, given the relatively small market share acquired by alternative trading systems in the U.K. to date.
Principle 26.	There should be ongoing regulatory supervision of exchanges and trading systems, which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.
Description	The recognition (authorization) requirements for RIEs prescribe that they ensure that business conducted by means of their facilities is conducted in an orderly manner and so as to afford proper protection to investors. The recognition requirements specify a number of safeguards for investors, including provisions relating to market access, proper markets in the investments traded, satisfactory arrangements for securing the timely discharge of the rights and liabilities of the parties to transactions effected on the exchange, and appropriate measures to reduce the extent to which the exchange’s facilities can be used for a purpose connected with market abuse or financial crime. With respect to market participants, the recognition requirements mandate that an exchange have appropriate procedures for rulemaking, including consultation with users of the exchange’s facilities, as well as effective arrangements for monitoring and enforcing compliance with those rules.
Assessment	Implemented
Comments	The ongoing monitoring of trading on these exchanges is done by the exchanges themselves, in their role as SROs. The FSA requires RIEs to address relevant matters cited by IOSCO, including standards for the admission of products to trading and the admission of participants to the trading system, equitable access to trading information, fair order routing and execution procedures, publication of post-trade information and maintenance of an audit trail, the supervision of the trading system and participants, and procedures for dealing with trading disruptions. See the AML/CFT assessment for a discussion of the extent to which RIEs can be used for a purpose connected with financial crime
Principle 27.	Regulation should promote transparency of trading.
Description	The FSA is predisposed to view transparency as an important contributor to market efficiency and investor protection. It and its predecessor body (the Securities and Investments Board) have encouraged improved transparency in U.K. securities markets in recent years. The FSA views transparency as a central ‘risk’ issue in markets, and believes that a regulator should keep transparency arrangements under review on a continuing basis.
Assessment	Implemented
Comments	According to IOSCO, ensuring timely access to trading information is a key to the regulation of secondary trading, and where a market permits some derogation from the objective of real-time transparency, the conditions need to be clearly defined. While the FSA generally encourages transparency, detailed guidance is not provided and the FSA explicitly recognizes that the optimum levels of transparency may vary from market to market, depending on such factors as the instrument being traded, the size and frequency of transactions, and the role played by liquidity providers. The FSA presently is conducting an internal review of transparency matters, and may wish to consider more vigorously encouraging RIEs to improve price transparency. While the transparency of the U.K. securities exchanges generally appears good, particularly for the most liquid securities, care should be taken not to permit competitive pressures at the RIEs to undermine the visibility of trading interest. Although it is recognized that there often is a trade-off between transparency and liquidity, particularly with respect to institutional order flow, allowing widespread pre-negotiation/internalization and delays in trade reporting could lead to a degradation of the price discovery process, and thereby the quality of trading in the

	U.K. exchange markets.
Principle 28.	Regulation should be designed to detect and deter manipulation and other unfair trading practices.
Description	The U.K. has for some years defined insider dealing and market manipulation as criminal offences. The FSMA provides for a broadening and strengthening of the U.K. regime against market abuse. In particular, the FSMA has placed responsibility for market conduct with the FSA, provided for the FSA to issue a Code of Market Conduct (addressing misuse of information, false or misleading impressions and distortion) and given the FSA powers to operate a 'financial penalties' regime alongside the continuing criminal regime.
Assessment	Implemented
Comments	The FSA and RIEs have sufficient authority to address manipulation and other unfair trading practices, and appear to have implemented this authority in a comprehensive fashion. Despite the limited reliance on SROs, the FSA has been able to work effectively with the RIEs to monitor market activity electronically. The FSA is responsible for monitoring unfair trading practices in the OTC markets, applying its 'risk-based' approach to supervision, which as previously noted has yet to be tested in practice. The FSA is expected to focus its scarce enforcement resources on cases it judges to be of systemic importance, but it is too soon to say how well this will work in practice.
Principle 29.	Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.
Description	The FSA has developed arrangements for the management of large exposures, default risk and potential market disruption. The FSA Handbook contains large exposure reporting requirements for investment firms. All RIEs and RCHs are required to have default rules (see the assessment of U.K. securities settlement systems against the IOSCO-CPSS recommendations) . In addition, RIEs and RCHs must have adequate financial resources to address counterparty or market risks, and their systems and controls must provide for the effective management of risk. The FSA also looks to RIEs and RCHs to monitor large exposures and to inform the FSA when these are considered significant.
Assessment	Implemented
Comments	Appropriate procedures appear to have been developed, largely through the SROs, to monitor and address large exposures, default risk, and market disruption. With respect to large exposures, IOSCO states in the discussion surrounding CP 29[Section 13.7] that market authorities should establish trigger levels for identifying large exposures that are appropriate to their markets, and continuously monitor the size of positions on those markets, so that they can assess the risks posed by them to a market or clearing firm. The FSA may wish to consider whether, in practice, the U.K. markets effectively achieve this goal of identifying large exposures and continuously monitoring of positions.
Principle 30.	Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.
Description	The provision of clearing and settlement services falls within the scope of regulated activities in the U.K. Those providing such services need to be authorized or recognized as RCHs. The RCH requirements prescribe that a clearing house must have sufficient financial resources for the proper performance of its functions, and must ensure that its systems and controls are adequate and appropriate for the scale and nature of its business. RCHs are regarded as potential 'high

	impact' institutions under the FSA's 'risk-based' approach, and therefore are subject to a relatively high level of regulatory scrutiny.
Assessment	Implemented
Comments	*See* Assessment of IOSCO/CPSS Recommendations for Securities Settlement Systems

Table 11. Summary Observance of the IOSCO Objectives and Principles of Securities Regulation

Assessment Grade	Principles Grouped by Assessment Grade	
	Count	List
Implemented	30	CPs 1 - 30
Partially Implemented		
Non-Implemented		
Not applicable		

F. Recommended Actions and Authorities' Response to the Assessment

53. Although the United Kingdom observes all of the IOSCO objectives and principles, some technical recommendations are outlined below to further improve the U.K.'s regulation of securities markets.

- When policy in the area of co-operation in international enforcement is next under review, consideration might be given as to whether the requirement in the FSMA to take account of the U.K.'s own interest when assessing whether or not to provide assistance to foreign regulators, is consistent with the priority a major international financial centre like the United Kingdom ought to place on securing effective enforcement across national borders.
- Consideration could be given as to whether it is economic or efficient for the law to require all prospectuses to be reviewed by the UKLA; the FSA's 'risk-based' assessment methodology could also be appropriate in this context.

54. In the area of collective investments, matters which might be considered include:

- Introducing a specific requirement for transactions with affiliated parties to be disclosed to investors and the FSA.
- Introducing a requirement that delegates receiving delegations of functions such as portfolio management, investment advisory and other core functions be bound not

only by contract with the operator, as at present, but also by law to comply with the same regulatory standards imposed on the operator itself.

- Extending the regulatory framework applicable to delegates, to sub-delegates.
- Requiring delegation arrangements for custody to also be notified in annual reports at least.
- Introducing continuous disclosure requirements for CISs.
- Finally, the FSA presently is conducting an internal review of transparency matters, and may wish to ensure that competitive pressures do not undermine the visibility of trading interest in the future.

G. Authorities' Response

55. The authorities welcomed the positive assessment of the U.K.'s observance of the IOSCO principles and noted that the United Kingdom has fully implemented all 30 principles. They also noted that the FSAP team has been able to make some technical recommendations which they regard as helpful in providing constructive input to their thinking and they are considering how best to take them forward. They feel that the technical recommendations are constructive and provide useful support for ongoing FSA work to further strengthen the U.K. securities regime. Specific comments on the technical recommendations outlined above are as follows:

- *Co-operation in international enforcement.* The authorities feel that in practice the recommendation concerning co-operation on international enforcement may be overstated, given both their record of effective co-operation and the requirements in FSMA to co-operate and to look beyond U.K. interests.

- *Review of all prospectuses by the UKLA.* The authorities consider the recommendation to apply their risk-based approach to their approval of documents to be useful. They are seeking to develop a more risk-based approach to this work, although they would emphasize that they must still meet their obligations under European Directives that require approval of documents.

- *Collective investments - disclosure of transactions with affiliated parties and requirement of delegation arrangements* The authorities noted that the U.K. has a very comprehensive and detailed regime for the regulation of Collective Investment Schemes (CIS) and in some areas they feel that their regime already provides sufficient protections equivalent to those suggested by the recommendations. On the recommendations on the use of delegates, and for continuous disclosure by CIS, they believe these measures are already undertaken within their regime. They are, however, reviewing their current requirements for continuing disclosure. On transactions with affiliated parties, the FSA is satisfied that the present requirements for information about such transactions to be passed to the FSA are consistent with their risk based approach to supervision and a proportionate regulatory regime. Nonetheless, they are also considering further refinements to their CIS regime through an ongoing current review and they noted that, in this respect, the FSAP recommendations more generally provide support for work already ongoing.

- *Encouraging RIEs to improve price transparency.* The authorities recognize the importance of sustaining improvements in an increasingly competitive environment. To this end they have been working to underpin high levels of transparency in a more fragmented marketplace, while also paying due attention to the need not to damage liquidity.

IV. CPSS Core Principles for SIPS and Central Bank Responsibilities in Applying the CPs—NewCHAPS

A. General

56. This assessment was undertaken in the context of an IMF Financial Sector Assessment Program (FSAP) exercise for the United Kingdom over the period February-July 2002 which covered, inter alia, the *Core Principles for Systemically Important Payment Systems*.[7] This assessment covers the NewCHAPS system, the basis for two schemes—CHAPS sterling and CHAPS euro, providing real-time gross settlement facilities for sterling and euro transactions, respectively.[8]

57. The Bank of England (the Bank) has conducted a formal self-assessment of the NewCHAPS system's observance of the Core Principles. This assessment was made available to the mission. The Bank also provided detailed answers to an IMF questionnaire and a number of documents relevant for the assessment. Extensive meetings were held with officials from the Bank, supplemented by discussions with officials from the CHAPS Company as well as with the Association for Payment Clearing Services (APACS), six NewCHAPS members and two non-member institutions.

58. The G-10 Committee on Payment and Settlement Systems' (CPSS) Report on Core Principles for Systemically Important Payment Systems Parts I and II and an IMF guidance note were used when assessing the NewCHAPS system. No obstacles were faced in the work. The authorities and others were fully cooperative.

The payment infrastructure in the United Kingdom

59. The majority of interbank transfers of funds in the United Kingdom are processed through four clearing systems, all of which operate under the umbrella of APACS:

- As part of NewCHAPS, the CHAPS Sterling and CHAPS euro systems settle payments on an RTGS basis. They are primarily designed for high-value payments, although there is no lower (or upper) limit on the value of individual payments. The two NewCHAPS systems currently have 21 participants, of which 20 are members of CHAPS euro and 13 of CHAPS Sterling.

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[7] Prepared by Tom Kokkola (European Central Bank) in collaboration with Martin Andersson (Sveriges Riksbank).

[8] CHAPS is an acronym for Clearing House Automated Payment System.

- BACS[9] is an Automated Clearing House (ACH), which processes large volumes of relatively low-value (retail) payments, including direct debits, direct credits, standing orders, and other non-urgent automated credit transfers.

- Finally, paper debit and credit payment items are cleared through two parallel systems run by the Cheque & Credit Clearing Company (C&CCC).

60. The CHAPS Clearing Company Limited (CHAPSCo) is the governing body for the CHAPS Sterling and Euro systems. CHAPS Sterling started operations in 1984 as a nation-wide, electronic interbank system for sending irrevocable, guaranteed and unconditional sterling credit transfers for same day value operating on an end-of-day multilateral net settlement basis. In April 1996, it was developed into an RTGS system. It now handles nearly all large-value same-day sterling payments between banks, other than those relating specifically to the settlement of securities transactions (handled through CREST).

61. In January 1999, a second CHAPS system—for euro-denominated payments—began operation. This system is connected to TARGET, the RTGS system for the euro. CHAPS euro is the U.K. national component of TARGET and is separate from the original CHAPS sterling system (although both are run by CHAPSCo). However, the technical differences between the two systems narrowed significantly in August 2001, when the NewCHAPS project moved the two systems onto the same (SWIFT-based) technical platform. The strategic decision to migrate to a common generic platform was motivated by the desire to achieve technological and cost efficiencies, to ensure a sufficiently flexible infrastructure to meet requirements for possible U.K. EMU entry, to prepare for implementation of 'full DVP' in the U.K. in November 2001 and to facilitate wider access to the CHAPS Sterling system.

62. The main components of the NewCHAPS systems are: message exchange within two closed user groups comprising CHAPS (euro and Sterling respectively) members and the Bank, over the SWIFT FIN Copy Financial Application service (used in 'Y-Copy' mode);[10] Computer Based Terminals (CBTs – SWIFT interfaces) located within members' systems and at the Bank (the RTGS CBT); sterling and euro settlement accounts within the Bank's real-time accounting system (the RTGS processor); and an Enquiry Link facility provided by the Bank, which enables system participants to interact with the RTGS processor to e.g., monitor payments progress, manage payments queues during the day and make certain funds transfers.

[9] Bankers' Automated Clearing Services. A formal assessment has not been undertaken for BACS—a more general analysis contained in The Selected Issues Volume.

[10] Y-copy mode refers to one of the main forms of RTGS message flow design: it is characterized by a central processor that, when it receives a payment message from a sending bank, strips commercial information not strictly necessary for settlement from the settlement request it passes to the central bank; then, when settlement confirmation is received back from the central bank, the central processor sends the full payment information on to the receiving bank.

63. The Bank is responsible for the provision and maintenance of the central scheduling and settlement accounting environment for the settlement during the day of CHAPS payments and other transactions between members outside the CHAPS operating day, as well as intraday payment flow monitoring. It is also responsible for the provision and maintenance of the Enquiry Link network (based on SWIFTNet and subject to bilateral contractual arrangements between the bank and SWIFT) and for the provision of intraday liquidity to CHAPS members through an intraday repo facility (subject to bilateral contractual arrangements between the Bank and members). CHAPSCo is responsible for the provision and maintenance of the messaging network conveying CHAPS payment information between CHAPS members and to and from the Bank over the SWIFT network (subject to contractual arrangements between CHAPSCo and SWIFT).

B. The Functioning of the NewCHAPS System

64. In NewCHAPS, payments are processed as follows: a payment message (MT100, MT103 or MT202) is submitted to the SWIFT network. This message is held in the FIN Copy service and a settlement request (MT096) containing a subset of the original message is forwarded to the RTGS Processor, via the RTGS CBT. On reaching the RTGS Processor, all payment messages pass through a validation process, for example to check for duplicate messages.

65. All valid payment requests submitted to the Bank are then routed via a *Central Scheduler* to the RTGS processor. It is expected that the vast majority of payments will pass straight through the Central Scheduler for settlement. However, payments will be forwarded for settlement only after they meet the conditions contained in certain 'filters' in the central scheduler. These filters are set by individual banks and are not compulsory. There are three filters and any combination of one, two or three filters may be set by banks:

- *Value 'threshold:'* Payments that are equal to or greater than this value are held in the central scheduler with a status of 'blocked by value.'
- *Individual payment 'filter'*: a bank may submit payments with a status of 'held.' Such payments are held within the central scheduler until the status is removed by that bank.
- *Individual domestic counterparty 'switch:'* individual banks can temporarily hold in the central scheduler all payments to another CHAPS member. Such payments will be held within the central scheduler with a status of 'held for counterparty'.

66. Items which pass through the Central Scheduler are held in the sending bank's *Funds Queue* (one for each currency). Payments on the Funds Queue are processed first by priority, then by value (with the lowest value settlement request queued ahead of higher value settlement requests), then by time input to the funds queue, then by time of input to the RTGS Processor.

67. Settlement requests can be allocated a 'Priority' number within the range of 1-99 with Priority 1 being the highest. Settlement requests within the range of 1 to 19 are able to use 'headroom' (see below). The Priority levels 1-9 and 90-99 are reserved for use by the Bank, while individual banks can allocate other priority levels to individual payment messages. If no Priority is allocated, the system default Priority of 50 is allocated. The Priority of a settlement request may be changed at any time provided it has not settled. Changing a Priority has the effect of moving the item in the funds queue.

68. The RTGS Processor settles payments by simultaneously debiting the sending member's Settlement Account while crediting that of the receiving member. Any payment from a sending member may not be revoked by it after the Bank has debited its Settlement Account. Once these entries have been made on the Settlement Accounts of the sending member and the receiving member, settlement is final. After settlement, a Settlement Confirmation (MT097) is sent from the RTGS Processor to the SWIFT FIN Copy service. The initial payment message is then automatically released, with full details plus a settlement confirmation, from FIN Copy to the receiving member, who is required to validate the payment and to accept it.[11]

69. The sending member may request that FIN Copy produces a Sender Notification message (MT012) to inform the member that a Settlement Confirmation has been received by FIN Copy from the RTGS Processor. The sending member may also request that FIN Copy produces a Delivery Notification (MT011) once the settled payment message has been successfully delivered to the receiving member.

70. According to the Memorandum of Understanding between the Bank and CHAPSCo ("the MoU"), the transmission time between one member's internal system and another's should be no longer than 60 seconds (30 seconds for network processing and 30 seconds for processing by the RTGS processor excluding any delays caused by queuing in the Central Scheduler or lack of liquidity).

71. To enable Members to make time-critical payments such as settlement of net obligations in ancillary payment systems, each bank can reserve part of its total available liquidity within the RTGS settlement process for those payments—so-called 'headroom.' A member-parameterized default setting allows individual banks to reserve a set amount at the start of each business day; members can change the amount reserved intraday. As noted above, 'priorities' are used to indicate payments which may use this reserved balance.

72. To improve the efficiency of liquidity usage *in the CHAPS sterling system*, by preventing any one institution from hoarding liquidity, members are required to comply with the following guidelines, measured over a calendar month.

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[11] If the receiving member is not able to validate the payment, the settlement finality of that payment still holds, but the member would initiate a separate "return payment".

Average of 50% of value throughput	By 12.00 U.K. Time
Average of 75% of value throughput	By 14.30 U.K. Time

73. At an aggregate level, the experience suggests that CHAPS Sterling appears to be meeting the throughput guidelines quite easily (some 30–40 minutes in advance of the deadlines).

74. The Enquiry Link, which is an interactive link between Members and the RTGS processor based on SWIFTNet Interact service, can be used to adjust Central Scheduler settings, to select payments on which the Member wishes to override thresholds, to cancel any payments queued in the Central Scheduler and in the Funds Queue or to alter the priority of payments. It can also be used by CHAPS members intraday to fund and defund their separate CREST RTGS account for DvP (there is automatic functionality available to do this too, the *Automatic Liquidity Transfer (ALT) Mechanism*).

75. *Cross-border TARGET payments* initially follow a similar path to domestic euro payments. However, when the sender's account is debited, an RT TARGET account is credited and a settlement confirmation is returned to FIN Copy. This releases the full payment message in SWIFT, which is sent back to the Interlinking component in the RTGS processor. The RT TARGET account is then debited and the recipient national central bank's (NCB) account is credited. A TARGET message is then sent through SWIFT to the destination NCB. The destination NCB credits the recipient's settlement account and relays the message in the domestic format.

Statistical information regarding volumes and values of transactions

NewCHAPS average daily volumes (000's) and values (£ millions):

	1999		2000		2001	
	Vol	Val	Vol	Val	Vol	Val
Sterling	78.5	177,396	86.1	195,023	91.7	202,857
Euro	9.7	85,367	12.9	99,277	14.5	118,368
Domestic	*2.5*	*11,926*	*3.0*	*12,143*	*3.4*	*15,534*
Cross-border	*7.2*	*73,441*	*9.9*	*87,134*	*11.1*	*102,834*

Average transaction values (£):

	1999	2000	2001
Sterling	2,259,420	2,264,212	2,211,854
Euro			
Domestic	*4,810,022*	*4,136,902*	*4,628,028*
Cross-border	*10,415,628*	*8,881,953*	*9,253,968*

76. The intraday pattern of payment flows differs slightly between sterling and euro:

Sterling: The CHAPS Sterling day is characterized by three peaks: two morning peaks around 07:30 (volume) and 10:00 (value) and an afternoon peak between 14:30 and 15:30. A trough is generally observed between 08:30 and 09:30, probably reflecting a pause between payments input ahead of settlement date and payments generated during the day.

Euro: The profile for CHAPS euro exhibits peaks from 07:30 to 08:00 and again from 15:00 to 15:30. In between, the number of payments drops steadily until 12:00 and stays low until 14:00. Generally, euro payments are processed earlier in the day than sterling payments with 20 percent of euro payments processed by 08:00 compared to 13 percent for sterling. The late peak largely reflects cross-border TARGET payments, with banks placing surplus liquidity in the euro area.

77. For CHAPS Sterling, financial transactions account for 76 percent by value transmitted and 38 percent by volume. Although financial transactions still dominate the value transmitted, their market share by volume is down from 45 percent in 2000. The rest is accounted for by commercial and consumer transactions. 21 percent of CHAPS Sterling payments are below ₤1,000 and 47 percent below ₤10,000.

Purpose of CHAPS payments:

Purpose of payment	% by volume	% by value	Average value of transaction (£000s)
FX	5-7	16	4,900
Total financial	38	76	4,600
Inter-account transfer	10	22	4,700
Housing & legal	16	1	300
Business	29	-	9

Source: CHAPS Traffic Survey 2001. Figures provided are indicative only, and may not add up to 100 percent.

78. Less detail is available for CHAPS euro. However, payments related to foreign exchange activity account for approximately 50 percent of euro values.

79. The three peak volume and value days for sterling and euro respectively are set out in the table below.

Three peak days within last year, volumes (000's) and values (£/€ billions):

	Volume	Value
Sterling	29/06/01: 188.806	28/09/01: £318.95
	28/09/01: 186.535	29/06/01: £311.30
	30/03/01: 178.086	29/09/00: £296.82
Euro	20/02/01: 23.982	29/06/01: €302.99
	16/01/01: 22.687	16/01/01: €253.95
	30/05/01: 21.767	29/09/00: €232.93

80. With regard to payments originated within CHAPS Sterling, payment flows are concentrated, with the 5 biggest banks accounting for over 80 percent of both value and volume. In CHAPS euro/TARGET, payment flows are less concentrated than for CHAPS Sterling, with the 5 biggest banks accounting for just over 67 percent of volumes.

General preconditions for effective payment systems

81. The United Kingdom has a stable macroeconomic environment and a well-developed public infrastructure, which support the financial market. Several key EU directives (including the Settlement Finality Directive), which all Member States have incorporated in their respective laws, cover the payment system.

82. The Association for Payment Clearing Services (APACS) was set up in 1985 as a non-statutory association of major banks and building societies. It has become the umbrella body providing a mechanism for consultation and acting as a representative for the U.K. payments industry with 31 members. APACS is an unincorporated association of members, one of whose tasks is to promote the operational efficiency and financial integrity of the U.K.'s payments infrastructure, including CHAPS. Until recently, all members of CHAPS also had to be members of APACS (but not vice-versa). There is no legal relationship between the two organizations.

83. The CHAPS Clearing Company (CHAPSCo) is responsible for setting the operational rules for the CHAPS Sterling and euro systems and for developing the system to meet Members' changing needs. The settlement members of CHAPS are involved in this process through their membership of the Board of the CHAPS Clearing Company and its committees.

84. The CHAPS Board usually meets on a bimonthly basis. Each member is entitled to appoint one Director, regardless of whether they belong to either one or both of the clearings. Members of the same corporate group are entitled to only a single seat on the Board between them. However, a Director appointed by a Member whose clearing volume exceeds 10 percent of the Company's total clearing volume is eligible for an extra vote at Board meetings. Directors have a fiduciary responsibility towards all shareholders of the company and not just the member they represent. Directors must be familiar with their own legal

responsibilities and the legal requirements of the company. Finally, they must be able to commit their institution where company decisions require member agreement and ensure their institutions' compliance with decisions taken by the Company. The Board appoints the Company Manager to be responsible for the day-to-day management of the Company and for implementing Board policies.

85. Any settlement member, or the Company Manager, may propose rule changes by submitting their request to the CHAPS Operational Committee which, after consulting all settlement members (and obtaining the views of the CHAPS Technical and Security Committees as appropriate), will forward the proposal and its recommendation to the Board. Under the Settlement Finality Directive, all changes to the Rules must be formally advised to the Bank in its capacity as designating authority under that Directive.

86. As all Members are represented at CHAPS Board they are thus consulted on all Board decisions. Indirect members and end-users are not consulted directly.

87. The Bank is a Member of CHAPS, and is represented as of right at APACS Council and the CHAPS Board. There is, in addition, close liaison between CHAPS' senior management and the Bank's Oversight Team. The Bank of England has clearly defined its oversight role vis-à-vis U.K. payment systems in a publication readily available on its web site.

Changes and reforms in process

88. Through its committee structure and the Strategic Planning Working Group, CHAPSCo, its members and the Bank review current functionality and the possible further development of NewCHAPS' functionality. This work is undertaken in parallel with discussions (in which the Bank is also participating) within the ESCB regarding the development of the TARGET 2 system. Whilst discussions are only at a very early stage, it remains unclear what features this development might add. Any significant development will clearly take some time to implement.

89. Over the years since its creation, APACS had come to adopt an influential role in the strategic direction of the schemes under its umbrella. Some concern existed that APACS' role had the potential to reduce the effectiveness of scheme governance. During the period of this assessment, these issues contributed to the development of proposals to reform APACS' role and to clarify that responsibility for the operation and development of each clearing lie with the relevant Clearing Company. At the same time, there was also a concern not to inhibit APACS from continuing to contribute to industry-wide initiatives. In September 2002, reforms to APACS role were introduced, and each of the clearing companies under APACS, including CHAPSCo, now has full and explicit responsibility for its own governance, while the previous requirement for CHAPS members to be members of APACS has been removed.

C. Main Findings—Summary

90. The mission has found that NewCHAPS observes the applicable Core Principles, following the recent reforms to arrangements involving APACS. In the initial phase of this assessment, NewCHAPS fully observed seven Core Principles, and two Core Principles were broadly observed. One Core Principle was (and remains) not applicable, while the four responsibilities of the central bank were (and are) observed. The mission's initial assessment therefore pointed to opportunities for further improvements with respect to fair and open access and governance to ensure full adherence to the Core Principles. The subsequent implementation of the reforms noted above, however, allows the recognition of the NewCHAPS service as fully compliant with the applicable core principles. Those aspects aside, there remain some other, more technical refinements at the margin in a few areas that the mission recommends be pursued.

Table 12. Detailed Assessment of Observance of CPSS Core Principles for SIPS and Central Bank Responsibilities in Applying the CPs—NewCHAPS

CP I - The system should have a well-founded legal basis under all relevant jurisdictions.	
Description	The NewCHAPS Rules are governed by and construed in accordance with the laws of England and Wales. Moreover, each member for the benefit of the other members and the CHAPS company agrees that the courts of England and Wales are to have exclusive jurisdiction to settle any disputes in connection with NewCHAPS Rules and submits to the exclusive jurisdiction of these courts. General principle on freedom of contract: It is a general principle of English law, that the parties to a contract are free to agree upon whatever terms and conditions they see fit, and their agreement will be respected and enforceable, *subject* only to certain areas where such freedom of contract is limited by overriding principles of English law. Thus, the terms and conditions agreed by the parties to a payment system (e.g., a settlement agent and the participants thereof) will be upheld *unless* they are contrary to or conflict with certain general legal principles (such as *equitable principles, principles of public policy, and statutory intervention*) and/or statute. Statutory Protections; *The Financial Markets and Insolvency (Settlement Finality) Regulations 1999:* Although the contractual freedom for the participants in a payment system to determine the extent of their rights and obligations is wide and permissive, because of the impact of insolvency provisions, there is the possibility - which cannot be totally excluded - that the settlement of transactions (i.e., the making of payments) already carried out through such a payment system might be subsequently challenged by a liquidator of an insolvent participant. This aspect of uncertainty has been remedied by the implementation into English law, of the provisions of the EU Directive on Settlement Finality in Payment and Securities Settlement Systems (Directive 98/26/EC). The U.K. Regulations named above provide that specific provisions of English insolvency law and the general law of insolvency do not apply to the settlement of transfer orders effected through a designated payment system and any action taken under the rules of such a system with respect to such orders. Furthermore, the U.K. Regulations not only protect the settlement of transfer orders, but also protect the provision of any "collateral security" (a term which includes, security provided under a pledge/security

	interest and under a repurchase agreement) for obligations incurred in connection with participation in a designated system. NewCHAPS has been designated by the Bank as being within the scope of the protections as conferred by the Regulations. As regards the CHAPS euro system, any internal Bank of England rules and procedures have to comply with European Central Bank (ECB) documentation on the processing of TARGET payments and, in particular, with the TARGET Guideline, the TARGET Agreement (both of which are legally binding) and the TARGET Manual of Procedures. Compliance has been verified by the ECB. Whilst not part of the CHAPS rules as such, the RTGS Mandate Agreement and the Master Repo Agreement (MRA) signed between each CHAPS member and the Bank form an important part of the legal and operational framework of the system. The Mandate governs the operation of each member's settlement accounts by the Bank (including 'events of default' following which the account may will be suspended); sets out the member's authority to the Bank; and contains indemnities from member to Bank and limitations of liability by the Bank. The MRA governs the provision of liquidity by the Bank against intraday repos. In addition to the above documents, the Bank and CHAPSCo (on behalf of the members) have signed a non-binding Memorandum of Understanding defining the responsibilities and roles of the members, CHAPSCo and the Bank in the live operation of CHAPS. It sets out the service levels each is expected to meet and explains the dispute resolution procedure in place.
Assessment	Observed
Comments	
CP II - The system's rules and procedures should enable participants to have a clear understanding of the system's impact on each of the financial risks they incur through participation in it.	
Description	The CHAPS Rules ("the Rules") cover, inter alia, the operational timetable, membership criteria, members' responsibilities (e.g., for the integrity of the system and for the maintenance of contingency facilities), arrangements for withdrawal and exclusion from membership and governing law and jurisdiction. The Rules are constructed at a fairly high level, but expressly incorporate the requirements of a range of other, more detailed, documents, including: - *NewCHAPS Procedural Documentation* ("the Procedures") which set out CHAPS' operational procedures in some detail, including procedures for normal operations, security procedures, communication channels, service level codes and contingency arrangements including disablement of members; and - The *RTGS Reference Manual* ("the Manual"), which describes the RTGS settlement facilities provided by the Bank for account holders. The manual focuses on the processing and settlement of payments and the provision of liquidity. It also covers Enquiry Link access, information dissemination and contingency. Other key documents are the RTGS Payment Mandate Agreement, ILS Master Repurchase Agreement, DVP framework Agreement, RTGS CREST Mandate Agreement, RTGS CREST Master Self-Collateralizing Repurchase Agreement, NewCHAPS Security Code of Conduct, the NewCHAPS Functional Specification, Information Guide for credit institutions using TARGET, and the SWIFT User Handbook.
Assessment	Observed
Comments	

CP III - The system should have clearly defined procedures for the management of credit risks and liquidity risks, which specify the respective responsibilities of the system operator and the participants and which provide appropriate incentives to manage and contain those risks.	
Description	As NewCHAPS is an RTGS system, credit risk can only arise between members in the extremely rare event of a move to Bypass mode. That aside, the main financial risks to which users are exposed are legal risk; operational risk; and liquidity risk. As to *legal risk*, NewCHAPS is designated under the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (FMIRs), which implement the Settlement Finality Directive in England and Wales. It is a condition of designation that the Rules specify clearly the points at which payment instructions are considered to have been input to the system, and the points at which they become irrevocable and at which settlement is final. Designation under the FMIRs provides certain protections from the application of insolvency rules in the European Economic Area. It provides less protection in relation to members incorporated or established elsewhere in the world, of which NewCHAPS has a small number. CHAPS itself does not seek legal opinions from overseas members addressing the likely scope of any conflicts of law and the member's *vires*, but all such members are required by the Bank to provide legal opinions in relation to their execution of the Bank's Mandate and MRA, and therefore indirectly in relation to their participation in NewCHAPS. The Rules also require each member to inform the Company Manager immediately upon becoming aware of any event (such as the presentation of a winding up petition, or technical problems) which might affect the member's ability to participate effectively in the system – an important aspect of the participant default arrangements. A range of controls and procedures aim at minimizing *liquidity risk*. These include *throughput guidelines* (for sterling activities only); the operation of *circles processing* by the Bank of England System Control to minimize the risk of gridlock; and the transfer of liquidity in *sterling contingency situations* (where System Control facilitates liquidity transfer from a member which is able to receive but not to make payments). The Procedures also explain the timing of settlement of ancillary systems, when liquidity to/from different sources is required or becomes available. The provision of intraday collateralized liquidity by the Bank is covered in the Manual, together with details on eligible collateral. The RTGS documentation contains provisions on business continuity procedures – it also identifies as a contingency measure the move of the payments processing to a so-called RTGS by-pass mode in which payment messages are exchanged directly between members without settlement requests being first submitted to the Bank.
Assessment	Observed
Comments	See comment on RTGS by-pass under CP VII below.
CP IV - The system should provide prompt final settlement on the day of value, preferably during the day and at a minimum at the end of the day.	
Description	Individual payments are settled on a real-time gross basis in both the CHAPS Sterling and the CHAPS euro scheme.
Assessment	Observed.
Comments	
CP V - A system in which multilateral netting takes place should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single settlement obligation.	
Description	Both CHAPS Sterling and CHAPS euro are RTGS schemes.

Assessment	Not applicable.
Comments	
CP VI – Assets used for settlement should preferably be a claim on the central bank; where other assets are used, they should carry little or no credit risk and little or no liquidity risk.	
Description	Settlement of both the CHAPS Sterling and the CHAPS euro scheme takes place in central bank money.
Assessment	Observed
Comments	
CP VII - The system should ensure a high degree of security and operational reliability and should have contingency arrangements for timely completion of daily processing.	
Description	CHAPS' security architecture is founded on a range of policies and procedures manuals governing the levels of security demanded of the system operator (the Bank), the network operator (SWIFT) and the CHAPS Members. Concerning *operational risk*, the procedures, documents and manuals mentioned above (under CP II) contain a range of information on operational procedures such as security procedures and contingency arrangements, the effect of which is to mitigate operational risk. In addition, there are a number of control policy documents which describe the system/control framework in place within the clearing. These documents form a broad hierarchy, with high level policies produced by APACS (APACS' Security Policy Framework for Clearing Companies, Conduct for Security Oversight of Clearing Companies and Guidelines for Risk Assessment); lower level documents such as the CHAPS Clearing Company Security Policy and the Security Code of Conduct; and working documents such as the questionnaires sent to members as part of the annual self-certification exercise. The most significant control document relevant to CHAPS' security architecture is the *CHAPS Clearing Company Security Policy* is a high-level policy description covering the end-to-end clearing. It has three audiences: the Company itself and its employees; the members of the clearings; and external organizations providing services to CHAPS. The Security Policy is reviewed annually or in the case of major changes and is approved by the CHAPS Board. CHAPS Internal Audit periodically reviews how the policy is being maintained. The *NewCHAPS Security Code of Conduct* specifies a range of security controls which CHAPS' members and suppliers are expected to have in place. The controls cover, *inter alia*, encryption, authentication and contingency. They also cover physical and logical access controls to systems. Pursuant to the Security Code of Conduct, members and key suppliers (including the Bank) are required to have in place appropriate segregation of duties and operations, particularly in respect of payment entry, authorization, encryption and authentication. All access to encryption, authentication and related elements must be under secure control. Development and operational resources must be segregated. Logical access to SWIFT CBTs must be segregated into specific roles, with privileges provided being the minimum necessary to fulfill their responsibilities. Audit trails and archive records must permit users' activities to be monitored. Access to the production environment must be restricted, its use closely monitored and be under at least dual control. Compliance with these requirements is assessed through an annual self-certification process. Both CHAPS and the Bank maintain error logs of operational incidents. All incidents are reviewed by the Operations Manager and the Operational Committee and, if sufficiently serious, are escalated to the Company Manager, Audit Committee and Board. Within the

	Bank, the RTGS team maintains an Incident Log of incidents (including any security breaches) and changes. Incidents are also discussed at the monthly Bank/CHAPS RTGS Liaison Group. Any incidents are also reviewed at weekly meetings between the Bank's operators and the Bank's IT support. The security policies and procedures of SWIFT are set out in its *User Handbooks*, in particular *FIN Policy, FIN and FIN Copy Service Descriptions, FIN Security Guide, Network Access Guide and Technical Security Features*. As regards control and audit functions, the *CHAPS Board* has overall responsibility for ensuring compliance with all risk control policies. The *CHAPS Audit Committee* reports to the Board on the effectiveness of the controls put in place to achieve the Board's risk policy objectives. In addition, APACS has an 'oversight' – effectively an audit – role in relation to each of the clearings under its umbrella. Each year, CHAPS' control framework is independently reviewed by *external auditors* – who review the control framework in CHAPS against the control objectives specified by the Board. No weaknesses were found in the CHAPS security arrangements in the reviews undertaken. In order to check that members comply with the various control documents, they are required to undertake *Code of Conduct* and *Availability Self-Certifications.* In terms of the Bank's role in the system, reliability is assessed against key performance measures set out in the Bank/CHAPS MoU. This requires, for example, that settlement facilities are available for 99.95% of the operating day on average over the course of each month. In general, the Bank surpasses this standard. Business continuity and contingency procedures are described in the NewCHAPS Procedures, the RTGS Manual and the NewCHAPS Functional Specification. Responsibility for determining contingency objectives rests with the CHAPS Board and with senior management in the Bank. The Bank's 'business continuity plan' consists of a range of procedures documented in the Office Disaster Plan, the Contingency Matrix (in the Manual), the System Control Manager's Contingency Manual and the System Control Contingency Manual. All of these documents and procedures are continuously updated. The RTGS documentation identifies as a contingency measure the move of the payments processing to a so-called RTGS by-pass mode, the use of which aims at ensuring a timely completion of the daily payments processing- not in an RTGS, but in an end-of-day net settlement procedure. Since payments to the Continued Linked Settlement (CLS) Bank could not be made in the RTGS by-pass circumstances, the Bank has developed a separate contingency mechanism which allows a very limited number of payments to be made over the books of the Bank, with immediate finality, to CLS. While NewCHAPS overall is a very robust and well functioning system, it has nevertheless suffered from a few longer outages during the last year. Similarly, within the Sterling service, cut-off extensions have been quite frequent.
Assessment	Observed
Comments	The RTGS documentation identifies as a contingency measure the move of the payments processing to a "RTGS by-pass" mode with end-of-day (bilateral) net settlement. Although the move to by-pass mode is preceded by a wide-ranging consultation and a comprehensive decision making process. Despite the potentially very high value turnover processed in RTGS by-pass (see paragraph 24 above), no centralized financial risk management rules

	currently apply and there is no requirement (or recommendation) that members apply risk management rules of their own (it is also unclear whether and/or how they may do so). Prior to the introduction of NewCHAPS, the Board had concluded that the risks associated with by-pass mode were sufficiently remote to justify not introducing express risk management procedures at that stage, but that the issue should be reviewed once NewCHAPS was live. Since the initial FSAP assessment, this has taken place, and the Board recently agreed changes to CHAPS rules and procedures based on sending banks applying limits to amounts sent into the system to limit the financial exposures which could build up in by-pass mode. These procedures and rules changes will be implemented during 2003. We understand that there are also firm plans to consider a loss-sharing agreement and to agree and describe in detail the procedures for the settlement of net positions *in all circumstances* (e.g., if a member is unable to settle due to a lack of funds). As noted above, while overall a very well functioning and robust system, it has nevertheless suffered from a few longer outages during the last year. In view of increased time sensitivity of intraday payments (due to DVP settlement of securities and the forthcoming payment-versus-payment settlement of foreign exchange transactions), due attention should be paid to the assurance of a high availability of the system. As to cut-off extensions, while members feel the existing disciplinary mechanisms, which in large part rely on peer pressure, work well, this should be monitored closely with a view to implementing more stringent criteria to enforce discipline if problems persist.
CP VIII - The system should provide a means of making payments, which is practical for its users and efficient for the economy.	
Description	RTGS payments are practical for large-value and time critical payments, as settlement occurs in real time. According to the Memorandum of Understanding between the Bank and CHAPSCo, the transmission time between one Member's payment system and another should be no longer than 60 seconds (30 seconds for network processing and 30 seconds for processing by the RTGS processor). As regards TARGET payments, the maximum total time for processing TARGET payments is 30 minutes, covering the time from the debiting of the account of the sending bank by the sending RTGS system until the crediting of the account of the beneficiary bank at the receiving NCB. In normal circumstances, the processing of a TARGET payment (the time between the debiting (or blocking) event in the sending NCB and the crediting event in the receiving NCB) takes no longer than a few minutes and the objective is that, under optimal circumstances, the delay between debiting on the sending side and crediting on the receiving side would be less than one minute. Those customers which choose to become indirect members of CHAPS can in principle be advised online of the receipt of CHAPS payments for their account and initiate outgoing CHAPS payments. For those for whom indirect membership is not a feasible option, there are no standard timeframes for the processing of payments down to customer accounts, other than (non-binding) service level codes specifying that 'outward payment transmission times' and 'inward payment transmission times' should not exceed one and a half hours. The CHAPS Company's charges are kept to a minimum consistent with the provision of appropriate services and the recovery of all *operating* costs. Costs are distributed pro rata among members (through what is called "Company Call") in relation to each member's share of the aggregate volume of CHAPS euro and CHAPS sterling payments subject to a minimum charge of 2% (applied up to an overall maximum of 26% of costs being charged in this manner, in order to limit the total contribution of low volume members). The Bank of England applies three objectives in determining its RTGS fees: • to recover the Bank's investment and running costs, including all allocated overheads

	attributed to the members • to recover attributable costs taking one year with another • and to avoid cross-subsidization of one service by another In practice, not all investment costs are 'recoverable'. The Bank did not seek to recover non-hardware-related development costs incurred in developing RTGS, the domestic element of CHAPS euro or intraday (trade-by-trade) DvP for CREST. As a rule, the Bank seeks to recover costs from the banks where the banks are the main beneficiaries of a service. Hence, operating and some development costs are recovered in full. Where there is wider benefit to the financial sector and economy (as with risk-reducing developments such as RTGS), costs are recovered in part from the banks indirectly via cash ratio deposits, in part from the public purse via the cash limit agreed with HM Treasury. APACS is a not for profit organization, and sets fees with a view to recovering costs. The allocation of costs is articulated in the Association Rules. Work carried out specifically on behalf of a Clearing Company (CHAPSCo) is charged direct to that Company and recovered from that Company's members. SWIFT membership and per item charges are additional. The basis on which CHAPSCo, APACS and the Bank seek to recover costs is transparent to members of CHAPS, although charges are not disclosed to the general public. CHAPS' and APACS' annual recoveries are approved by their respective Board/Council, on which all members are represented.
Assessment	Observed
Comments	At the time of the assessment, the RTGS Reference Manual provided that Account Management fees were almost three times higher for sterling accounts than for euro accounts. Following the 2003 tariff review, however, these fees were made identical for both services (at £15,000). Transaction fees are set at the same (relatively low) level for sterling and euro denominated transactions, although the two RTGS services have different memberships and the payments volumes in the CHAPS sterling service are much larger than those in the euro service. This raises the question of whether the current tariff would enable the euro service to recover costs fully, were some facilities not shared with the sterling service.
CP IX - The system should have objective and publicly disclosed criteria for participation, which permit fair and open access.	
Description	The membership criteria are set out in the NewCHAPS Rules. They specify that the applicant must be an 'appropriately supervised' financial institution 'engaged in the provision of payment and transmission services' (or a public authority or a company wholly owned by Government).'Appropriately supervised' is defined as meaning 'supervision as a credit institution (or equivalent) in an EU or EEA member state or G10 country'. The applicant must also be able and willing to meet the technical and operational requirements of the clearing company and willing to abide by its rules. This includes adhering to the procedures and standards outlined in the Procedural Documentation and the Security Codes of Conduct. A minimum volume criterion previously applied, but has now been removed. As NewCHAPS is a SWIFT-based system, members must either (a) already be a member or sub-member of SWIFT, or (b) become a SWIFT "Payment System Participant" (based on their membership of CHAPS). It is worth noting here that the move to the NewCHAPS system has lowered the cost of becoming a participating member: the previous (non-SWIFT-based) CHAPS system would have required each existing member to make relatively expensive changes in its internal system to accommodate a new member, the cost of which would have been charged back to the new member.

	Finally, the applicant must have settlement account facilities at the Bank of England for use in the clearing. According to the Bank's criteria, applicants must have the necessary operational expertise, be willing and able to pay the costs of account maintenance (which aim at full cost recovery), and be a member of a system for which the Bank is prepared to provide settlement facilities. The Bank does not limit accounts to credit institutions, although only regulated financial institutions (banks and, in principle, investment banks), will be granted access to (collateralized) credit. CHAPS Rules are made available to interested parties on request. The NewCHAPS Rules contain provisions explaining the procedures for withdrawal and exclusion of members. The Bank's criteria for access to settlement accounts are objective and fair – any member of a payment system for which the Bank is prepared to settle, may have an account. Differences in service levels (in particular the availability of intraday credit) are determined using objective, risk-based standards. They have been publicly disclosed.
Assessment	Observed
Comments	At the time of the initial assessment. although the access criteria as such were objective, all information relevant for the membership criteria was not publicly available and the application for membership had to be made to and be approved by a body (APACS) which had no legal relationship with the body directly responsible for the system concerned, i.e., CHAPSCo. Furthermore, membership in the system was linked to membership in another organization (APACS), committing the applicant to the payment of not insignificant fees. Even at that stage, however, discussions on changes in these areas were already underway, and these issues were addressed later in the assessment process, allowing this principle to be rated as observed. The measures taken included publication of membership criteria on the internet and a change in the governance of APACS and the clearing companies, effective from September 8, 2002.
CP X – The system's governance arrangements should be effective, accountable and transparent.	
Description	Formal responsibility for determining the rules of both CHAPS systems rests with the CHAPS Board, which may amend them as it sees fit. The Board has delegated to the Legal Committee responsibility for ensuring that the Rules remain robust and up to date and for vetting proposed changes to the Rules. In addition, the Operational Committee is charged with considering any changes that are required either to the Rules or to Procedures from an operational perspective. The CHAPS Clearing Company (CHAPSCo) is responsible for setting the operational rules for the CHAPS Sterling and Euro systems and for developing the system to meet Members' changing needs. The settlement members of CHAPS are involved in this process through their membership of the Board of the CHAPS Clearing Company and its committees. CHAPSCo's authorized share capital amounts to £10,000 divided into 100,000 shares of 10p each. In terms of issued capital, each member currently has a single share regardless of payment volumes (i.e., shares issued equals the number of members). The CHAPS Board usually meets on a bimonthly basis. Each member is entitled to appoint one Director regardless of whether they belong to either one or both of the clearings. Members of the same corporate group are entitled to only a single seat on the Board between them. However, a Director appointed by a Member whose clearing volume exceeds 10% of the Company's total clearing volume is eligible for an extra vote at Board meetings. A three quarter's majority is required for a vote to pass. However in practice Board decisions are generally made by consensus, and there have been no instances where the Board has been forced to resort to voting to resolve differences.

	Directors have a fiduciary responsibility towards all shareholders of the company and not just the member they represent. Directors must be familiar with their own legal responsibilities and the legal requirements of the company. Finally, they must be able to commit their institution where company decisions require member agreement and ensure their institutions' compliance with decisions taken by the Company. The Board appoints the Company Manager to be responsible for the day to day management of the Company and for implementing Board policies. The (non-executive) Chairman of the Company has to date been drawn from APACS Council, with a term of 3 years. The Board is responsible for the determining the rules of both CHAPS Sterling and CHAPS euro and may amend them as it sees fit. Any settlement member, or the Company Manager, may propose rule changes by submitting their request to the CHAPS Operational Committee which, after consulting all settlement members (and obtaining the views of the CHAPS Technical and Security Committees as appropriate), will forward the proposal and its recommendation to the Board. Under the Settlement Finality Directive, all changes to the Rules must be formally advised to the Bank in its capacity as designating authority under that Directive.
Assessment	Observed
Comments	Although discussions on reforms were already underway at that stage, in the initial phase of the assessment process, there were some shortcomings in the boundaries of CHAPSCo's and APACS' responsibilities, and in the allocation of costs between the two. These issues were subsequently addressed, through a change in governance arrangements for APACS and the clearing companies effective from September 8, 2002, as noted above. The changes allow this Core Principle to be assessed as observed. Nevertheless, while the system's governance arrangements are effective and accountable, they are not transparent to non-members. Although CHAPS Clearing Company is the organization responsible for NewCHAPS, it does not itself make public any report on its own or the systems activity (payments statistics are published by APACS). Improvements could usefully be considered in this regard.
Central Bank Responsibilities in applying the CPSIPS	
Responsibility A – *The central bank should define clearly its payment system objectives and should disclose publicly its role and major policies with respect to systemically important payment systems.*	
Description	The Bank of England (the Bank) published a paper on "Oversight of Payment Systems" in November 2000, explaining its objectives in regard to the oversight of U.K. payment systems. The paper explains the importance of effective payment systems for the functioning of the financial markets and of the economy more generally, and the possible impact of disruption to a system whether for technical reasons or because of the failure of a major participant. It distinguishes between Systemically Important Systems (SIPS – defined as per the Core Principles) and systems of System Wide Importance (SWIPS – which typically settle lower value payments both in aggregate and individually, the failure of which could nevertheless cause wide disruption to the economy). The paper explains the Bank's responsibility for the overall stability of the financial system; for providing the Chancellor of the Exchequer with advice on any major problem inherent in the payments systems (as set out in the Memorandum of Understanding between the Bank, HM Treasury and the Financial Services Authority - the memorandum is published on the Banks' web-site); and, under the Financial Markets and Insolvency (Settlement Finality) Regulations 1999, for the designation of payment systems under the Regulations. The objectives of oversight are to ensure that sufficient weight is given to risk reduction and

	management in the design of payments systems; and also to promote improvements in the U.K. payment and settlement infrastructure for the benefit of members and end-users. It explains how the Bank carries out oversight in practice, assessing how effectively credit, liquidity, operational and legal risks are controlled. Moreover, it presents the Core Principles for Systemically Important Payment Systems as the primary basis on which the Bank will assess how effectively systems control risk. The Bank's oversight encompasses both SIPS and SWIPS, but the intensity of its oversight is proportionate to its assessment of the systemic or system-wide risks posed by each system. The Bank undertook to publish separately a statement on its policy on the provision of settlement account facilities to systems, and their members and to report on its payments systems oversight activities annually. The statement on settlement account policy has been published, and at the time of writing, the period for public review and comment was underway. This is an example, in the payments system area, of the broader Bank policy of consulting widely on initiatives relevant to the operation of the financial markets.
Assessment	Observed
Comments	Apart from a brief summary in its Annual Report, at the time of the assessment mission, the Bank had not yet published any follow-up/annual account of its oversight activities. However, in the June 2002 FSR, a useful box has been included to give some more detail of developments in this area. It would be very helpful for this, or a similar vehicle, to evolve into a regular (annual) account of progress here, with some further elaboration of oversight issues and processes from time to time. This could include (e.g.) some more detail on the relationship between the Bank's oversight role and its role as a member in its own right of both NewCHAPs and BACS.
Responsibility B – The central bank should ensure that the systems it operates comply with the core principles.	
Description	The Bank has, together with CHAPSCo and CRESTCo, developed the RTGS Central System, which it operates and provides to these companies as well as to other settlement systems with net end of day settlement. The oversight process described under responsibility A above, including the review of compliance with the Core Principles takes account of the Bank's operation of the RTGS Central System, as it affects compliance with any of the Core Principles.
Assessment	Observed
Comments	
Responsibility C – The central bank should oversee observance with the core principles by systems it does not operate and it should have the ability to carry out this oversight.	
Description	The Bank recently formalized its oversight of U.K. payment systems. It created an Oversight Team in the Market Infrastructure Division (MID) with express responsibility for the oversight of payments systems. Quarterly meetings are held between the Bank and senior management of each of the U.K. payment systems. It has begun the process of assessing the key U.K. systems against the core principles – with the main focus initially on CHAPS and BACS, for which self-assessments against the Core Principles have been produced
Assessment	Observed
Comments	To increase the public awareness of the Banks' oversight activities and the implementation of its oversight policies, it is recommended that the main thrust of the assessment against the Core Principles of different U.K. payment schemes be made public. More broadly, it would be desirable to lay out more fully and formally in statute the Bank's

	critical payments and settlement systems oversight responsibility, arising from its central banking functions which inherently underpin monetary policy and financial system stability. (As noted in the assessment of financial policy transparency for the Bank, the Bank's--and other--legislation points to its financial stability responsibilities, this is in an indirect and more implicit fashion.) Since the Bank has few formal legal powers in relation to payment and settlement systems, it can only use moral suasion in its endeavors to achieve its oversight objectives. While the achievement of progress on the basis of moral suasion is to be preferred, the existence of formal authority may in some circumstances be a precondition for the effective enforcement, where necessary, of the oversight policy.
Responsibility D – The central bank, in promoting payment system safety and efficiency through the core principles, should cooperate with other central banks and with any other relevant domestic or foreign authorities.	
Description	The Bank has close and frequent contact with its European and G10 counterparts both through formal mechanisms - in particular G10, ESCB and EU committees–and ad hoc contacts. An example of the Bank's co-operation with overseas authorities regarding payment systems best practice is its participation in (and chairmanship of) the sub-group of the G10 Committee on Payment and Settlement Systems which produced the report on "Core Principles for Systemically important Payment Systems." The Bank also has close contacts with other U.K. authorities. The Tripartite Standing Committee is a forum in which senior representatives of the Chancellor of the Exchequer, the Governor of the Bank of England and the Chairman of the Financial Services Authority meet monthly to discuss financial stability. Contacts extend throughout the three organizations, at all levels, both through formal committees and through ad hoc contact. The Bank also maintains regular contact with the U.K. Competition Authorities: quarterly liaison meetings are held with representatives of the Office of Fair Trading. The Bank is party to the "Memorandum of Understanding (MoU) between Payment Systems Overseers and Banking Supervisors in Stage Three of Economic and Monetary Union". This MoU is aimed at promoting co-operation and information sharing between European Union payment overseers and banking supervisors in relation to large-value interbank transfer systems with a view to ensuring the soundness and stability of such systems and of their participating credit institutions.
Assessment	Observed
Comments	

Table 13. Summary Observance of CPSS Core Principles and Central Bank Responsibilities in Applying the CPs—NewCHAPS

Assessment grade	Principles grouped by assessment grade	
	Count	List
Observed	9 + 4	CP I, II, III, IV, VI, VII, VIII, IX and IX; Responsibilities A – D
Broadly observed	-	
Partly observed	-	
Non-observed	-	
Not applicable	1	CP V

D. Recommended Actions and Authorities' Response to the Assessment

Recommended actions

91. The mission conducted an assessment of the NewCHAPS system relative to the Core Principles for Sytemically Important Payments Systems and confirmed observance of these principles. While the mission's initial assessment pointed to opportunities for further improvements in fair and open access and governance to ensure full adherence to the Core Principles, changes which subsequently became effective addressed these issues.

92. While the mission's assessment is that the applicable Core Principles and central bank Responsibilities are already observed, there are nevertheless a few other, more technical, refinements that the mission believes would desirably still be pursued, to further improve existing arrangements:

- The RTGS documentation identifies as a contingency measure the move of the payments processing to a so-called RTGS "by-pass" mode. Currently, this materially implies a move to an unprotected end-of-day (bilateral) net settlement procedure where no centralised risk management rules apply. There is currently no requirement that banks apply risk management rules of their own—it is also unclear whether and/or how they may do so. Since the initial FSAP assessment, however, the CHAPS Board has agreed procedures, to be implemented during 2003, to limit the financial exposures which could build up in by-pass mode. The fact that the documentation specifies a contingency arrangement (required to allow the handling of all payments due on that date) is itself positive (many systems do not do so); and since it is specified, it would be highly desirable to elaborate more fully, in the RTGS documentation, the means by which financial risks will be controlled and by which end-of-day net settlement will be achieved in all circumstances.

- While NewCHAPS overall is a very well functioning and robust system, it has nevertheless suffered from a few longer outages during the last year. There were specific problems behind some of these episodes that have since been rectified but, in any event, and in view of the increase in time critical intraday payments (due to DVP

settlement of securities and the forthcoming payment-versus-payment settlement of foreign exchange transactions), due attention should be paid to the assurance of continued high availability of the system.

- Within the sterling service, cut-off extensions have been quite frequent. While participants feel the existing disciplinary mechanisms, which in large part rely on peer pressure, work well, this should be monitored closely with a view to implementing more stringent criteria to enforce discipline if problems persist.

- Account management and transaction fees for the two RTGS services are set in a way that raises the question of whether the current tariff would enable the euro service to recover costs fully, were some facilities not shared with the sterling service. The Bank could usefully check the consistency of fees charged for the two RTGS services with its pricing objectives.

- It would be useful for the CHAPS Clearing Company to take measures to increase external transparency in the governance and activities of NewCHAPS.

- In its paper on "Oversight of Payment Systems", published in November 2000, the Bank undertook to report on its payment systems oversight activities annually. The box on payments oversight in the June 2002 FSR is a useful step in this direction, and we would encourage the Bank to further develop this (or a similar vehicle) into a regular (annual) account of developments in this area. Inter alia, in such an account, the Bank could usefully elaborate more fully on (e.g.) the evolving relationship between its oversight role and its operational role as a member in its own right of both NewCHAPs and BACS.

- The Bank has begun the process of assessing the key U.K. systems, with the main focus initially on CHAPS and BACS, for which self-assessments against the Core Principles have been produced. To increase the public awareness of the Banks' oversight activities and the implementation of its oversight policies, it is recommended that the main thrust of the assessment against the Core Principles of different U.K. payment schemes be made public.

- When an appropriate opportunity arises, it would be desirable to lay out more fully and formally in statute the Bank's critical payments and settlement systems oversight responsibility, arising from its central banking functions which inherently underpin monetary policy and financial system stability. Since the Bank has few formal legal powers in relation to payment and settlement systems, it can only use moral suasion in its endeavors to achieve its oversight objectives. While the achievement of progress on the basis of mutual understanding and agreement is desirable, the existence of formal authority may in some circumstances be a precondition for the effective enforcement, where necessary, of the oversight policy.

E. Authorities' Response

93. The FSAP visit was a valuable opportunity to have the management of risk within the U.K.'s main payment systems reviewed by external experts, and the authorities welcomed the constructive approach taken by the IMF team throughout the mission. The thorough review process illustrated the strengths of the U.K. system, but also provided useful insights into a number of areas where work was needed if CHAPS is to remain at the forefront internationally.

94. Much of that work has already been completed since the initial review by the IMF team, and a number of concerns expressed at that time have been addressed. The authorities welcome the fact that CHAPS was subsequently found to comply fully with the relevant Core Principles and that its oversight of U.K. payment systems meets international standards. CHAPS' continued observance of the Core Principles is a high priority for the U.K. authorities and for CHAPS members. The authorities take note of the recommendation to increase the transparency of the Bank's oversight work; the Bank has taken steps in this direction.

V. IMF'S MFP TRANSPARENCY CODE—TRANSPARENCY OF MONETARY POLICY

A. General

95. This report assesses the consistency of monetary policy in the United Kingdom with the monetary policy portion of the *Code of Good Practices on Transparency in Monetary and Financial Policies*. The assessment was made in the context of a Financial Sector Assessment Program (FSAP) mission to the United Kingdom from February 6–20, 2002.[12]

B. Information and Methodology Used for Assessment

96. The assessment was based on an updated self-assessment prepared by the Bank of England in January 2002; a review of documents maintained on the Bank's website, such as the Annual Report, the quarterly Inflation Report, the Quarterly Bulletin, minutes of Monetary Policy Committee (MPC) meetings, the 1998 Bank of England Act, and various operational notices that guide the Bank's dealings with the private sector; discussions with Bank and HM Treasury staff, and members of the MPC; and discussions with a wide range of informed external observers of U.K. monetary policy, including financial market participants, private-sector economists, journalists, and a member of the academic community.

97. The U.K. authorities fully cooperated with the assessment, and all required information and documents were provided.

C. Institutional and Market Structure—Overview

98. In October 1992, the U.K. adopted inflation targeting as its framework for monetary policy following its exit from the European Exchange Rate Mechanism one month earlier. Between October 1992 and June 1995, monetary policy operated with a target range of 1 to 4 percent. From June 1995 to May 1997, the target was 2½ percent or less. In both of those periods monetary policy decisions were taken by the Chancellor of the Exchequer in consultation with the Bank of England.[13] In May 1997, the Chancellor delegated operational responsibility for the conduct of monetary policy to the Bank of England's MPC, while retaining the right for the government to set the inflation target. This new regime was formalized in the Bank of England Act 1998 (Act). The MPC's task is to set the Bank's official lending rate (two-week repo rate), on the basis of a majority vote, to achieve the inflation target it has been given—currently 2½ percent for RPIX inflation. The MPC

[12] The assessment was prepared by Mark Zelmer, and Eric Parrado, both of the Monetary and Exchange Affairs Department of the IMF.

[13] The transparency of the Bank's advisory role was significantly improved in 1993 when it began publishing a quarterly Inflation Report that presented the economic outlook underpinning its advice to the Chancellor. Summaries of the discussions between the Governor and the Chancellor on monetary policy decisions were also published with a six week lag.

consists of the Governor and two Deputy Governors of the Bank, two other internal members appointed by the Bank after consulting with the Chancellor, and four external members appointed by the Chancellor for renewable three-year terms. In addition, a representative of HM Treasury is allowed to attend and speak at MPC meetings, but this individual has no vote. The MPC is required to meet at least once a month. The Act requires the MPC to publish minutes of its meetings within six weeks (they are released in practice within two weeks) and a quarterly inflation report that spells out how inflation has performed relative to target and sets out the MPC's outlook for inflation going forward.

99. The inflation target is symmetric in that deviations below target are treated in the same way as those above target. Mortgage interest costs are excluded from the target in order to avoid the perverse short-term effects of higher interest rates feeding into higher mortgage rates, and ultimately higher inflation in the short run. Inflation has consistently been within one percentage point of target since the introduction of the current framework in 1997.

100. The Bank implements monetary policy by lending to its counterparties in the sterling money market at interest rates tied to the official repo rate chosen by the MPC. Liquidity forecasts are published and market operations are conducted by the Bank several times each business day. There are no statutory reserve requirements in the U.K. —settlement banks are required to maintain positive balances in their accounts at the Bank at the end of each business day. However, all banks and building societies with average eligible liabilities in excess of £400 million are required to hold noninterest bearing 'cash ratio deposits' at the Bank set at 0.15 percent of their domestic deposit base. These deposits are meant to provide the Bank with revenue to finance the unrecovered costs associated with monetary policy and financial stability activities. Settlement banks are also able to obtain intraday credit from the Bank on a collateralized basis to facilitate the smooth functioning of the real-time gross settlement (RTGS) payment system.

D. Practice-by-Practice Assessment

General comments

101. U.K. monetary policy is grounded in an inflation targeting framework that is one of the most transparent in the world—a view that is widely shared by market participants and other observers. The framework was significantly improved in 1997 when the government: granted the Bank operational independence in the conduct of monetary policy; introduced a point-target for inflation and clarified that the target is to be pursued over time in a symmetric fashion; created the MPC with external participants, which facilitated the consideration of different perspectives in monetary policy decisions; and introduced individual accountability for monetary policy votes. External observers generally praised the changes to the framework and the Bank for its efforts to highlight the uncertainty in monetary policy through the use of probabilistic fan-charts in its quarterly Inflation Report and its discussion of its economic outlook in a probabilistic sense. Moreover, the strong performance of the current framework is illustrated by the fact that inflation expectations seem to be well anchored by the inflation target, the degree of uncertainty in markets

regarding future policy actions has declined over time, and the Bank scores well in public opinion polls (although the latter may reflect the current low level of interest rates and the overall strong performance of the U.K. economy). Indeed, the Bank of England observes most of the elements of the monetary policy portion of the Transparency Code.

Section 1: Clarity of Roles, Responsibilities, and Objectives

102. The Bank of England observes all of the elements of this principle. External observers applauded the U.K. authorities for introducing major improvements to the clarity of monetary policy objectives and the governance structure surrounding monetary policy in the Bank of England Act 1998. In particular, they welcomed the introduction of a point-target for inflation, and the delegation by the Chancellor of the Exchequer of interest rate settings to the MPC. Nonetheless, a couple of observers questioned whether the recently-observed tendency of inflation to run just below the target (both in practice and in the Bank's projections) introduced an element of uncertainty to the objectives of monetary policy. The MPC spoke to this issue directly in the minutes of its February 2002 meeting, which were published on the Bank's website on February 20, 2002.

Section 2: Open Process for Formulating and Reporting Monetary Policy Decisions

103. The Bank of England observes all of the elements of this principle. The framework for monetary policy and the modalities used to conduct monetary policy are outlined and discussed in the Bank's publications and on its website. Similarly, the details surrounding the composition, structure and functions of the MPC are clearly documented and publicly disclosed through various channels. Changes in interest rate settings are announced immediately after the MPC meetings, which normally take place monthly. The schedule for these meetings is publicized prior to the start of the year. The minutes of the MPC meetings, which contain the votes of individual members and a nonattributed summary of the discussion, are released within 13 days of the meeting, even though by law they need only be released within six weeks of the meeting. In addition, the Bank issues a quarterly Inflation Report that discusses monetary policy objectives, and the prospects for achieving them. It also works collaboratively with financial market participants to champion measures to promote well-functioning markets and solicit their views on changes to monetary operating procedures. And data reporting forms and regulations are available on the Bank's web site together with accompanying definitions.

104. External observers generally praised the Bank for its efforts to highlight the uncertainty in monetary policy through the use of probabilistic fan-charts and its attempts to discuss its economic outlook in a probabilistic sense without focusing on point-estimates. That said, there appears to be some uncertainty outside the Bank as to what the fan-charts represent: the uncertainty inherent in the consensus forecast of the MPC versus an illustration of the range of views of MPC members. The Bank has sought to clarify this issue in boxes contained in several Inflation Reports, and by providing a table in the Report that summarizes MPC members' different assumptions. In addition, the Bank was criticized for not pre-announcing the extraordinary meeting of the MPC in September 2001. However,

given the prevailing circumstances, the decision of whether to preannounce such a meeting is a difficult judgment call. The Bank's decision to not announce the meeting ahead of time on this occasion was consistent with those of other central banks, such as the European Central Bank and the Federal Reserve.

Section 3: Public Availability of Information on Monetary Policy

105. The Bank observes all of the elements of this principle except the one dealing with timeliness of data that are published in accordance with the IMF's data dissemination standards, and the one dealing with the disclosure of aggregate information on emergency financial support provided by the central bank; these are broadly observed. In the former case, the SDDS' prescribed timeliness for data publication is 14 days, while the Bank publishes the data after 21 working days. The requirements of the SDDS are met by making use of a 'flexibility' option with respect to the timeliness of publication of data for the Analytical Accounts of the Central Bank. This is because the data disseminated are an integral part of the balance sheet of all monetary financial institutions that forms the basis of the U.K. monetary statistics, and these data are published as a complete package at the earliest opportunity. In the case of information on emergency financial support operations, the Bank does not provide enough information to enable outsiders to fully discern the effects of the operations on the Bank's revenues and expenses for the year(s) in question.

106. The Bank has an extensive public relations program to build public awareness of monetary policy and the MPC's mandate. In addition, members of the MPC make a large number of public presentations over the course of a year, and are frequently interviewed by members of the media, both in London and around the U.K.

Section 4: Accountability and Assurances of Integrity by the Central Bank

107. The Bank observes all of the elements of this principle, except those dealing with the disclosure of information on expenses and profit in operating the central bank and the publication of conflict of interest guidelines, which are broadly observed. In the case of the former, since the Bank does not publish detailed profit and loss accounts, external observers are not able to fully discern the effects of lender-of-last-resort operations on the Bank's revenues and expenses for the year(s) in question. In the case of the latter, the Bank has very stringent conflict of interest guidelines, which are not formally published. However, as a matter of policy the Bank will provide oral briefings of the rules in response to external requests.

Table 14. Detailed Assessment of Observance of IMF's MFP Transparency Code—Monetary Policy

I. CLARITY OF ROLES, RESPONSIBILITIES AND OBJECTIVES OF CENTRAL BANKS FOR MONETARY POLICY	
1.1	The ultimate objective(s) and institutional framework of monetary policy should be clearly defined in relevant legislation or regulation, including, where appropriate, a central bank law.
Description	The ultimate objectives and institutional framework for monetary policy in the United Kingdom (U.K.) are clearly defined in the Bank of England Act 1998. The Act, which amended the 1946 Act, gave the Bank operational authority and responsibility for monetary policy. The Act states that the Bank's monetary policy objective is to deliver price stability (this is currently defined as an inflation target, set by the government) and, without prejudice to that objective, to support the government's economic policy, including its objectives for growth and employment. The Act provides for the establishment of a Monetary Policy Committee and prescribes the operational framework for that Committee.
Assessment	Observed
Comments	External observers noted that the 1998 Act represents a significant improvement over the previous arrangements in which the government was responsible for monetary policy, and the Bank's role was as an advisor.
1.1.1	The ultimate objective(s) of monetary policy should be specified in legislation and publicly disclosed and explained.
Description	The objective of monetary policy is to maintain price stability, which is set out in the Bank of England Act 1998 (Part II, Section 11). In practice, this means that the Bank is responsible for setting short-term interest rates to achieve the government's inflation target, confirmed annually in the Chancellor of the Exchequer's Budget statement. The details of the Act are published on the Bank of England's public web site, and the full document is available from The Stationery Office. The provisions of the Act in relation to monetary policy are regularly explained and discussed in the Bank's *Quarterly Bulletin, Inflation Report* and *Annual Report.*
Assessment	Observed
Comments	External observers applauded the introduction of a point-target for inflation, which they believe has provided more clarity to the objective of monetary policy than the previous arrangement, where the target was set with reference to an upper-limit. Indeed, inflation expectations seem to have become better anchored to the target since the introduction of the current framework. However, a couple of them questioned whether the previously observed tendency of inflation to run just below the target (both in practice and in the Bank's inflation forecast) introduced an element of uncertainty into the objectives of monetary policy. The MPC clarified its approach in this regard in the minutes to its February 2002 meeting.
1.1.2	The responsibilities of the central bank should be specified in legislation.
Description	The Bank of England Act 1998 (Part II) sets out the statutory basis for the Bank's operational responsibility for monetary policy.
Assessment	Observed
Comments	
1.1.3	The legislation establishing the central bank should specify that the central bank has the authority to utilize monetary policy instruments to attain the policy objective(s).
Description	The Bank of England Act 1998 gives operational responsibility for monetary policy to the Bank of England. The Act also assigns the Bank the authority to intervene in the financial markets and to take other actions necessary to achieve its monetary policy objectives.
Assessment	Observed
Comments	External observers commented that the current situation represents a significant

	improvement over the pre-1997 period when the authority to set interest rates rested with the Chancellor of the Exchequer. The MPC now has the discretion to set its policy interest rate at a level it deems appropriate for achieving the inflation target, with appropriate accountability and disclosure requirements.
1.1.4	Institutional responsibility for foreign exchange policy should be publicly disclosed.
Description	The government is responsible for determining the exchange rate regime. It may instruct the Bank, acting as its agent, to intervene in the foreign exchange markets by buying or selling the government's foreign exchange reserves. The government now publishes at Budget time the broad framework within which the Bank is to manage the government's foreign exchange reserves. However, the Bank also has its own separate pool of foreign exchange assets to use at its discretion to support its monetary policy objective. The provisions relating to foreign exchange policy are discussed in the Bank's *Annual Report* and *Quarterly Bulletin*, and publicized on the Bank's website.
Assessment	Observed
Comments	
1.1.5	The broad modalities of accountability for the conduct of monetary policy and for any other responsibilities assigned to the central bank should be specified in legislation.
Description	The Chancellor of the Exchequer, who is accountable to Parliament, has overall responsibility for the monetary policy framework and sets the inflation target. The role of the MPC is to determine the level of interest rates to meet the target. The Governor of the Bank and other Committee members are regularly called to appear before the Treasury Select Committee of the House of Commons to account for their decisions. If the out-turn for inflation is more than 1 percentage point away from the government's target, the Governor of the Bank, on behalf of the MPC, is required to write an open letter to the Chancellor to account for the divergence and explain the policy action that is being taken to deal with it, the period in which inflation is expected to return to target and how this approach meets the government's objectives for growth and employment. The MPC also reports to a monthly meeting of the Bank's Court of Directors as part of the Court's legal responsibility for reviewing the MPC's procedures. The Court exercises its responsibilities in this regard by regularly reviewing reports prepared by Bank staff on MPC procedures, and by commissioning external peer-reviews of monetary policy processes and inflation forecasting procedures. Its conclusions in this regard are presented each year in the Bank's Annual Report. The Bank of England Act requires the MPC to meet regularly; any operational decisions are announced immediately, and the minutes of the meetings, including a record of the voting, must be published within six weeks (in practice they are usually published within two weeks after the end of the meeting). In addition the Bank, with the approval of the MPC, is legally required to publish a quarterly report, which explains the basis for its operational decisions.
Assessment	Observed
Comments	The 'Kohn' report on the Bank of England's monetary processes and the work of its Monetary Analysis Division is a recent example of an external peer review of monetary policy commissioned by the Court. The Bank is to be commended for publishing the report and its response to it.
1.1.6	If, in exceptional circumstances, the government has the authority to override central bank policy decisions, the conditions under which this authority may be invoked and the manner in which it is publicly disclosed should be specified in legislation.
Description	The Bank of England Act 1998 (Part II, Section 19) assigns the Treasury reserve powers to instruct the Bank on interest rates for a limited period if it is deemed to be in the public interest and in extreme economic circumstances. Any such instruction would be in consultation with the Governor of the Bank. The Treasury's reserve powers would be exercised through subordinate legislation approved by Parliament.
Assessment	Observed
Comments	Since the government's decision to grant operational independence to the Bank of England

	in 1997, the government has not exercised its power to override the MPC's interest rate decisions.
1.1.7	The procedures for appointment, terms of office, and any general criteria for removal of the heads and members of the governing body of the central bank should be specified in legislation.
Description	The Bank of England Act 1998 (Schedule 1) sets out the procedures for appointment, terms of office, and removal of the Bank's Court of Directors. Details of the membership of Court are given in the Bank's *Annual Report*, which includes a report from Court Members. The Act also specifies the functions of the Court of Directors in relation to the general management of the Bank's affairs and specifically in relation to ongoing review of the MPC and the monetary policy process. In particular, the Court regularly assesses whether the MPC has collected the regional, sectoral, and other information needed to conduct monetary policy.
Assessment	Observed
Comments	Under the Bank of England Act (Part I, Section 2 and Part II, Section 16), the responsibilities of the Court of Directors are to manage the Bank's affairs, other than the formulation of monetary policy, which is the exclusively responsibility of the MPC. This includes determining the Bank's objectives and strategies, aiming to ensure the effective discharge of the Bank's functions and the most efficient use of the Bank's resources. The Bank of England Act demands that Bank's Court meets at least once a month. The Bank of England Act 1998 also provides for a subcommittee of the Court consisting of the non-executive Directors (known as NedCo). NedCo is responsible for reviewing the Bank's performance in relation to its objectives and strategy, and monitoring the extent to which the Bank's financial management objectives are met. NedCo is also in charge of reviewing the procedures of the MPC, and in particular whether the MPC has collected all the necessary information for formulating the assessment of monetary policy stance. A summary of its findings is presented in a section of the Annual Report each year.
1.2	The institutional relationship between monetary and fiscal operations should be clearly defined.
Description	Fiscal operations carried out by the Bank (e.g., as banker and agent for the government) are clearly defined and disclosed in the Bank's *Annual Report*; in practice, these roles do not affect the conduct of monetary policy.
Assessment	Observed
Comments	Responsibility for management of the government's debt and domestic cash balances were transferred to HM Treasury's Debt Management Office (DMO) in 1998 and 2000, respectively. Examples of fiscal operations that continue to be handled by the Bank are managing the government's foreign exchange reserves and maintaining the gilt-edged stock register.
1.2.1	If credits, advances, or overdrafts to the government by the central bank are permitted, the conditions when they are permitted, and any limits thereof, should be publicly disclosed.
Description	One of the assets on the Bank's balance sheet is the Ways and Means advance to the National Loans Fund, which is an advance to the government. The U.K. protocol to the Maastricht Treaty allows this advance to exist unless, and until, the U.K. enters the third stage of EMU. When responsibility for Exchequer cash management was transferred from the Bank to the DMO in April 2000, the level of the advance was frozen at £13.4 billion and is still outstanding. It is at the Treasury's discretion, unless the U.K. decides to enter the third stage of Monetary Union, when to repay it. The existence of the Ways and Means advance (as an element of public sector debt) is reported in the public sector debt statistics, the Bank's *Annual Report* and in HM Treasury's annual *Debt and Reserves Management Report*.
Assessment	Observed
Comments	

1.2.2	The amounts and terms of credits, advances, or overdrafts to the government by the central bank and those of deposits of the government with the central bank should be publicly disclosed.
Description	The level of the Ways and Means advance at end-February (the end of the Bank's financial year) is published in the Bank's *Annual Report*. The proposed level at end-March (the end of the government's financial year) is published in HM Treasury's annual *Debt and Reserves Management Report*. The level of government deposits with the Bank is published in the Bank's *Annual Report* and in the Bank's weekly summary balance sheet (the 'Bank Return'). Beginning in March 2002, the terms and conditions of these facilities were published in the *Debt and Reserve Management Report.*
Assessment	Observed
Comments	The interest rate payable on the Ways and Means Advance and on deposits held by the Debt Management Office on behalf of the government is set at the Bank's official repo rate.
1.2.3	The procedures for direct central bank participation in the primary markets for government securities, where permitted, and in the secondary markets, should be publicly disclosed.
Description	The Bank does not participate in the primary market for British government securities (gilts) as this is not permitted under the Maastricht Treaty. The Bank buys and sells gilts in the secondary market for its own account, on behalf of central bank customers, and in operating a brokerage service for U.K. retail investors. Details of the brokerage service are available on the Bank's website (and publicly available documentation). The service for central bank customers is described in a prospectus. The Bank's own holdings of gilts are disclosed in the Bank's *Annual Report*.
Assessment	Observed
Comments	The retail brokerage service provides a way for private investors to buy and sell gilts in small amounts, The commission charged is often less than what they would pay to deal through a bank or stock broker.
1.2.4	Central bank involvement in the rest of the economy (e.g., through equity ownership, membership on governing boards, procurement, or provision of services for fee) should be conducted in an open and public manner on the basis of clear practices and procedures.
Description	The Bank holds shares in its subsidiaries and various bodies, international and domestic, related to central bank and payments activities. It holds no other equity nor do its staff sit on the boards of private sector companies except in relation to central bank and payments activities. (Equities are held by the Bank's staff pension fund, but this is managed off-balance sheet by in-house investment managers that do not have access to market-sensitive information collected by the rest of the Bank.) Procurement of fixed assets from the private sector is conducted in an open, public, and competitive manner. The Bank provides banking and custodial services to some private sector customers for a fee. The Bank tenders for these services on a competitive basis.
Assessment	Observed
Comments	The banking and custodial services for private sector customers mainly reflect dealings with customers that are a holdover from the period before 1946 when the Bank was a private company.
1.2.5	The manner in which central bank profits are allocated and how capital is maintained should be publicly disclosed.
Description	The Bank's *Annual Report* discloses the allocation of the Bank's profits between the government and the Bank's 'capital and reserves'.
Assessment	Observed
Comments	In practice, a 50:50 split of the Bank's profits between itself and HM Treasury is adhered to. If the Court and HM Treasury were to agree on a different split (which they are entitled to do under the 1998 Bank of England Act), then the Bank would reveal why in its Annual Report.
1.3	Agency roles performed by the central bank on behalf of the government should be clearly defined.

Description	The Bank's agency roles are described below in 1.3.1.
Assessment	Observed
Comments	
1.3.1	Responsibilities, if any, of the central bank in (i) the management of domestic and external public debt and foreign exchange reserves, (ii) as banker to the government, (iii) as fiscal agent of the government, and (iv) as advisor on economic and financial policies and in the field of international cooperation, should be publicly disclosed.
Description	(i) The Bank manages the U.K.'s external public debt and foreign exchange reserves. HM Treasury provides a formal annual remit to the Bank, which is published in the Treasury's annual *Debt and Reserves Management Report*. (Domestic public debt has been managed by the U.K. Debt Management Office since April 1998.) (ii) The Bank acts as the principal banker to central government. This is a matter of public record (see, for example, the Bank's *Annual Report*). (iii) The Bank is required under statute to provide the stock registration service for certificated British government securities (see Stock Transfer Act 1963 and earlier versions and Government Stock Regulations). (iv) There is no formal requirement for the Bank to serve as an advisor on economic and financial policies and in the field of international cooperation. In practice, since May 1997 the MPC has had operational responsibility for setting interest rates to meet the government's target for inflation. In addition, the Bank participates with the government on an ad hoc basis in a number of international fora, for example the IMF/World Bank.
Assessment	Observed
Comments	Examples of issues that the Bank has addressed in an advisory capacity include sovereign debt restructuring (see, for example, the joint Bank of Canada-Bank of England working paper on this issue published in 2000), and other G-7 issues (when informally asked to do so by the government). The Bank also acts as an agent for HM Treasury in implementing financial sanctions as per a Memorandum of Understanding between Bank and HM Treasury.
1.3.2	The allocation of responsibilities among the central bank, the ministry of finance, or a separate public agency, for the primary debt issues, secondary market arrangements, depository facilities, and clearing and settlement arrangements for trade in government securities, should be publicly disclosed.
Description	The allocation of responsibilities is disclosed in HM Treasury's annual *Debt and Reserves Management Report*, and on the web sites of U.K. Debt Management Office (the agency responsible for primary issues and secondary market arrangements) and CRESTCo (the company providing depository, and settlement arrangements).
Assessment	Observed
Comments	
II. OPEN PROCESS FOR FORMULATING AND REPORTING MONETARY POLICY DECISIONS	
2.1	The framework, instruments, and any targets that are used to pursue the objectives of monetary policy should be publicly disclosed and explained.
Description	The framework for setting monetary policy is described and explained in the Bank's *Annual Report*, its quarterly *Inflation Report*, and on the Bank's website. It is also discussed at length in a book published in 2002 by HM Treasury, *Reforming Britain's Economic and Financial Policy: Towards Greater Economic Stability*. The operational instruments used to implement the MPC's interest rate decision are regularly described and explained in the Bank's *Quarterly Bulletin*; the technical framework of money market operations is set out in the Bank's *Operational Notice* for its operations in the sterling money markets.
Assessment	Observed
Comments	The *Inflation Report* presents projections for inflation and GDP over a two-year horizon in the form of probabilistic fan charts to emphasize the degree of uncertainty that surrounds the

	projections. External observers commented that the report is comprehensive in its coverage and well organized. They commended the Bank for its efforts to highlight the uncertainty in monetary policy through the use of these charts, and its discussion of the economic outlook in a probabilistic sense without focusing on point-estimates. Nonetheless, there is some public confusion as to whether the fan-charts are meant to illustrate the uncertainty inherent in the MPC's consensus economic outlook, or whether they are conveying a sense of the diversity of views held by MPC members. The Bank has sought to address this in boxes contained in several Inflation Reports, and by including a table in the Report that summarizes MPC members' different economic assumptions.
2.1.1	The procedures and practices governing monetary policy instruments and operations should be publicly disclosed and explained.
Description	Details of the Bank's operations in the sterling money markets are set out in the Bank's *Operational Notice* and reported regularly in the '*Markets and Operations*' article in the Bank's *Quarterly Bulletin*. In 1997, the Chancellor authorized the Bank to undertake foreign exchange operations on its own balance sheet to intervene in support of its monetary policy objective. According to the 1998 Bank of England Act, the Bank has discretion about revealing decisions to intervene if publishing would impede the original purpose of the intervention. This discretion applies to both domestic open market operations and foreign exchange market intervention, but in practice it only applies to the latter, since all domestic market operations are conducted in a public fashion. Otherwise, there is a presumption that the Bank will publish any decision taken by the MPC to intervene in foreign exchange markets alongside its other monetary policy decisions. Minutes relating to the decision to intervene must be published within six weeks of an announcement of the decision (see Sections 14 and 15 of the Act).
Assessment	Observed
Comments	Since the introduction of the current framework in 1997, the Bank has not intervened in the foreign exchange market for domestic monetary policy purposes; hence, there is no example to illustrate how such an operation would be conducted in practice.
2.1.2	The rules and procedures for the central bank's relationships and transactions with counterparties in its monetary operations and in the markets where it operates should be publicly disclosed.
Description	The rules and procedures that guide the Bank's dealing with counterparties and the modalities of its market operations are set out in the Bank's *Operational Notice* for its operations in the sterling money markets. The 'functional criteria' which the Bank expects its counterparties to meet were published in the February 1997 paper '*Reform of the Bank of England's operations in the sterling money markets*' and republished most recently in the May 2002 paper *'The Bank of England's Operations in the Sterling Money Markets'*, which sets out the current procedures .
Assessment	Observed
Comments	The list of counterparties is not made public because the Bank wants to avoid creating the perception in the market that the obligations of those institutions would receive special treatment in the event of financial distress. Nonetheless, some market participants believe they have a fair understanding of which institutions are on the list. The functional criteria governing the selection of counterparties address issues such as: a counterparty's presence in the market; its ability to efficiently handle the Bank's operations; the degree to which it participates in the Bank's operations; and the quality of information on market conditions provided to Bank staff.
2.2	Where a permanent monetary policy making body meets to assess underlying economic developments, monitor progress toward achieving its monetary policy objective(s), and formulate policy for the period ahead, information on the composition, structure, and functions of that body should be publicly disclosed.
Description	The Bank of England Act 1998 (Part II, Section 13) assigns operational responsibility for

	monetary policy to the MPC, and specifies the composition, structure and functions of the Committee. Details are published in the Bank's Annual Report and Quarterly Bulletin and on the Bank's public web site.
Assessment	Observed
Comments	
2.2.1	If the policy making body has regularly scheduled meetings to assess underlying economic developments, monitor progress toward achieving its monetary policy objective(s), and formulate policy for the period ahead, the advance meeting schedule should be publicly disclosed.
Description	The MPC normally meets monthly to discuss its monetary policy decision. The schedule of meetings is published as a press release in the autumn of each year for the calendar year ahead, and is available on the Bank's web site. The Governor of the Bank (or in his absence the Deputy Governor with responsibility for monetary policy) may summon an unscheduled policy meeting at any time giving such notice, which in his judgment the circumstances may require. Since the MPC's inception, only one such meeting has been called, following the extraordinary events of September 11, 2001 and their immediate aftermath.
Assessment	Observed
Comments	A report published by Lehman Brothers in August 2001 suggests that the amount of uncertainty in markets regarding future policy actions has declined since the introduction of the current framework in 1997. External observers criticized the Bank for not announcing in September 2001 that an extraordinary meeting of the MPC was being held. They noted that rumors of such a meeting surfaced in any event, and a pre-announcement might have saved the Bank from having to transact at two different interest rate levels that day. (Normally the Bank does not transact until the afternoon on the day of an MPC meeting). In response, the Bank noted that given the prevailing circumstances, the decision of whether to announce the meeting ahead of time represented a difficult judgment call. The Bank's decision to not preannounce was consistent with decisions of other central banks, such as the European Central Bank and the Federal Reserve.
2.3	Changes in the setting of monetary policy instruments (other than fine-tuning measures) should be publicly announced and explained in a timely manner.
Description	At noon on the final day of the MPC's monthly policy meeting, the Bank releases a press statement to announce the decision made at the meeting. The minutes identify how each member of the Committee voted at the meeting and explains any dissent from the majority vote. They also contain a summary of the recent economic developments considered at the meeting including the level of interest rates preferred by the dissenters. As noted above, additional meetings are permitted in exceptional circumstances. As with the scheduled meetings, any decision is announced immediately after the meeting and minutes must be published within six weeks.
Assessment	Observed
Comments	Bank officials noted that while the votes of individual MPC members are disclosed, the views they express during the meeting are not attributed in the minutes. They explained that this is to encourage more frank and open discussion among MPC members. On the other hand, some external observers suggested that this might hinder the accountability of MPC members because not knowing the views that lie behind the votes makes it difficult to assess the performance of MPC members ex post. That said, some market participants commented that they believe they can link, to a certain extent, MPC member votes with the non-attributed statements in the minutes. They believe that being able to associate the different views expressed in the minutes with individual MPC members provides useful context when interpreting the public comments of MPC members. In turn, this helps to moderate market responses to their public statements.

2.3.1	The central bank should publicly disclose, with a preannounced maximum delay, the main considerations underlying its monetary policy decisions.
Description	Minutes of the MPC policy meetings, which contain the main considerations underlying monetary policy decisions, are normally published 13 days after the meeting even though the 1998 Act only requires that they be released within six weeks.
Assessment	Observed
Comments	
2.4	The central bank should issue periodic public statements on progress toward achieving its monetary policy objective(s) as well as prospects for achieving them. The arrangements could differ depending on the monetary policy framework, including the exchange rate regime.
Description	The Bank publishes a quarterly *Inflation Report* as required by the Bank of England Act 1998. The Report discusses the MPC's progress towards achieving the government's inflation target, accounts for its monetary policy actions, and sets out and justifies its outlook for the economy and inflation.
Assessment	Observed
Comments	
2.4.1	The central bank should periodically present its monetary policy objectives to the public, specifying, inter alia, their rationale, quantitative targets and instruments where applicable, and the key underlying assumptions.
Description	The Bank has a continuous education and public relations program on monetary policy, with many facets including speeches and written material. More recently the Bank introduced a monetary policy competition for schools to explain the objectives and processes of monetary policy more widely (see responses to 3.3 and its sub-sections).
Assessment	Observed
Comments	The Bank of England/Times Target 2Point5 schools competition provides an opportunity for the MPC to explain itself to an important audience throughout the U.K.The effect is heightened by the accompanying publicity for the regional heats and the national final in The Times newspaper, in regional newspapers, and in regional and national broadcasting media.
2.4.2	The central bank should present to the public on a specified schedule a report on the evolving macroeconomic situation, and their implications for its monetary policy objective(s).
Description	The Bank's quarterly *Inflation Report* describes and analyses the MPC's assessment of the current macroeconomic situation. Individual sections of the *Report* set out and interpret recent and current developments across the different areas of the economy, and a final section synthesizes the overall assessment for the macroeconomic outlook. The schedule for publishing the *Report* is published in the autumn of each year for the following calendar year. The schedule forms the basis of a press release and is publicized in the Bank's *Quarterly Bulletin* and on its website.
Assessment	Observed
Comments	
2.5	For proposed substantive technical changes to the structure of monetary regulations, there should be a presumption in favor of public consultations, within an appropriate period.
Description	The Bank believes in consulting participants in the sterling money markets on substantive technical changes to its operations. The last substantive change to the Bank's system of operating in the sterling money markets was in March 1997. The Bank's proposals for these changes were set out in a consultative paper, published in December 1996.
Assessment	Observed
Comments	The Bank plays an active role together with market participants in championing the development of U.K. financial markets. In addition to a continuous bilateral relationship with market participants, the Bank liaises with them through three key committees—the Foreign Exchange Joint Standing Committee, the Sterling Money Markets Liaison Group, and the Stock Lending and Repo Committee. All three committees are chaired by senior Bank officials. Market participants generally praised the Bank's willingness to work with them in an open collaborative fashion to foster the development of well-functioning money and

	foreign exchange markets.
2.6	The regulations on data reporting by financial institutions to the central bank for monetary policy purposes should be publicly disclosed.
Description	All reporting forms and accompanying definitions are available on the Bank's web site. Updates to the definitions are also immediately posted on the website. The General Notes and Definitions make it clear that the data are collected in accordance with the Bank of England Act 1998.
Assessment	Observed
Comments	
III. PUBLIC AVAILABILITY OF INFORMATION ON MONETARY POLICY	
3.1	Presentations and releases of central bank data should meet the standards related to coverage, periodicity, timeliness of data and access by the public that are consistent with the International Monetary Fund's data dissemination standards.
Description	Data for the Analytical Accounts of the Banking Sector (Broad Money components and counterparts) and for the Analytical Accounts of the Central Bank both meet the IMF's Data Dissemination Standards. (A 'flexibility option' is taken in respect of one of the prescribed components of the Analytical Accounts of the Central Bank; see below)
Assessment	Broadly Observed
Comments	The requirements of the SDDS are met by making use of a 'flexibility option' in respect of the timeliness of publication of data for the Analytical Accounts of the Central Bank. The prescribed timeliness is 14 days, but the data are published after 21 working days. This is because the data disseminated are an integral part of the balance sheet of all monetary financial institutions that forms the basis of the U.K. monetary statistics, and these data are published as a complete package at the earliest opportunity.
3.2	The central bank should publicly disclose its balance sheet on a preannounced schedule and, after a predetermined interval, publicly disclose selected information on its aggregate market transactions.
Description	See responses to 3.2.1, 3.2.2, 3.2.3, and 3.2.4.
Assessment	Observed
Comments	
3.2.1	Summary central bank balance sheets should be publicly disclosed on a frequent and preannounced schedule. Detailed central bank balance sheets prepared according to appropriate and publicly documented accounting standards should be publicly disclosed at least annually by the central bank.
Description	The Bank of England's accounts take the form of two balance sheets—one, the Issue Department, covering the assets and liabilities relating to the note issue functions of the Bank and the other, the Banking Department, covering all other assets and liabilities. The Bank of England has a statutory requirement to prepare a weekly return of its accounts under section 6 of the Bank Charter Act 1844. The Act sets out the format that the return should take. The weekly Bank return is published in the *London Gazette* and as such is available to the public each Thursday. More detailed balance sheets are prepared for the Bank's annual accounts. The Bank of England Act 1998 requires the Banking Department balance sheet to be prepared according to U.K. standards for commercial banks (apart from some disclosures). Full accounting policies are disclosed in the Bank's Annual Report. The Issue Department balance sheet is prepared according to rules agreed with HM Treasury, the main ones being disclosed.
Assessment	Observed
Comments	
3.2.2	Information on the central bank's monetary operations, including aggregate amounts and terms of refinance or other facilities (subject to the maintenance of commercial confidentiality) should be publicly disclosed on a preannounced schedule.
Description	Details of the refinancing provided at each of the Bank of England's daily dealing rounds are immediately published on the wire services. Factors influencing the market's daily cash

	position are also published. Table D2.1 in the monthly publication *Bank of England: Monetary and Financial Statistics* provides a daily summary of the Bank's market operations, analyzed by amount, interest rate and collateral instrument. Table D2.2 gives a monthly summary by amount and collateral instrument, including the amounts outstanding.
Assessment	Observed
Comments	
3.2.3	Consistent with confidentiality and privacy of information on individual firms, aggregate information on emergency financial support by the central bank should be publicly disclosed through an appropriate central bank statement when such disclosure will not be disruptive to financial stability.
Description	In exceptional circumstances, as part of its central banking functions, the Bank may act as "lender of last resort" to financial institutions in difficulty to prevent a loss of confidence spreading through the financial system as a whole. All lender of last resort support operations are disclosed and that disclosure happens in a timely manner. There will be a presumption in favor of disclosing support in the Bank of England's first annual report following the support operation. If disclosure at that time would be damaging to financial stability or the support operation itself then disclosure would be postponed and the issue re-considered after a further year and, if necessary, in subsequent years until disclosure took place. In disclosing information, those factors which meant that an earlier disclosure would have been unsafe will be explained. It may be possible to safely disclose some items of information before others.
Assessment	Broadly Observed
Comments	When the Bank publishes information on lender-of-last-resort support operations, it does not provide enough information to enable external observers to fully discern the effects of these operations on the Bank's revenues and expenses for the year(s) in question.
3.2.4	Information about the country's foreign exchange reserve assets, liabilities and commitments by the monetary authorities should be publicly disclosed on a preannounced schedule, consistent with the International Monetary Fund's Data Dissemination Standards.
Description	The foreign exchange assets, liabilities and commitments, of the U.K. Government and the Bank of England, are published in accordance with methodology developed by the International Monetary Fund in the context of revisions to their Special Data Dissemination Standard (SDDS), and the G10 central banks in their report "Enhancing transparency regarding authorities' foreign currency liquidity position." The U.K. began to disclose additional information on its foreign currency assets and liabilities in accordance with the IMF template from July 1999. Data are published on a done date basis to remove the distinction between the spot and forward books (the former comprises all settled transactions, the latter all unsettled transactions). The template integrates on-balance sheet and off-balance sheet international financial assets and liabilities. With effect from August 2001 data on foreign currency holdings of central government, which are not classed as reserve assets, have been included in section I-B and IV of the template. Associated foreign currency drains are scored against the U.K. Government in Section II. The data are published by HM Treasury and the Bank at 9.30am on the third working day of every month and are available on both HM Treasury's and the Bank's web sites.
Assessment	Observed
Comments	
3.3	The central bank should establish and maintain public information services.
Description	The Bank of England maintains an extensive public information service. By law it must publish the minutes of monthly Monetary Policy Committee meetings, including the vote, and a quarterly *Inflation Report*. The Bank must also by law indicate its expected approach to meeting the objectives for price stability set by government, and this is done both through the *Inflation Report* and the minutes. The press conference to introduce the quarterly *Inflation Report* is televised and web cast live. The MPC makes regular speeches throughout the U.K., and the Bank's 12 regional agents play an important role in explaining policy to the business community and other

	members of the public. The Bank has set up a program to build a constituency for low inflation among the general public, aimed at increasing public understanding and support for the Bank's objectives and the means it uses to achieve them. The public understanding work includes an education program, a key feature of which is a successful economics competition for schools. There is also a regular program of talks for visitors to the Bank. The Bank maintains an extensive web site, which contains everything it publishes, plus information about the Bank. The Bank has a Public Enquiries Group, whose job is to respond to letters, e-mails, and telephone calls from the general public. There is also an information program for members of parliament, and a community relations program.
Assessment	Observed
Comments	
3.3.1	The central bank should have a publications program, including an Annual Report.
Description	By law the Bank must publish an annual report, which includes a separate report from the non-executive directors of the Bank. The Bank also issues a very wide range of other regular documents including an *Inflation Report*, a *Quarterly Bulletin*, working papers by staff, statistics releases, and also occasional publications related to policymaking, such as a description of the transmission mechanism. It publishes a regular *Financial Stability Review*. There is a further range of publications designed to inform the general public.
Assessment	Observed
Comments	
3.3.2	Senior central bank officials should be ready to explain their institution's objective(s) and performance to the public, and have a presumption in favor of releasing the text of their statements to the public.
Description	Senior officials appear regularly in public (often televised) before the House of Commons Treasury Committee and the House of Lords Economic Affairs Committee. Senior officials have a comprehensive public speaking and media interview program. Related to this, there is a coordinated program of visits to the regions of the United Kingdom for meetings with local interests, speeches, visits to businesses, and local media interviews. Senior officials have a presumption in favor of releasing the text of their statements to the public.
Assessment	Observed
Comments	There were about 35 published speeches and lectures on monetary policy and related economic issues by the Governor and other MPC members in the 12 months ending October 2001. In addition, MPC members typically give more than 100 other private and public speeches, lectures, and informal talks on the economy each year. MPC members gave just over 200 interviews to the media on monetary policy issues in the 12 months ending October 2001, of which 122 were on the record. On the record interviews were evenly split between national and regional press and broadcasting media. The numbers were similar in the previous 12 months. MPC members have planned a total of 50 regional visits for the financial year 2001/2002, in line with the previous year's total.
3.4	Texts of regulations issued by the central bank should be readily available to the public.
Description	Rules and instruments having legal status that are issued by the Bank to the general public are published and available on the Bank's web site, including lists of names of individuals and organizations published under United Nations sanctions legislation.
Assessment	Observed
Comments	
IV. Accountability and Assurances of Integrity by the Central Bank	
4.1	Officials of the central bank should be available to appear before a designated public authority to report on the conduct of monetary policy, explain the policy objective(s) of their institution, describe their performance in achieving their objective(s), and, as appropriate, exchange views on the state of the economy and the financial system.
Description	As noted above, senior officials appear regularly in public before the House of Commons Treasury Committee and the House of Lords Economic Affairs Committee. At these meetings,

	senior officials report on the conduct of monetary policy, explain the Bank's objectives, describe performance in achieving them and exchange views on the state of the economy and the financial system. The committees publish their own reports on the hearings, together with transcripts of evidence. There is also an information program for members of Parliament. The Bank's *Annual Report* is laid before Parliament by the Chancellor of the Exchequer.
Assessment	Observed
Comments	In the first 10 months of the 2001–2002 fiscal year ending February, MPC staff appeared in public before the House of Commons Treasury committee on two occasions, and before the House's Public Accounts Committee on one occasion. In addition, there were two occasions where MPC members appeared before the House of Lords Economic Affairs Committee.
4.2	The central bank should publicly disclose audited financial statements of its operations on a preannounced schedule.
Description	Audited financial statements are published in the Bank's *Annual Report*.
Assessment	Observed
Comments	
4.2.1	The financial statements should be audited by an independent auditor. Information on accounting policies and any qualification to the statements should be an integral part of the publicly disclosed financial statements.
Description	The financial statements of the Bank are audited by an independent auditor. Accounting policies are published in the Bank's *Annual Report*. In 2001, after having used the same auditor for many years, the Bank introduced a public tender process for choosing the auditor, which was advertised in the European Union journal. The selection panel consisted of a Deputy Governor, the Finance Director, and a nonexecutive director from the Audit Committee. Each interested firm was invited to interview various people to gather data prior to a final interview and presentation to the selection panel. The panel selects the auditor based on these presentations. The recommendation then goes to the full Bank's Court of Directors.
Assessment	Observed
Comments	Currently, Price Waterhouse Coopers is the Bank's auditor, with an appointment of four years, so 2002 will be the second year under the new framework. Two firms were ruled out in the last tender due to conflicts of interest.
4.2.2	Internal governance procedures necessary to ensure the integrity of operations, including internal audit arrangements, should be publicly disclosed.
Description	Internal governance procedures are described in the Bank's *Annual Report*. The Court is responsible for managing the Bank's affairs, other than the formulation of monetary policy, which is the function of the MPC. NedCo (sub-committee of Court consisting of non-executive Directors) is responsible for reviewing the Bank's performance in relation to its objectives and strategy and monitoring the extent to which the Bank's financial management objectives are met. NedCo is also responsible for reviewing the procedures of the MPC (discussed previously), reviewing the Bank's internal controls, and determining the Governor's and Deputy Governor's remuneration and pensions. In addition, there are formal audit and remuneration committees. Under the Court, the Bank's senior policy-making body is the Governor's Committee, comprising the Governors and Executive Directors. The internal management of the Bank is the responsibility of the Management Committee, comprising the Deputy Governor (Financial Stability), the Deputy Directors, the Finance Director, and the Director of Personnel.
Assessment	Observed
Comments	
4.3	Information on the expenses and revenues in operating the central bank should be publicly disclosed annually.
Description	The Bank's *Annual Report* contains information on profit and expenditure. It is not possible to publish revenue numbers without revealing information about provisions. The latter would alert readers to the possibility that the Bank had engaged in a lender of last resort activity, when such an operation had indeed taken place. Consequently, the Bank does not wish to

	publish revenue information for reasons, which it believes are entirely consistent with Section 3.2.3 of the Code. When circumstances permit details of support operations are published (see Note 1 to the Bank's Accounts).
Assessment	Broadly Observed
Comments	When the Bank publishes information on lender-of-last-resort operations, external observers are not able to fully discern the impact on the Bank's revenues and expenses for the year(s) in question.
4.4	Standards for the conduct of personal financial affairs of officials and staff of the central bank and rules to prevent exploitation of conflicts of interest, including any general fiduciary obligation, should be publicly disclosed.
Description	The Bank has internal rules on personal financial dealings set by Court, which are designed to address the issue of possible, actual or perceived financial conflict of interest or misuse of confidential information. These rules require MPC members and staff to obtain prior authorization for every financial transaction, including new mortgage borrowing switching between fixed and floating rate mortgages and switching between funds in a personal pension plan. The only exception to the internal reporting of every transaction is if members place their investments at arms length under fully discretionary management. Any such arrangements must also be approved by the Bank when they are set up.
Assessment	Broadly Observed
Comments	The conflict of interest guidelines are contained in a number of documents, which have not been published. However, the Bank has a policy of providing oral briefings on the rules in response to external requests, even though it does not formally published them. The rules were tightened further in 2002, when MPC members and some staff will be required to disclose information on asset holdings as well as the flows associated with financial transactions.
4.4.1	Information about legal protections for officials and staff of the central bank in the conduct of their official duties should be publicly disclosed.
Description	Bank staff have statutory immunity in respect of banking supervisory acts or omissions before June 1998 when supervision was transferred to the Financial Services Authority. Bank staff also enjoy statutory immunity under the Settlement Finality Regulations 1999. The Bank has indemnified members of its Court of Directors against personal civil liability arising from the carrying out of their functions. These immunities are publicly disclosed. There is a specific provision in the Financial Markets and Insolvency (Settlement Finality) Regulations 1999, which deals with immunity for the Bank and staff. This is contained in Regulation 11 (Exemption from liability in damages), which provides as follows: (1) neither the designating authority nor any person who is, or is acting as, a member, officer or member of staff of the designating authority shall be liable in damages for anything done or omitted in the discharge, or purported discharge, of the designating authority's functions under these Regulations. (2) paragraph (1) does not apply (a) if the act or omission is shown to have been in bad faith; or (b) so as to prevent an award of damages made in respect of an act or omission on the ground that the act or omission was unlawful as a result of section 6(1) of the Human Rights Act 1998 (acts of public authorities). The Bank is a 'designating authority' for this purpose.
Assessment	Observed
Comments	

Table 15. Summary Observance of IMF's MFP Transparency Code—Monetary Policy

Assessment Grade	Practices Grouped by Assessment Grade	
	Count	List
Observed	42	
Broadly observed	4	Principles 3.1, 3.2.3, 4.2.1, 4.4
Partly observed		
Not observed		
Not applicable		

E. Recommended Action Plan and Authorities' Response to the Assessment

Recommended action plan

108. Section 3.1: When feasible, shorten the publication period of the U.K. monetary statistics from 21 days to 14 days.

109. Sections 3.2.3 and 4.2.1: When disclosing lender-of-last-resort support provided to distressed financial institutions, consider providing enough information to enable external observers to fully discern the effects of these operations on the Bank's revenues and expenses for the year(s) in question.

110. Section 4.4: Although the conflict of interest guidelines are contained in a number of documents and the Bank has a policy of orally explaining them upon request, it should consider publishing a summary of them, and make it clear how members of the public can obtain further information (or the underlying documents) if they so wish.

Table 16. Recommended Action Plan to Improve Observance of IMF's MFP Transparency Code Practices—Monetary Policy

Reference Practice	Recommended Action
III. Public Availability of Information on Monetary Policy	
3.1	When feasible, shorten the publication period of the U.K. monetary statistics form 21 days to 14 days.
3.2.3	When disclosing lender-of-last-resort support provided to distressed financial institutions, consider providing enough information to enable external observers to fully discern the effects of these operations on the Bank's revenues and expenses for the year(s) in question.
IV. Accountability and Assurances of Integrity by the Central Bank	
4.2.1	Same as 3.2.3
4.4	Although the conflict of interest guidelines are contained in a number of documents, the Bank should consider publishing a summary of them, and make it clear how members of the public can obtain further information (or the underlying documents) if they so wish.

Authorities' response

111. Because of the interrelationships between some of the issues in the monetary policy transparency assessment and some of those in the transparency assessment covering the Bank of England's financial policy functions (See Part F below), the authorities' response here covers *both* Bank of England assessments.

112. The authorities welcomed the recognition that the Bank of England's monetary and financial policy frameworks are some of the most transparent in the world. Their specific responses on the main recommendations above are as follows.

- On *Principle 3.1*, the authorities indicated that shortening the publication period of U.K. monetary statistics could only be achieved by imposing significant additional costs on some of the contributors to the data. They noted that, with the exception of the Analytical Accounts of the Central Bank, the U.K. monetary statistics fully meet the requirements of the SDDS in respect of timeliness of publication. Narrow money data are published on the third working day after the final Wednesday of the reference month and Broad money and credit data are published after 14 working days. It is the sectoral breakdowns of broad money and credit, and the consolidated balance sheet of monetary financial institutions, that are not published until after 21 working days. Publication of the sectoral breakdowns takes place 4 working days after the last data become available, and could only be accelerated by imposing unjustifiably high costs on contributors. The requirements of the SDDS are met by the use of a 'flexibility' option in respect of the timeliness of publication of the Analytical Accounts of the Central Bank.

- In relation to *Principles 3.2.3, 4.3, 7.3.1 and 8.3*, the authorities noted that in exceptional circumstances, as part of its central banking functions, the Bank may act as "lender of last resort" to financial institutions in difficulty so as to prevent a loss of confidence spreading through the financial system as a whole. All lender of last resort support operations are disclosed and that disclosure happens in a timely manner. There will be a presumption in favor of disclosing support in the Bank of England's first annual report following the support operation. If disclosure at that time would be damaging to financial stability or the support operation itself, then disclosure would be postponed and the issue re-considered after a further year and, if necessary, in subsequent years until disclosure took place. In disclosing information, those factors which meant that an earlier disclosure would have been unsafe will be explained. Note 1 of the Bank's Annual Accounts explains the Bank's policy in this area in more detail.

- On *Principles 4.4 and 8.4*, the authorities noted that the Court of the Bank has set rules on personal financial dealing which are designed to address the issue of possible financial conflict of interest or misuse of confidential information. MPC members and executive directors are required to disclose the stock of their financial assets, and some liabilities, to the Personnel Director (or in the case of the Governors to the Chairman of the Committee of Non-Executive Directors). MPC members are strongly advised wherever practicable to place their investments at arms length under fully discretionary management. Where this is not practicable they must seek prior agreement before every transaction. Briefings on these rules have been provided in response to external requests up to now. In November 2002, the Bank sent a detailed summary of the rules as they apply to MPC members to the Treasury Committee of the House of Commons, on the assumption that the Treasury Committee will in due course publish them as evidence. Once that happens, the Bank will place a copy of the summary on its web site.

VI. IMF's MFP Transparency Code—Transparency of Payment Systems Oversight and Other Financial Stability functions of the Bank of England

A. General

113. This assessment of the transparency of payment systems oversight and other financial stability functions of the Bank of England was undertaken in conjunction with the evaluation of U.K.'s financial system made in February-July 2002 by the IMF as part of its Financial Sector Assessment Program. The assessment was made by Mr. Martin Andersson (Sveriges Riksbank) and Mr. Tom Kokkola (European Central Bank). The assessment was conducted within the framework of the IMF's Code on Good Practices in Transparency of Monetary and Financial Policies.

B. Information and Methodology Used for the Assessment

114. The assessment was undertaken on the basis of a self-assessment made by the Bank of England, together with a review of various relevant documents including especially the Annual Report, successive editions of the Financial Stability Review and the Quarterly Bulletin and the 1998 Bank of England Act and key documents on its website relating to payments system oversight in particular. In addition, the mission held a variety of discussions with the Bank of England, the Financial Services Authority (FSA), HM Treasury (HMT), market participants and representatives of the media and academia. The U.K. authorities fully cooperated with the assessment, and all required information and documents were provided. Compared to the self-assessment, differences reflected in the mission's assessment have been largely in the nature of elaboration and extension rather than revision.

C. Institutional and Market Structure—Overview

115. There is currently no direct specification, in law or regulation, of payment and settlement systems oversight or a broader financial stability responsibility as key roles of the Bank, with the exception that the Bank is the designator of payment systems under the Financial Markets and Insolvency (Settlement Finality) Regulations 1999.[14] However, there are a number of less direct references that quite clearly imply or presume these responsibilities for the Bank.[15]

116. Instead, the framework for the Bank's role with regard to payment systems oversight is given in the *Memorandum of Understanding* (MoU) between the Bank of England, the FSA and HMT, while for the Bank's financial stability work more generally, the broad framework is laid down in the MoU and its *Annual Report.* The latter sets out the Bank's

[14] The U.K. national implementation of Directive 98/26/EC.

[15] One example is the references in the Bank's statute to the "Deputy Governor for Financial Stability".

Core Purposes, and Objectives and Strategy, as determined by the Court of Directors acting under Section 2 of the Bank of England Act 1998.

117. The MoU sets out the Bank's responsibilities within a broader structure for coordination between the three organizations, under the aegis of the tripartite Financial Stability Standing Committee (FSSC). It specifies that the Bank is responsible for the overall stability of the financial system as a whole, and identifies five financial stability roles which stem from this:

- Stability of the monetary system.
- Financial system infrastructure, in particular payments systems at home and abroad.
- Broad overview of the system as a whole.
- Being able in exceptional circumstances to undertake official support operations having informed HMT (under MoU arrangements).
- The efficiency and effectiveness of the financial sector, with particular regard to international competitiveness.

D. Practice-by-Practice Assessment

General comments

118. The transparency of the financial stability function of the Bank of England is, to a large extent, at the forefront, internationally. For example, the Bank was among the first central banks to regularly publish financial stability assessments, which is done biannually in the Financial Stability Review (FSR)

119. Much progress has been made in recent years and the Bank complies with all the elements of the IMF's Financial Policy Transparency Code, except those dealing with the disclosure of information on expenses and profit in operating the central bank and the publication of conflict of interest guidelines. These are rated as broadly observed. (The details are covered in the assessment of Transparency in Monetary Policies and are therefore only noted briefly here.) There are some other issues where there is still some room for further refinement of already strong transparency practices, but these are issues at the margin.

Section 5: Clarity of Roles, Responsibilities, and Objectives

120. Overall, the Bank's payments oversight and other financial policy responsibilities are publicly disclosed and discussed in a way that compares very well with good practice internationally. This is done mainly through regular Bank publications--specifically:

- The Annual Report

- The Financial Stability Review (FSR), which is produced biannually and is widely regarded as a leading example of central bank publications on financial stability developments and analysis.

121. In addition, the Bank has also published separately its framework for payment systems oversight (*Oversight of Payment Systems*, November 2000) and its policy with regards to settlement accounts (*Bank of England Settlement Accounts: consultative document*, January 2002). There is also a separate Financial Stability section on the Bank's website.

122. Discussions with market participants and other observers have confirmed the view that the Bank is clear and transparent with respect to its payment systems oversight and financial stability functions. In the Annual Report 2001, it was noted that there had been some 65,000 hits on the website for the stability assessment in the week following its publication.

123. To supplement the above mechanisms, the IMF mission believes that it would be helpful, at a convenient time in the legislative schedule, to lay out more fully and formally in statute the Bank's financial stability and payments and settlement systems oversight responsibility.

124. It is stated in the MoU that the three institutions concerned have to work together and coordinate amongst each other in financial crisis situations. In practice, such co-operation is organized within the framework of the FSSC. Due to the central role played by the Bank in the financial markets, it has market-based experience and capabilities that are of utmost importance in dealing with such crisis situations. The possibility of the Bank acting in support operations in order to resolve a financial crisis situation is explicitly recognized in both the MoU and the Annual Report. What that means in practice—both as to the Bank's role as provider of emergency liquidity assistance and to any role it may have under the tripartite structure, in working out market solutions to systemically important financial sector problems—has not, however, been elaborated further in any recent, readily available documentation. The most recent elaboration is contained in a 1993 Governor's speech, which outlines the general framework and principles for the Bank's role as a provider of emergency liquidity assistance. While the structure and procedures for effective and coordinated crisis management seem to be in place, public awareness thus may remain somewhat limited. The possibility of providing further clarification on the division of roles, and the guiding principles and procedures used in crisis management, could usefully be explored.[16]

[16] This is not to imply that a complete specification of policy responses to future crisis situations is needed (or possible)—rather, the point is that an updated and more accessible elaboration of broader principles, in the spirit of the 1993 Governor's lecture, would be desirable.

Section 6: Open process for Formulating and Reporting of Financial Policies

125. The Bank formulates its financial policy objectives in the *Annual Report*. This includes the overall objectives, the priorities for the coming year and a description of what progress has been made. In addition, the Court's evaluation[17] of how well this has been done is presented.

126. Internally, there is a Financial Stability Committee (FSC), which meets on a monthly basis. The FSC reviews major current policy issues and the staff's assessment of actual and potential risks to stability. The discussions in the FSC also help to establish the Bank's position on questions which are under consideration in U.K. (e.g., at the level of the FSSC) or internationally. The FSC discussions are open to a wide range of staff, which is acknowledged as a positive way of involving staff in the policy process. However, more sensitive issues may be discussed outside the FSC, in a narrower group.

127. The Bank of England's reporting requirements for statistical returns, and copies of the returns, are available from the Bank's website. Changes to reporting requirements are communicated via statistical notices, which are sent to each reporting institution and posted on the website. These requirements, and more comprehensive information about the Bank's approach to collection and dissemination, are embodied in the "*Code of practice for Bank of England statistics*"; available in hard copy and on the website. Links to all the references above, along with other information about Monetary and Financial Statistics, are available on the website.

Section 7: Public Availability of Information on Financial Policies

128. The Bank's principal action, given its macro-prudential surveillance role, is the article in the biannual *Financial Stability Review* (FSR) on the Financial Stability Conjuncture and Outlook, which surveys incipient risks to the financial system, and its capacity to absorb any such shocks. This surveillance work is also reflected in regular articles in the *Quarterly Bulletin*.

129. The Bank also publishes material on structural developments relevant to financial stability, for example on new financial instruments or patterns of exposures, on payments system developments, and on regulatory changes—domestically or internationally—likely to affect the system as a whole.

130. This publication program is supported by an active and extensive speaking program by senior officials of the Bank.

131. In the paper on *Oversight of Payment Systems* it is said that the Bank will publish yearly reports of its oversight activities. Until quite recently, there was only a very brief

[17] This evaluation is done by the Court's sub-committee of non-executive directors ("NEDCO").

summary in the Annual Report to meet this commitment. However, the June 2002 FSR contained a useful box on payments system oversight. This box also rightly notes that the Bank has a broader oversight and financial stability interest in securities settlement systems and clearing houses (including central counterparties), in addition to their interest stemming from the "embedded payments systems" aspect of the securities settlement systems. (Previously, this broader dimension was somewhat submerged in the Bank's publications, with the emphasis on the narrower payments system perspective.) Finally, the box also briefly notes the Bank's operational role in U.K. payments systems, which is an important point to communicate given that the Bank is a member in its own right of both NewCHAPS and BACS. This box, or some other similar vehicle, could be suitable for evolving into a form of brief annual review of this area.

132. The Bank reports aggregate financial data using a variety of media and delivery channels: a monthly publication of key data series "*Monetary and Financial Statistics*" and an annual "*Statistical Abstract*" are available in hard copy and also on the Bank website. Press releases are issued in paper form and posted on the website, as new data become available. Most series are available via Datastream; in addition, Bloomberg, Knight Ridder and Reuters carry selected series.

133. The Bank publishes the results of its money market operations each day on wire services; an aggregate monthly summary in Bankstats (tables D2.1/2.2); and a quarterly summary in the *Quarterly Bulletin.* A highly aggregated balance sheet, the 'Bank Return', is published weekly.

Section 8: Accountability and Assurances of Integrity

134. Senior officials of the Bank appear in public before the House of Commons Treasury Committee and the House of Lords Economic Affairs Committee. The Bank is obliged to submit to the Chancellor of the Exchequer an *Annual Report* on its activities in that year. The Bank's Annual Report is laid before Parliament by the Chancellor of the Exchequer.

135. Data on the Bank's balance sheet and income/expenditure are publicly disclosed on a regular basis. The Bank's accounts are audited by an external auditor. Audit is conducted in accordance with Companies Act requirements and auditing standards issued by the U.K. Auditing Practices Board, except where this would be inconsistent with the Bank's functions.

136. Internal governance procedures are described in the Bank's *Annual Report.* The Court is responsible for managing the Bank's affairs, other than the formulation of monetary policy, which is the function of the Monetary Policy Committee. Under the Court, the Bank's senior policy-making body is the Governor's Committee, comprising the Governors and Executive Directors. The internal management of the Bank is the responsibility of the Management Committee.

137. The Bank has internal rules on personal financial dealings set by the Court, which are designed to address the issue of possible, actual or perceived financial conflict of interest or misuse of confidential information. Bank staff have statutory immunity in respect of banking

supervisory acts or omissions before June 1998 when supervision was transferred to the Financial Services Authority. Bank staff also enjoy statutory immunity under the Settlement Finality Regulations 1999. The Bank has indemnified members of its Court of Directors against personal civil liability arising from the carrying out of their functions. These immunities are publicly disclosed.

Detailed assessment

138. The assessment was undertaken on a qualitative basis based on a five-fold assessment categorization: observed, broadly observed, partly observed, non-observed, and not applicable. A practice is considered *observed* whenever all assessment criteria are generally met without any significant deficiencies. A practice is considered *broadly observed* whenever only minor shortcomings are found, which do not raise major concerns and when corrective actions to achieve full observance with the practice are scheduled and realistically achievable within a prescribed period of time. A practice is considered *partly observed* whenever the shortcomings are sufficient to raise doubts about the ability to achieve observance within a reasonable time frame. A practice is considered *non-observed* whenever major shortcomings are found in adhering with the assessment criteria. Whenever a practice is assessed to be broadly, partly or non-observed, suggestions are proposed for achieving full observance. (Even when a practice is considered *observed,* recommendations may also be given for further refinement of the arrangements.) A practice is considered *not applicable* whenever it does not apply given the structural, legal and institutional conditions.

Table 17. Detailed Assessment of Observance of MFP Transparency Code—Financial Stability and Payment Systems Oversight.

V. Clarity of Roles, Responsibilities and Objectives of Financial Agencies responsible for Financial policies	
5.1	**The broad objective(s) and institutional framework of financial agencies should be clearly defined, preferably in relevant legislation or regulation.**
Description	The broad framework for the Bank's financial stability work is set out in two main documents: (1) the *Memorandum of Understanding* between Bank Governor, Chairman of the Financial Services Authority and Treasury Ministers; and (2) the *Annual Report,* which sets out the Bank's Core Purposes, and Objectives and Strategy, as determined by the Court of Directors acting under Section 2 of the Bank of England Act 1998. The Bank's Act (and other legislation) implies but does not explicitly and directly specify the Bank's financial stability role. In addition, the Bank has specific roles in relation to the IMF, the ECB General Council, the BIS, the G-10 Governors and related Committees, and other similar international organizations and fora the functions of which include financial stability. The basis for many of these roles is set out in relevant international treaties and agreements.
Assessment	Observed
Comments	In line with the recommendations in the mission's CPSIPS assessment, it would be desirable to lay out more fully and formally in statute the Bank's financial stability and payments and settlement systems oversight responsibility, when an appropriate opportunity arises.
5.1.1	The broad objective(s) of financial agencies should be publicly disclosed and explained.
Description	The *Memorandum of Understanding* and the *Annual Report* set out this information. They are both available on the Bank website. The *Memorandum of Understanding* sets out the Bank's responsibilities (see especially paragraph 2). The Bank is responsible for the overall stability of the financial system as a whole. The *MoU* identifies five financial stability roles which stem from this: (1) Stability of the monetary system. (2) Financial system infrastructure, in particular payments systems at home and abroad. (3) Broad overview of the system as a whole. (4) Being able in exceptional circumstances to undertake official support operations having informed HMT (under MoU arrangements). (5) The efficiency and effectiveness of the financial sector, with particular regard to international competitiveness. The *Annual Report* records that one of the Bank's three core purposes is 'Maintaining the stability of the financial system, both domestic and international'. It sets out how that translates into action to identify potential threats to financial stability and to improve the resilience of the system in the face of shocks. The former is taken forward through the Bank's surveillance of the domestic and international financial system; the latter through initiatives in areas such as payment and settlement arrangements and capital standards for banks (e.g., the New Basel Capital Accord). The Bank is also closely involved in domestic and international work on how best to handle crises as and when these arise.
Assessment	Observed
Comments	
5.1.2	The responsibilities of the financial agencies and the authority to conduct financial policies should be publicly disclosed.
Description	See 5.1 and 5.1.1 above.
Assessment	Observed

Comments	See comment under 5.1 above.
5.1.3	Where applicable, the broad modalities of accountability for financial agencies should be publicly disclosed.
Description	The Bank is accountable to the Court of Directors (who are appointed by the Crown), who in turn are accountable to Parliament through the Chancellor of the Exchequer. It is set out in Section 4 of the Bank of England Act that "as soon as practicable after the end of each of its financial years, the Bank shall make to the Chancellor of the Exchequer a report on its activities in that year." The Bank's *Annual Report* is published on the Bank of England website.
Assessment	Observed
Comments	
5.1.4	Where applicable, the procedures for appointment, terms of office, and any general criteria for removal of the heads and members of the governing bodies of financial agencies should be publicly disclosed.
Description	The Bank of England Act 1998 (Schedule 1) sets out the procedures for appointment, terms of office, and removal of the Bank's Court of Directors. Details of the membership of Court are given in the Bank's *Annual Report*, which includes a report from Court Members. The Act also specifies the functions of the Court of Directors in relation to the general management of the Bank's affairs and specifically in relation to ongoing review of the Monetary Policy Committee and the monetary policy process. Inter alia, the Court regularly assesses whether the MPC has collected the regional, sectoral, and other information needed to conduct monetary policy.
Assessment	Observed
Comments	
5.2	**The relationship between financial agencies should be publicly disclosed.**
Description	The *MoU* describes the responsibilities of the Bank, the FSA and HM Treasury in the field of financial policies. It is published on the Bank of England's website. As the *MoU* notes, there are extensive contacts between the three institutions on financial stability issues. In particular, a Standing Committee has been established, comprising Chancellor, Governor and FSA Chairman: this meets roughly monthly, generally at deputy level. In addition, the FSA Chairman is a member of the Bank's Court of Directors; and the Deputy Governor (Financial Stability) is a member of the FSA's Board of Directors.
Assessment	Observed
Comments	As to the clarity of roles, it is stated in the MoU that the three institutions concerned have to work together and coordinate amongst themselves in financial crisis situations. In practice, such co-operation is organized within the framework of the FSSC. Due to the central role played by the Bank in the financial market, it has the market experience and capability that is of utmost importance in dealing with such crisis situations. The Bank's ability to act in support operations in order to resolve a financial crisis situation is explicitly recognized in both the MoU and the Annual Report. What that means in practice has, however, not been elaborated further in recent, readily available documentation. This relates both to the Bank's role as provider of emergency liquidity assistance and to any role it would play, under the tripartite financial stability framework, in working out market solutions to a significant financial sector problem. While the structure and procedures for an effective and coordinated crisis management seem to be in place, public awareness remain somewhat limited. The possibility of providing further clarification on the division of roles and core procedures used in crisis management could usefully be explored.
5.3	**The role of oversight agencies with regard to payments systems should be publicly disclosed.**

Description	The Bank's role as overseer of payment systems is set out in the Bank's publication "*Oversight of Payment Systems*" November 2000. It is available on the Financial Stability section of the Bank of England's website. The paper explains the importance of effective payment systems for the functioning of the financial markets and of the economy more generally, and the possible impact of disruption to a system whether for technical reasons or because of the failure of a major participant. It distinguishes between Systemically Important Systems (SIPS – defined as per the Core Principles) and systems of System Wide Importance (SWIPS – which typically settle lower value payments both in aggregate and individually, the failure of which could nevertheless cause wide disruption to the economy). The paper explains the Bank's responsibility for the overall stability of the financial system; for providing the Chancellor of the Exchequer with advice on any major problem inherent in the payments systems. The objectives of oversight are to ensure that sufficient weight is given to risk reduction and management in the design of payments systems; and also to promote improvements in the U.K. payment and settlement infrastructure for the benefit of members and end-users. The paper explains how the Bank carries out oversight in practice, assessing how effectively credit, liquidity, operational and legal risks are controlled. Moreover, it presents the Core Principles for Systemically Important Payment Systems as the primary basis on which the Bank will assess how effectively systems control risk. The Bank is the U.K. authority which designates payment systems under the EU Settlement Finality Directive, which provides clear protection for default rules from the insolvency laws applying to EU members. The U.K. implementing legislation also provides that the FSA should consult the Bank about the designation of securities settlement systems which have an embedded payment system, which they did in the case of the designation of CREST. The relevant legislation - the Financial Markets and Insolvency (Settlement Finality) Regulations 1999—can be found on www.hmso.gov.uk (Her Majesty's Stationary Office website).
Assessment	Observed
Comments	At the time of the assessment mission, the Bank had not described its interest with respect to securities settlement systems and clearing houses (including central counterparties) as clearly as it might have. Both in the paper on "Oversight of Payment Systems" (November 2000) and in the MoU, this interest had been described as stemming from "the embedded payment system in securities settlement systems". However, in a special box in the June 2002 FSR, the Bank rightly noted that its interest is more far-reaching, given the importance of these schemes from an overall financial stability perspective. Some further elaboration on this point would be useful in future.
5.3.1	The agencies overseeing the payment system should promote the timely public disclosure of general policy principles (including risk management policies) that affect the robustness of systemically important payment systems.

Description	The Bank aims to be transparent in its own dealings with payments systems. The "*Oversight of Payment Systems*" November 2000 paper sets out that the Bank will report each year on its payments systems oversight activities at the time of its Annual Report (as it does on its other, related financial stability activities). Accordingly, the *2001 Annual Report* contained a summary of those activities. The Bank also publishes detailed analyses of structural and risk issues related to payments and settlement systems in its *Financial Stability Review*. The principles that are used to assess the safety and efficiency of payment systems and the intensity of oversight are those in the BIS report on "*Core principles for systemically important payment systems*". The Core Principles place weight on transparency and disclosure to interested parties in a variety of areas, including in relation to the management of risk. The Bank encourages payment system operators to comply with this aspect of the Core Principles across the range of their business.
Assessment	Observed
Comments	In the paper on *Oversight of Payment Systems* it is said that the Bank will publish yearly reports of its oversight activities. Apart from the summary referred to above, this has not been done until recently: as noted above, however, in the June 2002 FSR, a useful box has been included to give some more detail of developments in this area. It would be very helpful for this, or a similar vehicle, to evolve into a regular (annual) account of progress here, with some further elaboration of oversight issues and processes from time to time.
5.4	**Where financial agencies have oversight responsibilities for self-regulatory organizations (e.g., payments systems), the relationship between them should be publicly disclosed.**
Description	The "*Oversight of Payment Systems*" paper was designed to clarify the Bank's oversight relationship with payments systems. That paper also mentions the Bank's membership, as the banking system's bank, of the principal systems, and its provision of a range of services to those systems (which is, in any event, a matter of public record).
Assessment	Observed
Comments	The Bank's objectives within regard to payment systems oversight have been communicated clearly to the public, and the June 2002 FSR box noted above reiterated its operational role in U.K. payment systems. Future such boxes or similar vehicles might usefully elaborate briefly on the relationship between the Bank's operational and oversight roles in payments systems.
5.5	**Where self-regulatory organizations are authorized to perform part of the regulatory and supervisory process, they should be guided by the same good transparency practices for financial agencies.**
Description	APACS (Association for Payment Clearing Services) performs an 'oversight' function which is more akin to advice on audit matters than regulation/supervision. Responsibility for oversight rests with the Bank of England. However, to the extent that they are relevant, APACS' activities are disclosed to the system operators and to their members, all of whom are also members of APACS.
Assessment	Observed
Comments	In the assessment of NewCHAPS against the Core Principles for Systemically Important Payment Systems, recommendations for actions were made - with regard to access rules and governance – which also concerned APACS. Consideration is currently being given by APACS to changes which may address some or all of the matters noted, but at the time of writing, the specific reforms to be implemented had not yet been finalized.
VI. Open Process for Formulating and Reporting of Financial Policies	
6.1	**The conduct of policies by financial agencies should be transparent, compatible with confidentiality considerations and the need to preserve the effectiveness of actions by regulatory and oversight agencies.**

Description	The overall policy framework for the Bank's financial stability work was set out in the Governor of the Bank's 1993 London School of Economics lecture: "*The pursuit of financial stability*" (Published in Bank *Quarterly Bulletin*, February 1994). The Bank's policy is to be as open and transparent as possible about its financial stability work, although there may be occasions when confidentiality is needed. This is recognized in the U.K.'s Freedom of Information Act 2000, which excludes from its application information held by the Bank with respect to: (1) monetary policy (2) financial operations intended to support financial institutions for the purposes of maintaining financial stability.
Assessment	Observed
Comments	(Re) publication of material similar to the 1993 lecture—or at least key parts of it—would be very helpful to set out in somewhat more detail the principles guiding how the financial stability policy framework operates in a period of significant financial sector stress.
6.1.1	The regulatory framework and operating procedures governing the conduct of financial policies should be publicly disclosed and explained.
Description	The framework and procedures for the Bank's work as a financial agency, as determined by the Court of Directors under Section 2 of the Bank of England Act 1998, are set out in the *Annual Report*. As to payment systems oversight, explanation is also given in the paper on "Oversight of Payment Systems", published in November 2000, with an update in the June 2002 FSR (box 12)
Assessment	Observed
Comments	
6.1.2	The regulations for financial reporting by financial institutions to financial agencies should be publicly disclosed.
Description	The data which the Bank collects from banks are available for use in the context of both monetary policy and financial stability, and some data are used for both purposes. The Bank of England's reporting requirements for statistical returns, and copies of the returns, are available from the Bank's website. Hard copies are available on request. Changes to reporting requirements are communicated via statistical notices, which are sent to each reporting institution and posted on the website. These requirements, and more comprehensive information about the Bank's approach to collection and dissemination, are embodied in the "*Code of practice for Bank of England statistics*"; available in hard copy and on the website. Links to all the references above, along with other information about Monetary and Financial Statistics, are available from www.bankofengland.co.uk/mfsd
Assessment	Observed
Comments	
6.1.3	The regulations for the operation of organized financial markets (including those for issuers of traded financial instruments) should be publicly disclosed.

<table>
<tr><td>Description</td><td>The Bank does not set any regulations for financial markets, or regulate such markets. That is amongst the FSA’s responsibilities. The Bank has however issued a number of guidance notices on market good practice, which are intended to promote orderly and efficient markets. Some of the guidance has been produced by market participants, with the Bank facilitating, usually by chairing (or providing the secretariat for) committees which are mainly comprised of market participants.

The Bank chairs the following committees:

(a) Sterling Money Markets Liaison Group (MMLG) – reviews structural and legal issues in the market, as well as recent monetary conditions.
(b) Stock Lending and Repo Committee (SLRC) – considers market infrastructure and legal/regulatory issues, and keeps under review the Gilt Repo, Equity Repo and Stock Borrowing and Lending Codes.
Both of these committees include leading market participants, representatives from market associations, and representatives from the FSA and CrestCo.

(c) Foreign Exchange Joint Standing Committee (FXJSC) – established under the auspices of the Bank in 1973, it considers issues of common concern to different participants in the foreign exchange market. In addition to issues arising from Continuous Linked Settlement Bank (CLSB), market liquidity and e-commerce, a key focus of its work recently has been the London Code of Conduct for Non-Investment Products (NIPS), in conjunction with its sister committees in the sterling deposit and London gold markets. The Committee includes senior staff from 11 of the major banks in the foreign exchange market, as well as voice and electronic brokers, corporate users of the market and the FSA.

The Bank has also issued guidance on Certificates of Deposit issued in London.

All of the above notices only set out guidance, not regulations, and there are no arrangements in place to monitor or enforce compliance. The codes and guidance are published on the Bank’s website or obtainable in hard copy from public enquiries. The minutes of the MMLG and SLRC meetings are available on the Bank website and there is an annual review of the work of the FXJSC in the Bank’s Spring Quarterly Bulletin.

The Bank also participates in the work of the London Bullion Market Committee.</td></tr>
<tr><td>Assessment</td><td>Observed</td></tr>
<tr><td>Comments</td><td></td></tr>
<tr><td>6.1.4</td><td>Where financial agencies charge fees to financial institutions, the structure of such fees should be publicly disclosed.</td></tr>
<tr><td>Description</td><td>The Bank does not charge direct fees in the context of its work as a financial agency (this is funded out of the Bank’s general income).

Much of the Bank’s income comes from Cash Ratio Deposits, which are non-operational, non-interest bearing deposits by banks and building societies with eligible liabilities in excess of a threshold, currently £400 mn. The deposit ratio is currently 0.15% of eligible liabilities. The legal basis for CRDs is published, and the size of deposits by banks, the threshold and the deposit ratio are published by the Bank’s Monetary and Financial Statistics Division (see also 6.1.2).</td></tr>
<tr><td>Assessment</td><td>Not applicable</td></tr>
</table>

Comments	The CRD arrangement amounts to an indirect form of fee for the covered financial institutions, albeit one that is not specifically linked to the Bank's financial stability responsibilities. Although a simpler arrangement than the CRD would appear to be charging an explicit fee, the CRD arrangement appears to be well-understood (by financial institutions at least) and transparent overall, with the magnitude of the implicit fee explicitly reviewed at regular intervals.
6.1.5	Where applicable, formal procedures for information sharing and consultation between financial agencies (including central banks), domestic and international, should be publicly disclosed.
Description	The tripartite Bank/FSA/HMT *MoU* sets out the principles which apply to information exchanges between these institutions. The EU MoU on co-operation between payment system overseers and banking supervisors describes the principles and procedures for the cross-border exchange of information between overseers and supervisors. The MoU itself is not published, but the ECB issued a press release (April 2001) which said that 'Co-operation and information sharing are specifically foreseen: (1) in case of an application to join an existing payment system or when a new system is established, (2) on an ongoing basis, and (3) in crisis management situations.'
Assessment	Observed
Comments	
6.2	**Significant changes in financial policies should be publicly announced and explained in a timely manner.**
Description	The Bank would publish any significant changes relevant to the system, for example, changes in their oversight of payment systems, as a matter of course. To illustrate, the Bank has published a consultative document *("Bank of England Settlement Accounts: consultative document*") on its policy on the provision of settlement facilities to payment systems and their members. It is available in the Financial Stability section of the Bank of England's website.
Assessment	Observed
Comments	
6.3	**Financial agencies should issue periodic public reports on how their overall policy objectives are being pursued.**
Description	The Bank reports its work in its *Annual Report*, which is tabled before Parliament. As required by the Bank of England Act 1998, the *Report* includes a review by the Committee of Non-Executive Directors of the Bank's performance in relation to its objectives and strategy. The Bank's financial stability work is published in detail in the biannual *Financial Stability Review*, which is its flagship publication for disseminating this work. The *Review* contains both a detailed assessment of the financial stability conjuncture and a series of articles which typically report the results of analysis and research on financial stability topics. In order to maximize accessibility and transparency, the *Review* contains brief summaries of both the conjunctural analysis and the articles. Financial stability work is also published in the *Quarterly Bulletin,* both regular articles, such as those on the U.K. external balance sheet and on public sector debt, as well as articles and speeches on topical subjects as they arise.
Assessment	Observed
Comments	See remark under point 5.3.1 above.
6.4	**For proposed substantive technical changes to the structure of financial regulations, there should be a presumption in favor of public consultations, within an appropriate period.**

Description	Whenever appropriate the Bank would consult publicly on anything within its power where there could be a material affect on financial stability (see also 6.2 above).
Assessment	Observed
Comments	
	VII. Public Availability of Information on Financial Policies
7.1	**Financial agencies should issue a periodic public report on the major developments of the sectors of the financial system for which they carry designated responsibility.**
Description	The Bank's principal action, given its macro-prudential surveillance role, is the article in the twice-yearly *Financial Stability Review* on the Financial Stability Conjuncture and Outlook, which surveys incipient risks to the financial system, and its capacity to absorb any such shocks. This surveillance work is also reflected in regular articles in the *Quarterly Bulletin* and speeches by senior officials. The Bank makes contributions to surveillance by international organizations such as the IMF, FSF and the BIS, much of which is also published. The Bank participates in a wide range of BIS fora, including meetings of central bank Governors; the Committee on the Global Financial System; the Basel Committee on Banking Supervision; and the Committee on Payment and Settlement Systems. The Bank's surveillance reflects its concern with the financial system both in London and globally. International factors can impact on U.K. firms through a variety of channels, including linkages through the international markets in the U.K. More generally, the Bank exercises an oversight role in relation to the U.K. as a financial centre, given that London is a centre of major international systemic significance. The Bank also publishes material on 'structural' developments relevant to financial stability, for example on new financial instruments or patterns of exposures, on payments system developments, and on regulatory changes, domestically or internationally, likely to affect the system as a whole.
Assessment	Observed
Comments	
7.2	**Financial agencies should seek to ensure that, consistent with confidentiality requirements, there is public reporting of aggregate data related to their jurisdictional responsibilities on a timely and regular basis.**
Description	This is met by the Bank's banking statistics and its contributions to the BIS. The Bank reports aggregate data using a variety of media and delivery channels: the FSR, Bulletin and Annual Report all report many financial sector variables on an aggregated (or peer group) basis in the context of their various analyses, while a monthly publication of key data series "*Monetary and Financial Statistics*" and an annual "*Statistical Abstract*" are available in hard copy and also on the Bank website. Press releases are issued in paper form and posted on the website, as new data become available. Most series are available via Datastream; in addition, Bloomberg, Knight Ridder and Reuters carry selected series. For payment systems, APACS publishes monthly aggregate data for the systems operated by the three clearing companies. This includes CHAPS, the U.K. RTGS system. It also publishes a Yearbook of Payment Statistics, which provides more detailed statistical information on the APACS system, plus statistics from the various payment card schemes. The ECB publishes aggregate monthly data on the EU's high-value euro payment systems, in total and by individual country; this includes data for the U.K.'s CHAPS Euro system.
Assessment	Observed
Comments	Links to externally produced payments-related data can be readily found on the Bank's website.

7.3	**Where applicable, financial agencies should publicly disclose their balance sheets on a preannounced schedule and after a predetermined interval publicly disclose information on aggregate market transactions.**
Description	The Bank of England's accounts take the form of two balance sheets—one, the Issue Department, covering the assets and liabilities relating to the note issue functions of the Bank and the other, the Banking Department, covering all other assets and liabilities. The Bank of England has a statutory requirement to prepare a weekly return of its accounts under section 6 of the Bank Charter Act 1844. The Act sets out the format that the return should take. The weekly Bank return is published in the *London Gazette* and as such is available to the public each Thursday. More detailed balance sheets are prepared for the Bank's annual accounts. The Bank of England Act 1998 requires the Banking Department balance sheet to be prepared according to U.K. standards for commercial banks (apart from some disclosures). Full accounting policies are disclosed in the Bank's Annual Report. The Issue Department balance sheet is prepared according to rules agreed with HM Treasury, the main ones being disclosed. The Bank publishes the result of the money market operations each day on wire services; an aggregate monthly summary in Bankstats (tables D2.1/2.2); and a quarterly summary in the *Quarterly Bulletin.* A highly aggregated balance sheet, the 'Bank Return', is published weekly.
Assessment	Observed
Comments	
7.3.1	Consistent with confidentiality and privacy of information on individual firms aggregate information on emergency financial support by financial agencies should be publicly disclosed through an appropriate statement when such disclosure will not be disruptive to financial stability.
Description	In exceptional circumstances, as part of its central banking functions, the Bank may act as "lender of last resort" to financial institutions in difficulty to prevent a loss of confidence spreading through the financial system as a whole. All lender of last resort support operations are disclosed and that disclosure happens in a timely manner. There will be a presumption in favor of disclosing support in the Bank of England's first annual report following the support operation. If disclosure at that time would be damaging to financial stability or the support operation itself then disclosure would be postponed and the issue re-considered after a further year and, if necessary, in subsequent years until disclosure took place. In disclosing information, those factors which meant that an earlier disclosure would have been unsafe will be explained. It may be possible to safely disclose some items of information before others.
Assessment	Broadly Observed
Comments	When the Bank publishes information on lender-of-last-resort support operations, it does not provide enough information to enable external observers to fully discern the effects of these operations on the Bank's revenues and expenses for the year(s) in question.
7.4	**Financial agencies should establish and maintain public information services.**
Description	The Bank makes information available through its publications programme, on its website and through its Public Enquiries Group and Press Office.
Assessment	Observed
Comments	
7.4.1	Financial agencies should have a publications program, including a periodic public report on their principal activities issued at least annually.
Description	The Bank has a publications programme that includes many regular publications, including the *Quarterly Bulletin*, *Financial Stability Review* and *Annual Report.* In addition, the Bank publishes other material relevant to financial stability, for example research in the Bank's *Working Papers* series.
Assessment	Observed
Comments	

7.4.2	Senior financial agency officials should be ready to explain their institution's objective(s) and performance to the public and have a presumption in favor of releasing the text of their statements to the public.
Description	The Governors and Directors give speeches on a range of financial stability-related issues, which are released to the press. These are available on the Bank's website.
Assessment	Observed
Comments	
7.5	**Texts of regulations and any other generally applicable directives and guidelines issued by financial agencies should be readily available to the public.**
Description	Bank notices, for example relating to statistics and market guidance, are readily available – see 6.1.2 and 6.1.3 above.
Assessment	Observed
Comments	
7.6	**Where there are deposit guarantees, policy holder guarantees and any other client asset protection schemes, information on the nature and form of such protections, on the operating procedures, on how the guarantee is financed, and on the performance of the arrangements, should be publicly disclosed.**
Description	See corresponding point in the assessment of the transparency of the Financial Services Authority.
Assessment	Not Applicable
Comments	
7.7	**Where financial agencies oversee consumer protection arrangements (such as dispute settlement processes), information on such arrangements should be publicly disclosed.**
Description	See corresponding point in the assessment of the transparency of the Financial Services Authority.
Assessment	Not Applicable
Comments	
VIII. Accountability and Assurances of Integrity by Financial Agencies	
8.1	**Officials of financial agencies should be available to appear before a designated public authority to report on the conduct of financial policies, explain the policy objective(s) of their institution, describe their performance in achieving their objective(s), and, as appropriate, exchange views on the state of the financial system.**
Description	Senior officials appear in public before the House of Commons Treasury Committee and the House of Lords Economic Affairs Committee.
Assessment	Observed
Comments	
8.2	**Where applicable, financial agencies should publicly disclose audited financial statements of their operations on a preannounced schedule.**
Description	The Bank's *Annual Report* contains information on profit and expenditure. It is not possible to publish revenue numbers without revealing information about provisions. The latter would alert readers to the possibility that the Bank had engaged in a lender of last resort activity, when such an operation had indeed taken place. Consequently, the Bank does not wish to publish revenue information for reasons, which it believes are entirely consistent with Section 3.2.3 of the Code. When circumstances permit details of support operations are published (see Note 1 to the Bank's Accounts). Central bank support operations are very rare in the United Kingdom, but details of these are published once the need for confidentiality has ceased.
Assessment	Observed
Comments	When the Bank publishes information on lender-of-last-resort support operations, it does not provide enough information to enable external observers to fully discern the effects of these operations on the Bank's revenues and expenses for the year(s) in question.

8.2.1	Financial statements, if any, should be audited by an independent auditor. Information on accounting policies and any qualification to the statements should be an integral part of the publicly disclosed financial statements.
Description	The Bank's accounts are audited by PricewaterhouseCoopers. Audit is conducted in accordance with Companies Act requirements and auditing standards issued by the U.K. Auditing Practices Board, except where this would be inconsistent with the Bank's functions, in particular in relation to any support operation. Statements of accounting policies are an integral part of the published financial statements.
Assessment	Observed
Comments	
8.2.2	Internal governance procedures necessary to ensure the integrity of operations, including internal audit arrangements, should be publicly disclosed.
Description	Internal governance procedures are described in the Bank's *Annual Report.* The Court is responsible for managing the Bank's affairs, other than the formulation of monetary policy, which is the function of the MPC. The Court subcommittee of non-executive Directors (NedCo) is responsible for reviewing the Bank's performance in relation to its objectives and strategy and monitoring the extent to which the Bank's financial management objectives are met. NedCo is also responsible for reviewing the procedures of the MPC, reviewing the Bank's internal controls, and determining the Governor's and Deputy Governor's remuneration and pensions. In addition, there are formal audit and remuneration committees. Under the Court, the Bank's senior policy-making body is the Governor's Committee, comprising the Governors and Executive Directors. The internal management of the Bank is the responsibility of the Management Committee, comprising the Deputy Governor (Financial Stability), the Deputy Directors, the Finance Director, and the Director of Personnel.
Assessment	Observed
Comments	
8.3	**Where applicable, information on the operating expenses and revenues of financial agencies should be publicly disclosed annually.**
Description	The Bank's *Annual Report* contains information on profit and expenditure on individual business units, including the Financial Stability function. It is not possible to publish revenue numbers without revealing information about provisions. The latter would alert readers to the possibility that the Bank had engaged in a lender of last resort activity, when such an operation had indeed taken place. Consequently, the Bank does not wish to publish revenue information for reasons, which are entirely consistent with Section 7.3.1 of the Code. When circumstances permit details of support operations are published. Note 1 of the Bank's Annual Accounts explains the Bank's difficulty in disclosing more details of the constituent elements of the profit and loss account.
Assessment	Broadly observed
Comments	When the Bank publishes information on lender-of-last-resort support operations, it does not provide enough information to enable external observers to fully discern the effects of these operations on the Bank's revenues and expenses for the year(s) in question.
8.4	**Standards for the conduct of personal financial affairs of officials and staff of financial agencies and rules to prevent exploitation of conflicts of interest, including any general fiduciary obligation, should be publicly disclosed.**
Description	The Bank has internal rules on personal financial dealings set by Court, which are designed to address the issue of possible, actual or perceived financial conflict of interest or misuse of confidential information. These rules require MPC members and staff to obtain prior authorization for every financial transaction, including new mortgage borrowing switching between fixed and floating rate mortgages and switching between funds in a personal pension plan. The only exception to the internal reporting of every transaction is if members place their investments at arms length under fully discretionary management. Any such arrangements must also be approved by the Bank when they are set up.
Assessment	Broadly Observed

Comments	As noted in the Monetary Policy Transparency assessment, the rules were tightened further in 2002, when MPC members and some staff will be required to disclose information on asset holdings as well as the flows associated with financial transactions. As also noted in the Monetary Policy Transparency assessment (4.4), the Bank has a policy of providing oral briefings on the rules in response to external requests, but has not published the rules.
8.4.1	Information about legal protections for officials and staff of financial agencies in the conduct of their official duties should be publicly disclosed.
Description	Bank staff have statutory immunity in respect of banking supervisory acts or omissions before June 1998 when supervision was transferred to the Financial Services Authority. Bank staff also enjoy statutory immunity under the Settlement Finality Regulations 1999. The Bank has indemnified members of its Court of Directors against personal civil liability arising from the carrying out of their functions. These immunities are publicly disclosed. There is a specific provision in the Financial Markets and Insolvency (Settlement Finality) Regulations 1999, which deals with immunity for the Bank and staff. This is contained in Regulation 11 (Exemption from liability in damages), which provides as follows: (1) neither the designating authority nor any person who is, or is acting as, a member, officer or member of staff of the designating authority shall be liable in damages for anything done or omitted in the discharge, or purported discharge, of the designating authority's functions under these Regulations. (2) paragraph (1) does not apply (a) if the act or omission is shown to have been in bad faith; or (b) so as to prevent an award of damages made in respect of an act or omission on the ground that the act or omission was unlawful as a result of section 6(1) of the Human Rights Act 1998 (acts of public authorities). The Bank is a 'designating authority' for this purpose.
Assessment	Observed
Comments	

139. Based on the detailed assessment, a summary table of observance is presented in Table 18.

Table 18. Summary Observance of IMF's MFP Transparency Code—Financial Policy

Assessment Grade	Practices Grouped by Assessment Grade	
	Count	List
Observed	29	
Broadly observed	3	Principles 7.3.1, 8.3, 8.4
Partly observed		
Not observed		
Not applicable	3	Principles 6.1.4, 7.6, 7.7

E. Recommended Action Plan and Authorities' Response to the Assessment

Recommended action plan

140. This section contains recommended steps for achieving observance. This is presented in the table 3 below in order to facilitate the monitoring of progress in relation to each

practice where shortcomings were assessed. Only those practices with respect to which specific recommendations are being made are listed.

Table 19. Recommended Action Plan to Improve Observance of IMF's MFP Transparency Code Practices—Financial Policy

Reference Practice	Recommended Action
VII. Public Availability of Information on Financial Policies	
7.3.1	When disclosing lender-of-last-resort support provided to distressed financial institutions, consider providing enough information to enable external observers to fully discern the effects of these operations on the Bank's revenues and expenses for the year(s) in question.
VIII. Accountability and Assurances of Integrity by Financial Agencies	
8.3, 8.4	The conflict of interest guidelines are contained in a number of documents, which have not been published. However, the Bank has a policy of providing oral briefings on the rules in response to external requests, even though it does not formally published them. The rules were tightened further in 2002, when MPC members and some staff will be required to disclose information on asset holdings as well as the flows associated with financial transactions.

141. In addition to the above, further refinements are recommended in a few areas where the MFP Transparency Code Practices are already considered to be observed. In the mission's view, such refinements would further bolster (albeit at the margin) the Bank of England's already strong commitment to financial policy transparency. Specifically:

- (5.1) When an appropriate opportunity arises, it would be desirable to lay out more directly and formally in statute the Bank's financial stability and payments/settlement system responsibilities.

- (5.2 and 6.1) Some further, readily accessible, elaboration would be desirable on the general principles for emergency liquidity assistance, and on the Bank's role more generally in financial crisis situations.

- (5.3.1 and 5.4) The recently published FSR box on payments system oversight (June 2002), or some other similar vehicle, should evolve into a regular (annual) account of the Bank's activities in payments system oversight. From time to time, such an account could usefully include some more elaboration on particular oversight issues or arrangements. For example, while the June 2002 box reiterated the Bank's operational role as a member in its own right of some systems, future boxes could

elaborate further on the Bank's oversight role with regard to securities clearing and settlement issues, and on the relationship between its oversight and operational roles.

Authorities' response

142. The authorities response to this assessment of transparency in respect of the Bank of England's financial policy responsibilities is incorporated into that for the monetary policy transparency assessment (see Part E above).

VII. MFP Transparency Code—Transparency of Financial Policies (Financial Services Authority)

A. General

143. This report assesses the consistency of the U.K.'s Financial Services Authority's practices with the financial policies portion of the *Code of Good Practices on Transparency in Monetary and Financial Policies*. The assessment was made in the context of a Financial Sector Assessment Program (FSAP) mission to the United Kingdom from May 8-24, 2002.[18]

B. Information and Methodology Used for Assessment

144. The assessment was mainly based on a self-assessment prepared by the Financial Services Authority (FSA) in April 2002 plus a review of relevant documents maintained on FSA's website, including: the *Financial Services and Markets Act 2000* (FSMA); the 2002 *Handbook of Rules and Guidance*; the 2000/01 *Annual Report*; the 2002/03 *Plan & Budget*; the 2002 *Financial Risk Outlook*; the 1997 *Memorandum of Understanding* between HM Treasury, the Bank of England and the FSA; public speeches by senior FSA officials; and various operational notices that guide the FSA's dealings with the private sector. In addition, discussions were held with FSA staff and informed external observers of U.K. financial policies. The latter included: financial institution officials, members of the FSA's consumer and practitioner panels; trade association representatives; and journalists. Input was also provided by colleagues who conducted the assessment of U.K. banking, insurance, and securities market supervisory practices against various international standards and codes.

145. The U.K. authorities fully cooperated with the assessment, and all required information and documents were provided.

C. Institutional and Market Structure—Overview

146. On December 1, 2001 the FSA became the single statutory regulator for the majority of financial services in the United Kingdom, replacing the previous sectoral regulators, such as the Securities and Futures Authority, the Personal Investment Authority, and the Investment Management Regulatory Organization. Responsibility for banking supervision under the Banking Act 1987 had passed from the Bank of England to the FSA in June 1998. From January 1999 the FSA had also undertaken prudential insurance supervision on behalf of HM Treasury, and now does so as its own responsibility. Thus, it now supervises, inter alia, banks, insurance companies, securities firms, financial exchanges and other financial markets, and investment advisors. The FSA's responsibilities are both wider and deeper than those of the predecessor bodies. Wider, in that they embrace additional firms, including those previously regulated by their professional bodies (for example, solicitors and accountants);

[18] The assessment was prepared by Mark Zelmer, and Eric Parrado, both of the Monetary and Exchange Affairs Department of the IMF.

and deeper, in that they extend the powers of the FSA in relation to regulated firms—for example, to promote standards of market conduct through a Code and to enforce firms' compliance with requirements to have anti-money laundering controls.

147. The FSA exercises statutory powers under the *Financial Services and Markets Act 2000* (FSMA). This provides a broad legal framework for financial regulation in the U.K. and equips the FSA with a single set of powers and responsibilities, supported by a range of accountability mechanisms. The FSA is an independent non-governmental body in that it has been structured as a limited company and financed by direct levies on the financial services industry. It is accountable to Treasury Ministers, and through them, to Parliament. The FSA's governing body is the Board, currently consisting of a Chairman, three executive directors, and eleven non-executive directors, all appointed by HM Treasury.

148. The FSMA requires the FSA to pursue four objectives:

- To maintain confidence in the U.K. financial system;
- To promote public understanding of the financial system;
- To secure an appropriate degree of protection for consumers while recognizing their own responsibilities; and
- To reduce the potential for regulated business to be used for a purpose connected with financial crime.

149. The legislation applies these objectives directly to specific FSA activities—making rules, preparing and issuing codes, giving advice and guidance, and determining the general policy by which it acts. In carrying out these activities the legislation requires the FSA to take into account a number of factors. They are:

- Using its resources in the most economic and efficient way;
- Recognizing the responsibilities of regulated firms' own management;
- Being proportionate in imposing burdens or restrictions on the industry;
- Taking into account the international character of financial services and the U.K.'s competitive position;
- Facilitating competition among regulated firms;
- The need to minimize the adverse effects of regulation on competition; and
- Facilitating innovation in connection with regulated activities.

150. The FSA takes a different approach to regulation from that of its predecessors. The current regime focuses on the risks to the FSA's various statutory objectives, and applies a risk-based approach to the regulation of financial institutions. In pursuing its objectives, the FSA regularly monitors the risks to its objectives and adjusts its resources and supervisory focus as needed to address the changing nature of these risks over time. The degree of supervision applied to each regulated institution depends on the impact of the institution on the realization of the FSA's statutory objectives if risk crystallizes and the probability or likelihood of risk crystallizing. In addition, the FSA regularly undertakes a thematic review of issues that cut across more than one industry sector and have wide-ranging implications for consumers. These reviews are usually conducted by investigating the practices of a sample of regulated firms operating in different industry sectors.

D. Practice-by-Practice Assessment

General comments

151. The FSA observes all of the elements of the financial policies section of the Code. External observers praised the current framework, and the FSA in particular, for making the regulatory process more transparent and accountable than the previous regime. That observation was evident across all of the major financial sectors. The FSA's roles, responsibilities, and objectives are clearly defined in the FSMA, and explained through various channels, including public speeches, conferences, and publications available on the FSA's website. The policy formulation and reporting process is transparent and involves regular consultation with consumers and industry. Extensive information on the relevant policies is available in FSA publications, the level of accountability is high, and the degree of assurance of integrity is appropriate.

Section 5: Clarity of Roles, Responsibilities, and Objectives

152. The Financial Services Authority observes all of the elements of this principle. The FSA's roles, responsibilities, and objectives are clearly defined in the FSMA and explained through various media, including publications, its website, and public speeches. The relationship between the FSA, HM Treasury, and the Bank of England is outlined in a Memorandum of Understanding (MoU) between these institutions.

153. There continues to be significant uncertainty in the financial community about the process used by the FSA to manage the various objectives assigned to it. To some extent this reflects the limited experience with the new regulatory approach, and to its credit, the FSA has endeavored through various publications, meetings with stakeholders, seminars, and workshops to explain its risk-based approach to supervision, and how its risk assessments drive the priorities assigned to its work on each of these objectives. Nonetheless, the continuing uncertainty suggests the need for further efforts to help regulated institutions and the general public improve their understanding of the new regulatory framework.

Section 6: Open Process for Formulating and Reporting of Financial Policies

154. The Financial Services Authority observes all of the elements of this principle. The framework for regulatory and supervisory policies and the risk-based approach used to conduct FSA's practices are outlined and discussed in FSA's publications and on its website. Similarly, the details surrounding the composition, structure and functions of the FSA are clearly documented and publicly disclosed through various channels. The policy formulation and reporting process is transparent and involves regular consultations with consumers and practitioners. In addition, The FSA reports publicly in a number of other ways on how it is pursuing its overall policy objectives – for example, in the publication *A New Regulator for the New Millennium*, in policy statements on individual issues, in its annual *Plan & Budget*, in evidence to parliamentary committees, and in speeches, conferences and press releases.

155. While a transparent regulatory and supervisory framework has been introduced with appropriate accountability mechanisms, there is still significant uncertainty in the financial community about how the FSA's policies will be implemented in practice. The FSA has sought to deal with this matter in a number of publications and conferences that outlined its risk-based approach to regulation. Both the FSA and the financial services industry recognize the challenge of setting up a single regulator with the new framework. However, the FSA should bear in mind that regulated firms will be closely scrutinizing its actions for examples of how its policies will be implemented in practice. In particular, they are eager to see the extent to which the FSA applies judgment and tailors supervision to individual circumstances, rather than adopting a mechanical rules-based approach to supervision.

156. In addition, while financial institutions generally praised the FSA's efforts to closely consult stakeholders when formulating policies for regulating institutions, a couple noted that the consultation process can be rather onerous and costly for the institutions involved. To some extent this is unavoidable, since many consultations are to be expected when one is introducing a new approach to regulation. Moreover, FSA officials noted that they continue to obtain good feedback from stakeholders despite the large number of consultations in recent years. The FSA is encouraged to continuously look for ways to streamline the consultation process, so that stakeholders' views can be collected and incorporated in a cost-effective and efficient fashion. To their credit, it should be noted that FSA officials are sensitive to this issue, and are awaiting feedback from the Practitioner Panel's annual survey, which includes questions that address this issue.

Section 7: Public Availability of Information on Financial Policies

157. The Financial Services Authority observes all of the elements of this principle. Information on the relevant policies is extensively available in FSA's publications. For instance, the FSA's *Annual Report* contains an overview of the main developments in the financial services sector in the U.K. during the year under review. Similarly, the FSA's annual *Plan & Budget* includes an overview of the external environment within which the FSA will operate over the coming period. The FSA also publishes a range of other publications that report on major developments, such as reports detailing the outcome of

work on various regulatory themes, and a new publication called *Financial Risk Outlook,* which summarizes significant developments in the broader environment within which the FSA operates.

158. The FSA has an extensive consumer education program to promote public understanding of the financial system and secure the appropriate degree of protection for consumers. In addition, FSA senior officials make a large number of public presentations over the course of a year, and are frequently interviewed by members of the media. However, there are some operational issues in which the FSA could further improve the transparency of its practices. For instance, consumers' awareness of their rights under the Financial Services Compensation Scheme (FSCS), which acts as a financial safety net for consumers that have claims against failed financial institutions, is limited. To its credit, the FSA recognizes this issue and issued a consultation paper in May 2002, which included proposed changes to business rules that would require firms to disclose relevant information about the compensation scheme, its coverage, and limits. Moreover, the FSCS is working with the FSA, stakeholders, and journalists to make its presence better known. Its website has recently been enhanced, and in recent months it has produced a range of booklets and other information for consumers that have been reviewed by the Plain Language Commission.

Section 8: Accountability and Assurances of Integrity by Financial Agencies

159. The FSA observes all of the elements of this principle. The level of accountability is high, and the degree of assurance of integrity appropriate. The FSA regularly provides evidence to parliamentary committees on the conduct of financial policies, policy objectives, and performance in pursuing FSA's objectives. The FSA appears twice a year before the Treasury Committee of the House of Commons, once to discuss its *Annual Report* and once to answer questions on its plans for the coming year. From time to time the FSA also gives evidence to the Committee on specific regulatory issues. The Committee publishes the FSA's evidence as part of its proceedings.

Table 20. Detailed Assessment of Observance of IMF's MFP Transparency Code—Financial Policies (FSA)

V. Clarity of Roles, Responsibilities, and Objectives of Financial Agencies Responsible for Financial Policies	
5.1	**The broad objective(s) and institutional framework of financial agencies should be clearly defined, preferably in relevant legislation or regulation.**
Description	The broad objectives and constitution of the FSA are set out in the Financial Services and Markets Act 2000 (FSMA), which also provides for the establishment of a number of related bodies. In particular, the FSA is required to establish a body corporate to manage a compensation scheme (the Financial Services Compensation Scheme) (see s 212 FSMA), and to establish a body to operate a financial ombudsman scheme (Schedule 17). The FSMA sets out certain requirements and powers in relation to the management of these schemes. The compensation scheme broadly pays compensation to claimants in respect of claims made in connection with regulated activities carried on by authorized persons, and the financial ombudsman scheme broadly operates to resolve disputes between authorized firms and their customers. The FSMA requires the FSA to pursue four objectives: • Market confidence, i.e., maintaining confidence in the financial system; • Public awareness, i.e., promoting public understanding of the financial system; • The protection of consumers, i.e., securing the appropriate degree of protection for consumers (which broadly covers consumers of regulated activities); and • The reduction of financial crime, i.e., reducing the extent to which it is possible for a business carried on - (a) by a regulated person, or (b) in contravention of the general prohibition - to be used for a purpose connected with financial crime. The legislation applies these objectives directly to specific FSA activities – making rules, preparing and issuing codes, giving advice and guidance, and determining the general policy by which it acts. In carrying out these activities the legislation requires the FSA to take into account a number of factors. They are: • Using its resources in the most economic and efficient way; • Recognizing the responsibilities of regulated firms' own management; • Being proportionate in imposing burdens or restrictions on the industry; • Taking into account the international character of financial services and the U.K.'s competitive position; • Facilitating competition among regulated firms; • The need to minimize the adverse effects of regulation on competition; and • Facilitating innovation in connection with regulated activities. The FSA refers to these as "the principles of good regulation" and has set out how it expects to apply them in its work in a document called *A New Regulator for the New Millennium* (January 2000). This can be found on the FSA website (www.fsa.gov.uk/pubs/policy/index-2000.html). The constitutional requirements applying to the FSA are set out in Schedule 1 of the FSMA.
Assessment	Observed
Comments	The FSMA represents a significant improvement in the transparency of the regime over the previous arrangements in which financial sector supervision was dispersed among a number of regulatory bodies.
5.1.1	**The broad objective(s) of financial agencies should be publicly disclosed and explained.**
Description	The broad objectives of the FSA are set out in the FSMA (see 5.1 above). The FSA publicizes the existence of the objectives and its interpretation of them through various media, including publications (e.g., *Annual Report* and *Plan & Budget*), its website, and public speeches.

Assessment	Observed
Comments	External observers suggested that there continues to be significant uncertainty in the financial community about the process used by the FSA to manage the various objectives assigned to it. To some extent this reflects the limited experience with the new regulatory approach, and to its credit, the FSA has endeavored through various publications, open public meetings, regular meetings with trade associations, media relations, seminars, and workshops to explain its risk-based approach to supervision, and how its risk assessments drive the priorities assigned to its work on each of these objectives. It believes that time will help generate practical experience and knowledge. Nonetheless, the continuing uncertainty suggests the need for further efforts to help regulated institutions and the general public improve their understanding of the new regulatory framework.
5.1.2	**The responsibilities of the financial agencies and the authority to conduct financial policies should be publicly disclosed.**
Description	The FSA's responsibilities and powers are set out in the FSMA (and related secondary legislation). The FSA is required to consult on its proposals to make rules and publish general guidance. In addition the FSA publicizes its responsibilities through various media, including publications, its website, and public speeches.
Assessment	Observed
Comments	An unusual feature of the FSA's governing legislation is that the U.K. Listing Authority (UKLA) has a separate legal relationship with HM Treasury even though it is now part of the FSA for administrative and operational purposes. FSA and Treasury officials explained that this reflects the fact that separate objectives needed to be set for the UKLA because the general ones applicable to the FSA do not adequately address the unique nature of the UKLA's mandate. The UKLA's objectives and accountability features are set out in Schedule 7 of the FSMA. However, it is not clear whether the FSA is operating in its own right or as agent of the Treasury in the case of UKLA activities. The independence of the FSA is reinforced by the accountability mechanisms listed below, including the published exchange of correspondence between the Chancellor and the Chairman of the FSA (December 2001). Although it is clear from the published exchange of correspondence that the Government supports the risk-based approach to financial regulation, some external observers suggested that the Government could defend the framework more openly in public, rather than leaving it to FSA officials to argue the case for both the framework and the FSA's performance within it.
5.1.3	**Where applicable, the broad modalities of accountability for financial agencies should be publicly disclosed.**
Description	There are a number of provisions in the FSMA covering accountability. These are: • The requirement (in Schedule 1 para 10) that the FSA must at least once a year make a report to HM Treasury (HMT) on, inter alia, the discharge of its functions. The government can direct the FSA on topics to be covered in the report. The report is laid before Parliament and published on the FSA's website. In addition, the FSA is required (in Schedule 1 para 11) to hold an annual public meeting to discuss its report; • The responsibilities of the non executive directors committee of the FSA Board in keeping under review, e.g., the FSA's internal financial controls, and its use of resources and to report on these matters to HMT (see para 4 Schedule 1); • The requirement (in s.8 & 9) for the FSA to publicly consult practitioners and consumers "on the extent to which its general policies and practices are consistent with its general duties" under s. 2 of the FSMA. The FSMA also establishes mechanisms for direct input into the regulatory process by practitioners and consumers – including through the Practitioner and Consumer Panels which the FSA is required to maintain; • The requirement (in Schedule 1 para 7) that the FSA must make arrangements for the investigation of complaints ("the complaints scheme") arising in connection with the

	exercise of its functions; • The power for HMT (in s.12) to appoint an independent person to conduct a review of the economy, efficiency and effectiveness with which the FSA has used its resources in discharging its functions; • The power for HMT (in s.14) to arrange for an inquiry to be held in certain cases where there has been a serious failure in the system of regulation established by the FSMA; and • The powers of the Director General of Fair Trading (Chapter III of Part X) to keep the FSA's regulatory provisions and practices under review. The Competition Commission also has a related role (s 162). • The FSMA also establishes an independent Financial Services and Markets Tribunal, established and run by the Lord Chancellor's Department (part of Government). The Tribunal will consider afresh case-related decisions by the FSA if the firm or individual involved chooses to refer the case to it. Subject to these accountability mechanisms and checks and balances, the FSA operates independently of Government. This was confirmed in December 2001 in a published exchange of correspondence between the Chancellor and the Chairman of the FSA. Among other things this confirmed that the FSA would notify the Chancellor in writing as soon as circumstances or issues arise which the FSA judges serious enough to be likely to prompt the Government to consider launching a statutory inquiry. The correspondence is to be found on the web at www.hm-treasury.gov.uk/Newsroom_and_Speeches/Press/2001/press_144_01.cfm?
Assessment	Observed
Comments	As required by the FSMA, the FSA regularly consults the financial services industry and consumer groups when it is considering adopting or changing regulations and supervisory practices. Discussions with external observers confirmed that the FSA has a good working relationship with the Consumer and Practitioner Panels that oversee its activities. The Consumer Panel, for instance, has supported the FSA in its efforts to improve protection and consumer awareness, pushing the FSA to do more for consumers as the regulatory system advances and new challenges are developed. The FSA also values the feedback provided by the Practitioner Panel from its survey of financial firms.
5.1.4	Where applicable, the procedures for appointment, terms of office, and any general criteria for removal of the heads and members of the governing bodies of financial agencies should be publicly disclosed.
Description	The FSA is required to comply with the requirements as to its constitution set out in Schedule 1 of the FSMA. This includes a requirement (Schedule 1 para 2) that the chairman and other members of the FSA's governing body must be appointed, and be liable to removal from office, by HMT. Appointments are made on principles of good corporate governance known as the Nolan Principles (www.ocpa.gov.uk/leaflets/code.htm). The composition of the FSA Board, and their period of office, is publicized on the FSA's website and in the FSA's *Annual Report*.
Assessment	Observed
Comments	Formal safeguards governing the removal of senior officials from office are limited. Although, officials are appointed for specific terms, their contracts indicate that they can be removed at any time. If dismissed, an official removed could pursue a judicial review in certain circumstances. However, an important safeguard in the U.K. context is the close public scrutiny provided by an independent media over the activities of public officials. In these circumstances, it is unlikely that a senior official could be removed from office without the government having to publicly disclose and defend the reasons behind its decision.
5.2	**The relationship between financial agencies should be publicly disclosed.**
Description	The terms of the 1997 Memorandum of Understanding (MoU) agreed between HM Treasury, the Bank of England and the FSA explain how the three authorities will work together towards their common objective of financial stability and sets out how their responsibilities will be discharged. The MoU is published on the FSA's website.
Assessment	Observed

Comments	
5.3	**The role of oversight agencies with regard to payment systems should be publicly disclosed.**
Description	
Assessment	Not applicable
Comments	
5.3.1	The agencies overseeing payment systems should promote the timely public disclosure of general policy principles (including risk management policies) that affect the robustness of systemically important payment systems.
Description	
Assessment	Not applicable
Comments	
5.4	**Where financial agencies have oversight responsibilities for self-regulatory organizations (e.g., payment systems), the relationship between them should be publicly disclosed.**
Description	One of the key elements of the Government's restructuring of U.K. financial regulation has been the replacement of the previous hybrid structure involving a multiplicity of regulatory bodies – some statutory and some self-regulating – with a single, statutory financial regulator. As a result, there are only limited areas within the financial sector in which the new framework provides for any significant elements of self-regulation. The FSMA gives the FSA responsibility for supervising recognized investment exchanges (RIEs) and recognized clearing houses (RCHs). RIEs and RCHs are, to a degree, self-regulatory organizations, but the legislative framework in the U.K. has been structured in such a way that RIEs and RCHs are not fully autonomous organizations. The responsibilities of these organizations in relation to the markets in which they operate, and the responsibilities and powers of the FSA vis-à-vis those organizations are set out in the FSMA, the Financial Services and Markets Act (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001, and the Recognized Investment Exchanges and Recognized Clearing Houses Sourcebook (REC). The position of RIEs and RCHs is covered in greater detail in the IOSCO assessment.
Assessment	Observed
Comments	Another self-regulatory organization that operates in the financial sector is the Takeover Panel, whose activities are not subject to formal oversight by the FSA. The Panel regulates takeovers and mergers in order to protect the interests of minority shareholders, and is widely respected by the financial community despite not having formal enforcement powers. If the Panel finds that there has been a violation, its options range from issuing private reprimands and public censure, to reporting the offender's conduct to another regulatory authority, such as the FSA. The FSA has made it clear that it will not exercise its enforcement powers in a takeover situation except in exceptional circumstances (e.g., at the request of the Panel).
5.5	**Where self-regulatory organizations are authorized to perform part of the regulatory and supervisory process, they should be guided by the same good transparency practices specified for financial agencies.**
Description	RIEs and RCHs are required to provide the FSA with notifications on a broad range of subjects - from changes in their internal organization, constitution and governance to financial information, complaints against the them, hours of operation etc. The FSA does not require the publication of such information but RIEs and RCHs are free to publish this information if they so choose, and we understand that some of them do so, either in their annual reports or on their websites. The regulatory and supervisory objectives of RIEs and RCHs are spelled out in the Recognition Requirements. The FSA Handbook provides additional guidance as to how the FSA interprets these regulatory and supervisory objectives.

	RIEs and RCHs do make texts of regulations and guidelines readily available to the public. The Recognition Requirements require RIEs and RCHs to have appropriate procedures for making and amending their rules. Such procedures must include procedures for consulting users of the facilities in appropriate cases. The FSA will thus have regard to the extent to which the RIE/RCHs' procedures include informal discussions at an early stage with users of its facilities or appropriate representative bodies; publication to users of its facilities of a formal consultation paper which includes clearly expressed reasons for the proposed changes and an appropriately detailed assessment of the likely costs and benefits; adequate time for users of its facilities to respond to the consultation paper and for the U.K. recognized body to take their responses properly into account; adequate arrangements for making responses to the consultation available for inspection by users of its facilities, unless the respondent requests otherwise; adequate arrangements for ensuring that the U.K. recognized body has proper regard to the representations received; and publication, no later than the publication of the amended rules, of a reasoned account of the U.K. recognized body's decision to amend its rules (REC 2.14.6). However, FSA allows RIEs and RCHs to restrict consultation where it is essential to make a change to their rules without delay in order to ensure continued compliance with the Recognition Requirements or other obligation under the FSMA. RIEs and RCHs must provide a copy of their annual reports and accounts to the FSA under the Notification rules. The annual report and accounts will include audited financial statements, operating expenses and revenues. If the RIE/RCH is publicly listed, then under the Listing Rules, it is required to disclose publicly its annual report and accounts on a pre-announced schedule. If the RIE/RCH is a mutual, the annual report and accounts will be disseminated to members. Most RIEs and RCHs publish statistics on trading volumes and other market data. The Recognition Requirements require RIEs/RCHs to have in place certain safeguards for investors – not only in terms of ensuring that business conducted on the RIE/RCH affords proper protection to investors, but also ensuring that there are adequate complaints procedures and disciplinary procedures. Typically, RIEs and RCHs will make details of complaints procedures and disciplinary procedures public. At the very least, these procedures will be disclosed to their members. Officials from RIEs and RCHs do appear before parliamentary committees to give evidence on a range of issues. The RIE/RCH Sourcebook says that in determining whether a RIE/RCH meets the Recognition Requirements, the FSA will have regard to the arrangements and systems and controls the RIE/RCH has in order to manage conflicts of interest. It is a matter for the individual RIE/RCH as to whether they choose to publicly disseminate the details of such arrangements.
Assessment	Observed
Comments	
VI. Open Process for Formulating and Reporting of Financial Policies	
6.1	**The conduct of policies by financial agencies should be transparent, compatible with confidentiality considerations and the need to preserve the effectiveness of actions by regulatory and oversight agencies.**
Description	The FSA is generally required to consult practitioners and consumers 'on the extent to which its general policies and practices are consistent with its general duties' (s 8). The FSA's policies are for example reflected through its use of its rule making powers (e.g., in Chapter 2 of Part X), its power to issue guidance (Chapter II of Part X) and statements of principle and codes in

	relation to approved persons (s 64). The FSA is required to consult publicly on its proposals to make rules (s.155), to give general guidance (s.157 (3)) and to issue a statement of principle or code in relation to approved persons (s.65). The FSA makes extensive use of its website to issue consultative papers, statements of policy etc and has published a statement of its open approach to regulation ("The Open Approach to Regulation" (1998)). The FSA's proposals to make rules must also be accompanied by a cost benefit analysis, an explanation of the purpose of the proposed rules, and an explanation of the FSA's reasons for believing that making the proposed rules is compatible with its general duties. The FSA has the power (s.148) to modify or waive various specified types of rules in relation to an authorized person. Unless it is satisfied that it is 'inappropriate or unnecessary to do so', the modification or waiver must be published by the Authority. In doing so the FSA must inter alia consider whether the publication would prejudice, to an unreasonable degree, the commercial interests of the authorized person concerned or any other member of his immediate group (s.148 (7)).
Assessment	Observed
Comments	
6.1.1	The regulatory framework and operating procedures governing the conduct of financial policies should be publicly disclosed and explained.
Description	The FSA consults in a range of ways in order to: obtain information and views to help the FSA take well-informed decisions, bearing in mind in particular the costs, benefits, and practical implications of proposed changes to regulatory requirements; receive alternative suggestions for achieving particular regulatory objectives; promote understanding of the FSA's overall objectives and the reasons for the policies and procedures it adopts; obtain feedback on the FSA's existing policies, practices and performance. Consultation is public and involves the full range of interested parties, including consumers, and their representative bodies; individuals, firms or groups with relevant expertise; trade associations; advisory groups established by the FSA; voluntary organizations; academics and professional training bodies; and the media. The FSA publishes its policies through various media, including publications and electronic media (CD ROMs, website) and publicizes and explains its policies through the press etc.
Assessment	Observed
Comments	Although the policy formulation process and reporting process is transparent and involves regular consultations with consumers and industry, external observers commented that there is still significant uncertainty in the financial community about how the FSA's policies will be implemented in practice. To some extent this reflects the limited experience with the new framework. The FSA has sought to deal with this matter in a number of publications and conferences that explain its risk-based approach to supervision and how it plans to enforce its policies. Nonetheless, the FSA should bear in mind that regulated institutions will be closely scrutinizing its actions for examples of how its policies will be implemented in practice. In particular, they are eager to see the extent to which the FSA applies judgment and tailors supervision to individual circumstances, rather than adopt a mechanical rules-based approach to supervision.
6.1.2	The regulations for financial reporting by financial institutions to financial agencies should be publicly disclosed.
Description	The rules setting out authorized firms' reporting requirements, and related guidance, are published in the FSA's Handbook of rules and guidance.
Assessment	Observed
Comments	
6.1.3	The regulations for the operation of organized financial markets (including those for issuers of

	traded financial instruments) should be publicly disclosed.
Description	The regulations applying to the participants in financial markets covered by the FSMA are published in the form of rules (in particular the rules in the Interim Prudential Sourcebook for Investment Business and the Conduct of Business Sourcebook which apply to authorized investment firms, and the rules applying more generally to market participants in the Market Conduct Sourcebook, which includes the Code of Market Conduct and Price Stabilizing rules). Investment exchanges and clearing houses recognized under the FSMA (Part XVIII) are required to have rules covering certain areas in order to be recognized (see The Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations (SI 2001 No. 995), and The Recognized Investment and Recognized Clearing Houses Sourcebooks in the FSA Handbook). The FSA is the competent authority for the Official List covering the listing of securities and has the power to make listing rules (e.g., s 76 FSMA). The listing rules are published on the FSA's website and are available (like all FSA publications) in hard copy.
Assessment	Observed
Comments	
6.1.4	Where financial agencies charge fees to financial institutions, the structure of such fees should be publicly disclosed.
Description	The FSA's power to charge fees is set out in the FSMA (the principal power is in Schedule 1 para 17). In making such rules the FSA is required to follow the public consultation procedures in the FSMA (see s.155). See also FSA Consultative Paper 111 on its proposed fees. The FSA also publishes its Budget and related operating plans which determine its financing requirement.
Assessment	Observed
Comments	
6.1.5	Where applicable, formal procedures for information sharing and consultation between financial agencies (including central banks), domestic and international, should be publicly disclosed.
Description	The provisions of the FSMA (Part XXIII) restrict the FSA's ability to disclose restricted information under the Act to others. The FSA has negotiated MoUs with various overseas supervisors/regulators covering the exchange of information. The FSA has also negotiated an MoU with the Bank of England and HM Treasury which inter alia covers the exchange of information (see 5.2 above). This has been published.
Assessment	Observed
Comments	
6.2	**Significant changes in financial policies should be publicly announced and explained in a timely manner.**
Description	The FSA is required under the FSMA to consult publicly on proposals to make rules, amend rules, and give general guidance and to publish cost-benefit analyses of such proposals. The procedures are set out in the FSMA (see 6.1 above).
Assessment	Observed
Comments	While financial institutions generally praised the FSA's efforts to closely consult stakeholders when formulating policies for regulating institutions, a couple of observers noted that the consultation process can be rather onerous and costly for the institutions involved. To some extent this is unavoidable, since many consultations are to be expected when one is introducing a new approach to regulation. Indeed, there were 41 consultations in 2001 and 22 in the first five months of 2002. Moreover, FSA officials noted that they continue to obtain good feedback from stakeholders despite the large number of consultations in recent years. The FSA is encouraged to continuously look for ways to streamline the consultation process, so that stakeholders' views can be collected and incorporated in a cost-effective and efficient fashion. To their credit, it should be noted that FSA officials are sensitive to the issue of consultation

	burden, and are awaiting feedback from the Practitioner Panel's annual survey, which includes questions that address this issue.
6.3	**Financial agencies should issue periodic public reports on how their overall policy objectives are being pursued.**
Description	The FSMA requires the FSA to report annually to Government on the extent to which, in its view, its regulatory objectives have been met during the year under review. The Government lays that report before Parliament and the FSA publishes it and places it on its website. The Report gives a wide-ranging account of the FSA's work. The FSMA provides that Government may direct the FSA to cover particular matters in such reports. The FSA's Annual Report describes publicly in a number of other ways on how it is pursuing its overall policy objectives – for example, in the publication *A new regulator for the new millennium*, in policy statements on individual issues (for instance, its approach to promoting consumer understanding of the financial system), in its annual *Plan & Budget*, and in evidence to parliamentary committees (which they publish as part of their proceedings), in speeches and press releases.
Assessment	Observed
Comments	
6.4	**For proposed substantive technical changes to the structure of financial regulations, there should be a presumption in favor of public consultations, within an appropriate period.**
Description	See answer at 6.1 and 6.2 above. In addition, consistent with HM Government practice, all significant changes to regulations made by HM Treasury under the FSMA are subject to public consultation.
Assessment	Observed
Comments	
	VII. PUBLIC AVAILABILITY OF INFORMATION ON FINANCIAL POLICIES
7.1	**Financial agencies should issue a periodic public report on the major developments of the sector(s) of the financial system for which they carry designated responsibility.**
Description	The FSA's *Annual Report*, referred to in 6.3 above, contains a brief overview of the main developments in the financial services sector in the United Kingdom during the year under review. The FSA's annual *Plan & Budget* includes an overview of the external environment within which the FSA will operate over the coming period. The FSA also publishes a range of other publications that report on major developments, such as reports detailing the outcome of work on various regulatory themes (e.g., the impact of e-commerce) and a new publication called *Financial Risk Outlook* which summarizes significant developments in the broader environment within which the FSA works.
Assessment	Observed
Comments	The *Financial Risk Outlook* discusses a broad set of risks and opportunities to the FSA's objectives. The publication was only introduced in 2002, and as such has yet to develop a strong public following. Although the analysis contained in the document was developed in consultation with the Bank of England, it is somewhat surprising to discover that it refers to IMF economic projections for the U.K. economy rather than those underpinning the Bank's *Inflation Report*. The FSA offered two main reasons for this: (i) the timing of IMF forecasts neatly corresponds to its needs; and (ii) the IMF forecasts cover the global environment, providing a consistent set of forecasts and a good degree of international detail.
7.2	**Financial agencies should seek to ensure that, consistent with confidentiality requirements, there is public reporting of aggregate data related to their jurisdictional responsibilities on a timely and regular basis.**
Description	The FSA publishes data, in its *Annual Report* and elsewhere, on levels of regulatory activity – for example, number of firms authorized and individuals approved, number of disciplinary proceedings against firms and individuals. Aggregate data on volumes of business conducted by the firms or undertaken in the markets appears in ad hoc reports, speeches etc that are placed on

	the FSA's website. The FSA has also introduced a new regular publication, *Financial Risk Outlook*, that carries a range of financial data. Many RIEs and RCHs publish statistics on trading volumes and other market data. See the Bank of England's response for further details on data regularly published by the U.K. authorities.
Assessment	Observed
Comments	See the assessment of the Bank of England against the financial policies section of the IMF Code of Good Practices on Transparency in Monetary and Financial Policies. The FSA indicated that it will bear in mind the desirability of being able to publish aggregate data in its work on data requirements.
7.3	**Where applicable, financial agencies should publicly disclose their balance sheets on a preannounced schedule and, after a predetermined interval, publicly disclose information on aggregate market transactions.**
Description	The FSA's balance sheet is published in its *Annual Report*, referred to in 6.3 above. See also 7.2 above.
Assessment	Observed
Comments	
7.3.1	Consistent with confidentiality and privacy of information on individual firms, aggregate information on emergency financial support by financial agencies should be publicly disclosed through an appropriate statement when such disclosure will not be disruptive to financial stability.
Description	
Assessment	Not applicable
Comments	
7.4	**Financial agencies should establish and maintain public information services.**
Description	The FSA maintains an extensive public information service. It issues a wide range of publications on its activities and policies in addition to its *Annual Report*, referred to above. All these publications are available on its website, as well as in hard copy. The FSA publishes a range of consumer guides, fact sheets, information packs, CD-ROM, and, when necessary, issues consumer alerts that warn the public about scams or developments to watch out for. In addition, the FSA maintains a dedicated website and telephone help line for consumers which offer a variety of information and advice. Members of the public can use the FSA's website to check if a firm is authorized to do certain business and also use the FSA's Comparative Tables to compare similar financial products from various providers (e.g., charges and other basic information). The FSA also provides a range of educational resources for schools and colleges, covering the full age range, and arranges conferences and seminars for educational specialists. The FSA's website has been vetted by the Plain Language Commission and awarded the 'Clear English Standard' for its clarity and ease of use. The FSA also has an active program to explain its policies and activities to the media.
Assessment	Observed
Comments	
7.4.1	Financial agencies should have a publications program, including a periodic public report on their principal activities issued at least annually.
Description	The FSA issues a wide range of publications on its activities and policies – Discussion Papers, Consultation Papers, Feedback and Policy Statements, Occasional Papers – in addition to its

	Annual Report and annual *Plan & Budget* referred to above. All these publications are available on its website, as well as in hard copy.
Assessment	Observed
Comments	
7.4.2	Senior financial agency officials should be ready to explain their institution's objective(s) and performance to the public, and have a presumption in favor of releasing the text of their statements to the public.
Description	FSA senior staff appear frequently on public platforms to give an account of the Authority's work (including an annual public meeting to discuss its *Annual Report*); speeches given on such occasions are often the subject of a press release and are sometimes made available in full, on its website. The FSA also has an active program to explain its policies and activities to the media.
Assessment	Observed
Comments	There were 16 published speeches on financial regulation policies and related regulatory issues by the Chairman and other FSA senior officials in 2001, and 11 in the first five months of 2002. Senior FSA officials members gave more than 170 on the record interviews to the media on regulatory and supervisory issues in 2001 and 50 in the first five months of 2002.
7.5	**Texts of regulations and any other generally applicable directives and guidelines issued by financial agencies should be readily available to the public.**
Description	The FSA's rules and guidance are publicly available in a number of media – on its website, on CD ROM and in hard copy.
Assessment	Observed
Comments	
7.6	**Where there are deposit insurance guarantees, policyholder guarantees, and any other client asset protection schemes, information on the nature and form of such protections, the operating procedures, how the guarantee is financed, and the performance of the arrangement should be publicly disclosed.**
Description	The Financial Services Compensation Scheme (FSCS) pays compensation, in appropriate cases, where a regulated firm is unable to meet its liabilities. The FSA is responsible for making the FSCS rules and for approving its annual budget. Those rules are available publicly in the same way as other FSA rules – see 7.5 above. Both the FSA and the FSCS publish information for consumers on the coverage of the FSCS and on the protection it provides – in booklets and on both organizations' websites (www.fsa.gov.uk and www.fscs.org.uk). The FSCS makes detailed information available to consumers on how to make a claim under the Scheme. The FSMA requires the FSA to approve the FSCS annual budget and to make the rules, following consultation, governing the funding of the Scheme. The FSCS budget is disclosed. The rules on funding the Scheme are publicly available through the usual channels – see 7.5 above. The FSCS publishes an annual report on its discharge of its responsibilities. It is largely in the usual format for a company report, including information on finances (with auditor sign off), directors, committees, and highlights and summaries of the activities through the year, including on claims decisions and compensation payments.
Assessment	Observed
Comments	External observers noted, and FSCS officials conceded, that consumers' awareness of their rights and privileges under the FSCS is limited. The FSA is aware of this issue, and issued a consultation paper in May 2002 that included proposed changes to conduct of business rules that would require firms to disclose relevant information about the compensation scheme, its coverage, and limits. Moreover, the FSCS is working with the FSA, trade associations, consumer advice organizations, and journalists to make its presence better known. Its website

	has recently been enhanced, an in recent months it has produced a range of booklets and other information for consumers that have been reviewed by the Plain Language Commission.
7.7	**Where financial agencies oversee consumer protection arrangements (such as dispute settlement processes), information on such arrangements should be publicly disclosed.**
Description	The FSMA requires the FSA to establish a scheme for resolving complaints between consumers and firms. Under this requirement, the FSA has set up the Financial Ombudshman Service (FOS), as the dispute resolution mechanism. The FSA is responsible for making rules governing complaints handling by firms, and for approving the rules which the FOS makes under the FSMA regarding its operation. These rules are publicly available in the usual ways – see 7.5 above. Both the FSA and FOS provide information to consumers – over the web, in brochures and by telephone – on how the arrangements work and on how to make a complaint. Under the FSA rules, firms are required to display in branches and sales offices a notice explaining that they are covered by the FOS. In addition, the rules oblige firms to provide a written copy of their complaints procedure to consumers on request, or when a complaint is made. The FOS annual budget is approved by the FSA and publicly consulted on yearly, before being published together with the FOS's business plan for that year. In addition, the FOS reports publicly each year on how it has fulfilled its statutory functions. FOS publishes monthly newsletters which outline interesting cases and judgments it has made and discuss their implications. FOS also issues occasional discussion papers where it thinks an adjudication may have wider ramifications for a product type which it thinks the industry should be aware of.
Assessment	Observed
Comments	
VIII. Accountability and Assurances of Integrity by Financial Agencies	
8.1	**Officials of financial agencies should be available to appear before a designated public authority to report on the conduct of financial policies, explain the policy objective(s) of their institution, describe their performance in pursuing their objective(s), and, as appropriate, exchange views on the state of the financial system.**
Description	The FSA regularly gives evidence to parliamentary committees on all these issues. It is now an accepted convention that the FSA appears twice a year before the Treasury Committee of the House of Commons, once to discuss its *Annual Report* and once to answer questions on its plans for the coming year. From time to time the FSA also gives evidence to the Committee on specific regulatory issues. The Committee publishes the FSA's evidence as part of its proceedings. In addition, the FSA from time to time gives evidence to other parliamentary committees in the context of individual inquiries – for example, on globalization, fighting financial crime, and e-commerce.
Assessment	Observed
Comments	See 7.4.2 for data and comments on public appearances.
8.2	**Where applicable, financial agencies should publicly disclose audited financial statements of their operations on a preannounced schedule.**
Description	As part of its *Annual Report*, referred to in 6.3 above, the FSA publishes, within 3 months of the financial year end, audited financial statements and information on its accounting practices. The *Annual Report* also includes information on internal governance and control procedures necessary to ensure the integrity of operations, including on the role of the Audit and other Committees. The FSA reports against those standards of good corporate governance which are applied in the U.K. to all listed companies and complies with those which are appropriate.
Assessment	Observed
Comments	
8.2.1	Financial statements, if any, should be audited by an independent auditor. Information on

	accounting policies and any qualification to the statements should be an integral part of the publicly disclosed financial statements.
Description	Financial statements are audited by an independent auditor and information on accounting policies is publicly disclosed in the *Annual Report*, referred to in 6.3 above.
Assessment	Observed
Comments	The FSA's financial statements are fully consistent with U.K. private sector accounting practices.
8.2.2	Internal governance procedures necessary to ensure the integrity of operations, including internal audit arrangements, should be publicly disclosed.
Description	As required by the FSMA (Schedule 1), the *Annual Report* includes information on internal governance and control procedures necessary to ensure the integrity of operations, including on the role of the Audit and other Committees. The FSA reports against those standards of good corporate governance which are applied in the U.K. to all listed companies and complies with those which are appropriate.
Assessment	Observed
Comments	
8.3	**Where applicable, information on the operating expenses and revenues of financial agencies should be publicly disclosed annually.**
Description	This information is included in the FSA's *Annual Report*, referred to in 6.3 above.
Assessment	Observed
Comments	
8.4	**Standards for the conduct of personal financial affairs of officials and staff of financial agencies and rules to prevent exploitation of conflicts of interest, including any general fiduciary obligation, should be publicly disclosed.**
Description	The terms and conditions in the employment contracts of FSA officials and staff include such standards. All staff are required to comply with a code of conduct designed to address the issue of possible, actual or perceived financial conflict of interest or misuse of confidential information. This code is published on the FSA's website.
Assessment	Observed
Comments	The FSA's Code of Conduct for staff is clear and comprehensive with stringent disclosure requirements for all staff.
8.4.1	Information about legal protections for officials and staff of financial agencies in the conduct of their official duties should be publicly disclosed.
Description	The FSMA (Schedule 1 paragraph 19) provides that the FSA and any person who is, or is acting as, a member, officer or member of staff of the FSA is not to be liable in damages for anything done or omitted in the discharge, or purported discharge, of the FSA's function. However this protection does not apply if the act or omission is shown to have been in bad faith, or unlawful as the result of section 6(1) of the Human Rights Act 1998.
Assessment	Observed
Comments	

Table 21. Summary Observance of IMF's MFP Transparency Code—Financial Policies (FSA)

Assessment Grade	Practices Grouped by Assessment Grade	
	Count	List
Observed	33	
Broadly observed		
Partly observed		
Not observed		
Not applicable	3	5.3, 5.3.1, 7.3.1

E. Recommended Action Plan and Authorities' Response to the Assessment

160. The FSA observes all of the elements of the Transparency Code. The following technical suggestions are provided to further improve the transparency of its activities.

- Some continuing uncertainty in the financial community about the process used by the FSA to manage the various objectives assigned to it suggests the need for further efforts to help regulated institutions and the general public improve their understanding of the new regulatory framework.

- It would be desirable to continue to look for ways to streamline the consultation process so that stakeholders' views can be collected and incorporated in a cost-effective fashion.

Authorities' response

161. The authorities welcomed this positive assessment and noted that the FSA observes all of the elements of the financial policies section of the Code. They also welcomed the FSAP team's comments about the transparency of the FSA's policy process, the provision of information and the FSA's high level of accountability. They accepted that under Sections 5 and 6 there may remain some uncertainty about how the FSA manages its various objectives and how it will implement its policies in practice. They noted that this is inevitable under a new regulatory regime, with a new regulator operating under a new statutory basis, but considered that any uncertainty will lessen over time as market participants learn more from the FSA's explanations, supervision and actions. They noted that, indeed, the industry's understanding of how they use their powers and pursue their objectives has considerably increased since the IMF visits in May 2002. The IMF mission made their assessment six months after FSMA came into force. The situation has developed and moved on and they have been operating with their new powers for over a year. Many of the uncertainties raised with the IMF assessors will have been answered.

VIII. Compliance with CPSS/IOSCO Recommendations for Securities Settlement Systems

A. Introduction

General

162. As part of the Financial Sector Assessment Program, missions from the International Monetary Fund visited the United Kingdom in the period February-July 2002. One of the objectives of the U.K. FSAP was to conduct an assessment of the observance of the Recommendations for Securities Settlements Systems (RSSS) prepared by the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization for Securities Commissions (IOSCO). Although the Recommendations had been agreed as a standard at the time of the mission, there was not at that time an agreed methodology for the assessment. The initial assessment was therefore revised at the end of 2002 according to the newly agreed methodology for CPSS-IOSCO RSSS.

163. The assessment was made on the overall process of securities clearing and settlement in the United Kingdom, with a substantial part of the focus on the settlement systems operated by CRESTCo. A recommendation-by-recommendation assessment was made for the system covering bonds and equities, the CREST system. A more limited, but still recommendation-by-recommendation assessment was made of the settlement system for money market instruments, the Central Money Markets Office system (CMO). At the time of the assessment, work was underway to prepare for the migration of money market instruments (MMI) from CMO to CREST. The suggested timetable was to complete this migration during 2003. The London Clearing House (LCH), which undertakes the central counterparty clearinghouse role in the United Kingdom, is the focus of Recommendation 4, but is not covered in detail in this assessment.

164. The assessor was Martin Andersson from Sveriges Riksbank (Bank of Sweden) in collaboration with Tom Kokkola from the ECB.

B. Institutional and Market Structure

165. CRESTCo operates two securities settlement systems—CREST and CMO. The CREST system is used for gilts and equities, and the CMO system is used for MMIs (including T-bills, Bank Bills and CDs). CREST acts as the central securities depository (CSD) for U.K. securities, of which the vast majority are dematerialized: since November 2001, a transfer of securities in the book-entry system of CREST has constituted the legal transfer of title, with CREST records being the register for dematerialized securities under U.K. law. [19] For the remaining securities held in paper form, and for those constituted under some other laws (e.g., Irish), the applicable external registrars have to separately register

[19] CREST is not a depository, however, in the narrow sense of keeping documents of title in its vaults.

changes of ownership according to the changes effected in the CREST settlement.[20] For the CMO system, the Bank of England acts as depository for immobilized securities.

166. In addition, CRESTCo runs a fully-owned subsidiary—CREST International Nominees Limited—which acts as depository/custodian for international securities settled in CREST.[21] CREST Depository Limited, meanwhile issues CREST Depository Interests, with exactly the same characteristics as the underlying international securities, but which can be settled in CREST according to English law.

167. Trading of securities in the United Kingdom is mainly done on a bilateral basis between market participants. The exception is equities, which can also be traded on the London Stock Exchange's electronic order book (SETS, the Stock Exchange Electronic Trading Service). Equity transactions traded electronically are cleared by London Clearing House (LCH), acting as central counterparty (CCP), before settlement in CREST.

168. In November 2001, real-time settlement was introduced between CREST settlement banks, across accounts at the BoE. This replaced the previous end-of-day multilateral net settlement of interbank obligations arising from securities transactions, thus eliminating the substantial intraday exposures between settlement banks previously existing, and instituting securities settlement in central bank money.

169. CREST's average daily transaction volume (for gilts and equities) in December 2001 was about 308,000 with an average daily value of £208 billion. CMO's daily settlement averages £7 billion, with less than around 1,000 transactions.

170. On July 4, 2002, Euroclear and CRESTCo announced plans for an agreed merger. Following approval of the merger by both groups of shareholders during August and the decision on September 16 of the U.K. government not to refer the merger to the competition authorities, the merger was completed on September 23. Under the terms of the merger, CRESTCo shareholders received a 19 percent shareholding in Euroclear plc. CRESTCo itself became a wholly-owned subsidiary of Euroclear Bank, itself a subsidiary of Euroclear plc and the operator of the Euroclear system.

171. The merged entity (which besides CREST and the original international Euroclear operation, also encompasses the national securities settlement systems of Belgium, France

[20] Such registrars are classed as CREST "participants", along with those who hold securities in CREST ("members"), and those who provide payment services ("settlement banks"). CREST "users" (as distinct from "participants") are those who communicate with CREST on behalf of participants. Most corporate members are "direct members", with their own securities accounts in CREST, while "personal members" maintain accounts in their own name but use the facilities of a CREST user. Active market participants who are not members of CREST typically hold their accounts with custodians or brokers who are direct members.

[21] CREST also operates cross–border links with DTCC (the U.S. CSD), Euroclear (the international CSD based in Belgium) and SIS (the Swiss CSD and securities settlement system).

and the Netherlands) aims to deliver efficient low-cost cross-border settlement to its users, through a combination of rationalized central infrastructure, standardized procedures and high transaction volumes. A two-phase business model for the new enlarged Euroclear group was published at the time of the merger announcement. This aims to deliver a high degree of user choice (as to, e.g., level of service, governing jurisdiction and as regards central bank or commercial bank money settlement) around a single settlement platform in an environment of strong user governance and consultation.

172. In practice there have not been any significant changes in CREST operations yet, and the assessment is therefore done on the CREST system as an individual system.

C. Description of Regulatory Structure and Practices

173. The Financial Services Authority (FSA) is the single supervisor in the U.K. Therefore, both market participants (banks, brokers, etc) are regulated and supervised by the FSA, as well as clearinghouses, CSDs and exchanges. In addition, the Bank of England takes an active role in this field in its role as overseer of payment systems and in their financial stability policymaking.

D. Information and Methodology Used for Assessment

174. The information used in the assessment included relevant laws, rules and procedures governing the systems, and a questionnaire completed by CRESTCo in cooperation with the Financial Services Authority (FSA). Discussions were held with the Bank of England (BoE), the FSA, CRESTCo Crest, London Stock Exchange, LIFFE, and a number of bank representatives as well as brokers. Information on websites of the FSA and CRESTCo was also extensively analyzed.

175. In the assessment process the key questions for assessment of implementation in section 5 of the Recommendations were used. In order to align the assessment with the subsequently-agreed RSSS methodology, these were complemented by additional key questions from the latter. The assessment has been structured in accordance with the structure for assessment in the Assessment Methodology for Recommendations for Securities Settlement Systems, September 2002.

176. Each Recommendation was assessed on a qualitative basis based on a **five-fold assessment categorization**: **observed, broadly observed, partly observed, non-observed**, and **not applicable**. The categorization follows the guidelines in the assessment methodology. As a general principle a Recommendation is considered ***observed*** whenever all assessment criteria are generally met without any significant deficiencies. A Recommendation is considered ***broadly observed*** whenever only minor shortcomings are found, which do not raise major concerns and when corrective actions to achieve full observance with the Recommendation are scheduled and realistically achievable within a prescribed period of time. A Recommendation is considered ***partly observed*** whenever the shortcomings are sufficient to raise doubts about the ability to achieve observance within a reasonable time frame. A Recommendation is considered ***non-observed*** whenever major

shortcomings are found in adhering with the assessment criteria. Whenever a Recommendation is assessed to be broadly, partly or non-observed with a Recommendation, suggestions are proposed for achieving full observance. A Recommendation is considered ***not applicable*** whenever it does not apply given the structural, legal, and institutional conditions.

177. In accordance with the assessment methodology the assignment of an assessment category with respect to a recommendation is based on the current situation existing without regard to any proposed or ongoing actions. Material changes underway are presented in the description and/or comment sections.

E. The Assessment of the Observance with RSSS—The CREST System

Executive summary

178. The overall assessment is that the CREST system itself is reliable and effective in providing delivery versus payment settlement on a real time gross basis. The CREST system started its operations in 1996, but it was not until November 2001 that the transfer of title in CREST's book-entry system became the legal transfer of title to securities constituted under U.K. law. At the same time, full DVP in central bank money was introduced.

179. Those recommendations where full observance is not achieved have more to do with aspects outside the scope of the CREST system, or of CRESTCo itself, and more related to others. In all these cases the grading is broadly observed, and it should not be too difficult to make the required improvements for observance. These recommendations concern the following issues:

Pre-settlement risks

180. CREST has together with exchanges been able to improve the performance with regard to confirmation, matching and settlement performance over the last year. This work needs to be continued in order to achieve full observance with this recommendation.

Central counterparty

181. Given the importance of LCH for the U.K. and the international financial market, high priority should be given to replacing the payments scheme with one based on settlement across the books of the BoE, for settlements in sterling and Euro. In addition, the placement of funds in the money market should be converted from the current unsecured basis to a collateralized basis, in order to limit unnecessary credit risk exposure of LCH. Losses from these particular risk exposures can not be covered by the default arrangements in place. Initiatives to address both these weaknesses were underway during the period of the FSAP exercise and when completed will significantly remove much of this risk. It is also important that U.K. authorities give a very high priority to ensuring that the legal uncertainties are rectified, especially with respect to the default fund.

Settlement risks

182. Most actively traded securities are dematerialized. However, MMIs are not. There are plans to introduce that in 2003 (legal amendments and certain operational and market practice changes are necessary and are underway) after which observance with this recommendation will be achieved.

Regulation and oversight

183. There is currently no specific framework for cooperation with relevant authorities outside the U.K., which is something that should be developed. In addition, the supervisory process should continue to develop towards more differentiation amongst supervised institutions, having regard in particular to the different sorts of risks in CREST and LCH (e.g., as related to different capital requirements for these institutions, a matter under consideration at the time of the assessment).

Table 22. Summary Observance of CPSS/IOSCO Recommendations for Securities Settlement Systems—CREST

Assessment grade	*Recommendations grouped by assessment grade*	
	Count	***List***
Observed	14	Rec. 1, 3, 5, 7, 8, 10, 11, 12, 13, 14, 15, 16, 17, and 19
Broadly observed	4	Rec. 2,4, 6, and 18
Partly observed	0	
Non-observed	0	
Not applicable	1	Rec. 9

F. Recommendation-by-Recommendation Assessment

Table 23. Detailed Assessment of Observance of CPSS/IOSCO Recommendations for Securities Settlement Systems—CREST

Legal risk	
Recommendation 1 – legal framework *Securities settlement systems should have a well founded, clear and transparent legal basis in the relevant jurisdictions.*	
Key questions	CREST is a designated system under the Settlement Finality Directive, so that both securities and payment transfers and default arrangements are protected from the ordinary operation of U.K. insolvency law. The legal framework relating to CREST consists of statutory provisions (company laws and regulations, financial services supervision etc) enacted in the relevant jurisdictions as well as contractual agreements between CRESTCo and CREST participants. These contractual agreements (including terms and conditions, rules etc) are exclusively governed by English law. On November 26 2001, the Uncertificated Securities Regulations 2001 came into force. These regulations re-enacted with modifications the USRs 1995, which set up the original legislative framework for Crest. The USR 2001 mean that the electronic transfer within Crest's book-entry system now represents the legal transfer of title, removing the interval between settlement in CREST and registration of ownership.
Assessment	Observed
Comments	
Pre-settlement risk	
Recommendation 2 – Trade confirmation *Confirmation of trades between direct market participants should occur as soon as possible after trade execution, but no later than trade date (T+0). Where confirmation of trades by indirect market participants (such as institutional investors) is required, it should occur as soon as possible after trade execution, preferably on T+0, but no later than T+1.*	

Key questions	For direct participants, trades executed on LSE's order book (SETS) are automatically fed into LCH and onwards to CREST, which creates the necessary settlement instruction. These are then matched (confirmed) by the two market counterparties. The percentage of trades that are matched within CREST on T+0 is over 95%. For bilateral trades direct participants will input settlement instructions into CREST and use CREST's real-time settlement facility. Of all trades, 90 percent will be confirmed on T+0. There is no single trade confirmation system for indirect members. Of all trades between indirect members 42 percent is confirmed in CREST on T+0, 75 percent at T+1 and 97 percent are confirmed on intended settlement day. The regulatory requirement on monitoring participants' timely confirmation and matching as well as settlement performance is with the exchanges, under their responsibilities for an 'orderly market'. There is no requirement on CREST in this. In addition, there is no regulatory requirement for confirmation of trades involving indirect market participants, nor is there a contractual relationship between CREST and these indirect participants.
Assessment	Broadly observed
Comments	CREST has together with exchanges been able to improve the performance with regard to confirmation, matching and settlement performance over the last year. This work needs to be continued in order to achieve full observance with this recommendation. Even though there is no formal requirement on the level of indirect participants the mission encourages the British authorities to work with market participants with the aim of improve the confirmation performance also at this level.

Recommendation 3 – Settlement cycles

Rolling settlement should be adopted in all securities markets. Final settlement should occur no later than T+3. The benefits and costs of a settlement cycle shorter than T+3 should be evaluated.

<table>
<tr><td>Key questions</td><td>The rolling settlement cycle for equities is T+3. For cash bonds, which account for approximately 70 percent of the value of settlement through CREST, the cycle is generally T+1 but with a significant T+0 component. 70 percent of stock lending and repos are settled on a T+0 basis for all instruments and the other 30 percent on T+1 or T+2.

The Bank, CRESTCo, LSE and APACS conducted a consultation with market participants in 1999 in advance of moving the settlement cycle down to T+3. It concluded that although T+1 was desirable in the long run for equity settlement, it would have a significant impact on the institutional and retail market. The conclusion was therefore that shortening to T+3 was to be recommended. This was adopted in February 2001.

For participants using CREST, settlement fails are normally less than 2% by numbers: Figures by value are not recorded, but are much lower than 2%. Because of the ability to borrow intraday, deals in liquid instruments very rarely fail to settle on intended settlement day. Fails are in practice always dependent on the inability to deliver the instrument and most involve retail sales of securities held outside CREST in certificated form.

CREST operates a settlement discipline regime that penalizes late matching and late settlement. In addition, the FSA requires firms to mark settlement fails to market and take a capital charge against the possibility that settlement may never occur.</td></tr>
<tr><td>Assessment</td><td>Observed</td></tr>
<tr><td>Comments</td><td></td></tr>
<tr><td colspan="2">Recommendation 4 – Central Counterparty (CCP)

The benefits and costs of a CCP should be evaluated. Where such a mechanism is introduced, the CCP should rigorously control the risks it assumes.</td></tr>
<tr><td>Key questions</td><td>The London Clearing House (LCH) is the major central counterparty clearer in the U.K. market. LCH act as counterparty in trades done at derivative exchanges, the LSE's electronic trading system (SETS) and OTC derivatives (swaps and repos). Overall, LCH seems to apply a conservative view in setting margin requirements. The monitoring of clearing members is very well developed with, among other things, daily stress testing of members' positions.

Despite this conservative approach to risk management, there is a weakness in LCH's payment scheme, in which LCH settles its cash payments across accounts held at various commercial banks, rather than in a default-risk free settlement asset. The resulting intraday risk exposures are material . Another weakness is that LCH has traditionally invested its cash resources in the unsecured deposit market, which brings exposure to credit risk.

On the legal side, there are uncertainties about certain minor parts of funds paid in by members to LCH's default fund, as well as some legal uncertainties attaching to the cross-margining link with CME (although this currently handles immaterial exposures).</td></tr>
<tr><td>Assessment</td><td>Broadly observed</td></tr>
</table>

Comments	Given the importance of LCH for the U.K. and the international financial market, high priority should be given to replacing the payments scheme with one based on settlement across the books of the BoE, for settlements in sterling and Euro. In addition, the placement of funds in the money market should be converted from the current unsecured basis to a collateralized basis, in order to limit unnecessary credit risk exposure of LCH. Losses from these particular risk exposures can not be covered by the default arrangements in place. Initiatives to address both these weaknesses were underway during the period of the FSAP exercise and when completed will significantly remove much of this risk. It is important that U.K. authorities give a very high priority to ensuring that the legal uncertainties are rectified, especially with respect to the default fund.
Recommendation 5 – Securities lending *Securities lending and borrowing (or repurchase agreements and other economically equivalent transactions) should be encouraged as a method for expediting the settlement of securities transactions. Barriers that inhibit the practice of lending securities for this purpose should be removed.*	
Key questions	There are active markets for securities lending, repos, and other collateralized borrowing for U.K. and Irish corporate securities and U.K. government debt. In addition, CREST offers an automated repo facility under which members may repo eligible securities to the BoE as necessary for the generation of intraday sterling liquidity. The market for securities lending and repurchase agreements are clearly acknowledged in, and supported by, law, regulation, tax and accounting systems. The tax treatment of equities lending requires one party to the transaction to be member of a recognized exchange to benefit from exemptions without which lending is highly uneconomic due to Stamp Duty Reserve Tax. Regulation of securities lending in collateral market is undertaken by the FSA and within the rules of the individual exchanges when the activity is undertaken on exchange. There are no restrictions on the range of securities or participants in the market – other than any supervisory restrictions that may apply to individual firms. The majority (70%) of securities are lent and executed on a same day basis (T+0) with the remainder undertaken for T+1 or T+2. The Stock Lending & Repo Committee (SLRC) chaired by the Bank is a forum for discussions on structural and legal developments in stock lending markets between market participants and authorities.
Assessment	Observed
Comments	
Settlement risk	
Recommendation 6 – Central Securities Depositories (CSDs) *Securities should be immobilized or dematerialized and transferred by book entry in CSDs to the greatest extent possible.*	

Key questions	Over 85 percent of the value of equities in the U.K. and Irish stock market are dematerialized. The figure for gilts is 99 percent. However, only a limited number of securities are issued in a fully dematerialized form. CREST provides securities settlement services but does not provide safekeeping facilities for physical certificates. Physical certificates can be dematerialized into CREST through CREST Courier and Sorting Services (CCSS) and rematerialized later if required. At the point of settlement 100 percent of securities are dematerialized in Crest's book entry system. The present regulation (Uncertificated Securities Regulations 2001) establishes the CREST records as the register for these dematerialized securities. At the point of settlement within CREST the buyer receives immediate and irrevocable direct legal title to the dematerialized securities. The present rules making it optional for issuers (and investors) to have securities in certificated form adds costs and operational risk for market participants. Money Market Instruments (MMI) are not dematerialized and thus can not be settled within CREST.
Assessment	Broadly observed
Comments	Most actively traded securities are dematerialized. However, MMIs are not. There are plans to introduce that in 2003 (legal amendments are necessary and are in hand) after which observance with this recommendation will be achieved. The fact that as much as 15% of the value of equities and still 1% of gilts are not dematerialized involves operational costs and risks for market participants. It would be beneficial for the market if steps were taken to lower these numbers. A mandatory dematerialization, as in many other countries (e.g., France and Sweden), could be considered.

Recommendation 7 – Delivery versus Payment (DVP)

CSDs should eliminate principal risk by linking securities transfers to funds transfers in a way that achieves delivery versus payment.

Key questions	For sterling and Euro-denominated securities, there is a DVP mechanism in CREST operating on a RTGS basis since November 2001 (giving trade-by-trade, or "model 1" DVP). The functionality is that CREST settles transactions in 200-300 batches a day. When a batch of trades is ready for settlement the CREST system checks the availability of funds on the buyer's settlement bank CREST account within the BoE's RTGS system (separate from the bank's regular RTGS settlement account). This information is then copied to the memorandum accounts in CREST. Funds and securities are then transferred finally and irrevocably from the sellers' accounts to the buyers' accounts in Crest. At the end of each batch the information is sent from the memorandum accounts in CREST to the BoE's RTGS system, where the accounts are updated. When settling a batch, the funds in the CREST accounts in the BoE are blocked, so that there can never be a discrepancy between those accounts and the memorandum accounts at CREST. This generates a payment instruction to the BoE's RTGS system and a final and irrevocable transfer is made. The CREST participants themselves control risk exposure amongst each other. CREST does, however, provide fully automated facilities by which a bank can limit its exposure to any member for which it offers settlement services. For transactions in USD, settlement banks are obliged to make (assured) payments on behalf of the participants for whom they provide settlement services. Settlement banks settle their payments at the end of the day in USD, using their correspondent banks. This leaves participants with full DVP, but settlement banks have intraday exposures between themselves. It should be noted that the value of settlement is relatively small, but still accounted for US$1.5 bn/day in December 2001.
Assessment	Observed
Comments	Even if USD transactions presently are small, it should be noted that there is an interbank credit risk stemming form the securities settlement mechanism, which means that principal risk is not fully eliminated. CRESTCo together with the U.K. authorities should evaluate alternative payment schemes that can reduce this exposure. If no such mechanism is found, it is important that supervisors are aware of this risk exposure and can discuss it with banks in their risk assessments.
Recommendation 8 – Settlement finality *Final settlement should occur no later than the end of the settlement day. Intraday or real-time finality should be provided where necessary to reduce risks.*	
Key questions	CREST offers real-time finality for all transfers against sterling and Euro. For USD transaction final settlement occurs at the end of the settlement day. Transfers of Irish, Jersey, Guernsey, and Manx securities confer statutorily backed equitable title on the transferee, pending registration of legal title by the issuer's registrar. Registration must occur within two hours of CREST settlement and generally occurs within 30 minutes. If the registrar rejects registration, CREST maintains rules to manage the reversal of settlements (including payments). This has never happened to date, but in any event means that there is an element of revocability for these instruments. In terms of value these transactions only accounts for approximately three percent. CREST operates cross-border links with DTCC and Euroclear (for free of payments transactions) and SIS (DVP-link). There are no provisional transfers within these links, and consequently all transfers into CREST via these links are final and irrevocable.

<table>
<tr><td>Assessment</td><td>Observed</td></tr>
<tr><td>Comments</td><td>There is a potential risk of revocability of the Irish, Jersey, Guernsey, and Manx securities in the two hours following settlement. However, the risks are made clear to members, the transactions are relatively small in volume and value, and an improvement would require changes in the relevant jurisdictions. In absolute terms the value of these transactions is approximately £6 billion a day, which is of course, not negligible. It is important that this risk is not forgotten in the supervisory process.</td></tr>
<tr><td colspan="2">Recommendation 9 – CSDs risk controls
CSDs that extend intraday credit to participants, including CSDs that operate net settlement systems, should institute risk controls that, at a minimum, ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle. The most reliable set of controls is a combination of collateral requirements and limits.</td></tr>
<tr><td>Key questions</td><td>CREST does not extend intraday credit to any participants. Nor does it permit debit balances in securities. CREST is not a net settlement system—it operates on a gross basis.</td></tr>
<tr><td>Assessment</td><td>N/A</td></tr>
<tr><td>Comments</td><td></td></tr>
<tr><td colspan="2">Recommendation 10 – Settlement assets
Assets used to settle the ultimate payment obligations arising from securities transactions should carry little or no credit or liquidity risk. If central bank money is not used, steps must be taken to protect CSD members from potential losses and liquidity pressures arising from the failure of the cash settlement agent whose assets are used for that purpose.</td></tr>
<tr><td>Key questions</td><td>CREST operates an intermediated banking model. All members have to have a CREST settlement bank. The settlement bank guarantees the obligations of its members. At the point of settlement in CREST the obligation of the buyer to the seller is extinguished and replaced with an obligation from the buyer's bank to the seller's bank (where different).

For sterling and Euro, the inter-bank obligation is immediately discharged by central bank money across the banks' CREST settlement accounts within the BoE .

For USD the interbank obligations are settled at the end of day between correspondent accounts. Settlement banks have intraday exposure until the obligations are discharged at the end of the day.
The availability of funds to members is determined by their private contractual arrangement with their settlement bank. CREST believes that larger members generally have arrangements for immediate, intraday funds availability. Proceeds can invariably be reused within CREST immediately (as debits and credits in the Cash Memorandum Account). For settlements in sterling and Euro, a settlement member has no exposure other than to their chosen settlement bank.

Almost 50 percent of the interbank payments within CREST are concentrated in two settlement banks. These banks are also those used by the highest percentage of CREST members.

According to CREST rules, all current settlement banks have to approve a new bank who wants to become a settlement bank. This rule stems from the pre-November 2001 period when settlement banks were facing considerable intraday exposures.</td></tr>
<tr><td>Assessment</td><td>Observed</td></tr>
</table>

<table>
<tr><td>Comments</td><td>Although CREST believes that larger members generally have arrangements for immediate finality, there is currently no specific information to verify this. The authorities should seek more specific information from CREST or its members about current payment finality arrangements between members and their banks, and examine whether and how to ensure that the finality arrangements are appropriate.

Even though USD transactions presently are small, it should be noted that there is an interbank credit risk stemming form the securities settlement mechanism. It is recommended that CREST together with the U.K. authorities explore this issue in more depth.

The high concentration of activities in two settlement banks should be noted by banking supervisors. Although these banks are very large and well-supervised banks, it is important that this particular dimension is carefully reflected in the supervisory process. In addition, the rules that settlement banks must approve new settlement banks before entering the scheme is of no relevance with today’s RTGS DVP settlement and should therefore be removed, due to the risk of it limiting the competitive pressure on existing settlement banks.</td></tr>
<tr><td colspan="2" align="center">Operational risk</td></tr>
<tr><td colspan="2">Recommendation 11 – Operational reliability

Sources of operational risk arising in the clearing and settlement process should be identified and minimized through the development of appropriate systems, controls and procedures. Systems should be reliable and secure, and have adequate, scalable capacity. Contingency plans and backup facilities should be established to allow for timely recovery of operations and completion of the settlement process.</td></tr>
<tr><td>Key questions</td><td>The CREST systems seem to be highly reliable. Maximum interruption last year was approximately one hour, and in all cases settlement could be done on settlement day. CREST publishes their settlement performance and availability in its monthly newsletter.

CREST have a full hot remote backup contingency site subject to regular live testing.

To ensure the integrity of messages data encryption and message authentication codes is used. Accredited network providers must meet CREST’s message security requirement.

CRESTCo has an independent Internal Audit Department, which reviews operational risks and controls across the CREST services. In addition, external auditors undertake an annual SAS 70 assessment against management’s statement of internal controls. This results in a report on operational risk, which is available to all members. The work of the internal and external auditors is reviewed by the Audit and Compliance Committee, which includes non-executive CRESTCo board directors and two professional audit co-optees from the banking sector.

CRESTCo has both a short-term capacity management function and a team that looks at medium and long term capacity projections.

Contracts and service level agreements are in place with service partners and outsourced facilities providers. These are constantly monitored and reviewed at regular meetings to the same standards as if they were provided directly by CRESTCo. The operation of key service providers is also subject to CRESTCo internal audit review.</td></tr>
<tr><td>Assessment</td><td>Observed</td></tr>
</table>

<table>
<tr><td>Comments</td><td></td></tr>
<tr><td colspan="2" align="center">Custody risk</td></tr>
<tr><td colspan="2">Recommendation 12 – Custody risk

Entities holding securities in custody should employ accounting practices and safekeeping procedures that fully protect customers' securities. It is essential that customers' securities be protected against the claims of a custodian's creditors.</td></tr>
<tr><td>Key questions</td><td>This question does not apply to CREST's domestic services, where members hold securities in their own name or, if they do not have an account with CREST, with one of the members.

CRESTCo does intermediate the ownership of international securities through a wholly owned subsidiary. Such securities are held under an English law trust arrangement for the benefit of the relevant CREST members. The insolvency of a custodian or other intermediary (whether the CREST Depository or otherwise) that holds any securities in CREST on behalf of clients, under a properly constructed English law trust, would not ordinarily pose a threat to the proprietary interest of the client. It seems the arrangement in place would cover the risk in the CRESTCo custodial area.

Reconciliation of records of securities in custody is done according to regulatory requirements. That is, balances are reconciled monthly, with a full reconciliation conducted quarterly. CRESTCo reconciles the CDI register and CSD positions daily.</td></tr>
<tr><td>Assessment</td><td>Observed</td></tr>
<tr><td>Comments</td><td>There is a need to better communicate the safeguards and the legal support for the custodial activity to market participants , some of whom have expressed concern in this area.</td></tr>
<tr><td colspan="2">Recommendation 13 - Governance

Governance arrangements for CSDs and CCPs should be designed to fulfil public interest requirements and to promote the objectives of owners and users.</td></tr>
</table>

Key questions	The CREST Annual Report and Accounts describe the system and disclose the ownership, board and management structure. It also contains a corporate governance section that states the responsibilities of the board, defines risk management procedures and the role of the board's committees including the Audit & Compliance Committee. The Board comprises 14 members, two of whom are executive directors. A Nominating Committee meets to review the criteria, which it must apply to new board appointments. The Board as a whole must comprise directors with appropriate skills and experience, who are, except in the case of two independent directors, drawn from the system's users. The Board is also balanced to reflect the diverse range of users of CREST services. Staff is appraised annually by appropriate line management against objectives matched to the business's needs. Personal bonus arrangements are linked to the delivery of these objectives. Key managers make monthly reports to a senior executive committee, i.e., key achievements, threats to the achievement of targets and priority tasks in the following month. All CREST shareholders are system users, with shares being rebalanced according to use of the system every two years. Feedback from customers is obtained and acted on by CRESTCo's Relationship Management team and through stakeholder surveys. The public interest is upheld through regular meetings between CREST and government, the BoE , the FSA, other authorities and key industry bodies.
Assessment	Observed
Comments	This assessment was carried out before the merger between Euroclear and CrestCo was agreed in September 2002. The business plan for the new enlarged Euroclear group places great emphasis on user ownership and governance.
Other issues	
Recommendation 14 - Access *CSDs and CCPs should have objective and publicly disclosed criteria for participation that permit fair and open access.*	
Key questions	Access to CREST is subject to CRESTCo's Terms and Conditions. These are sent out to all potential applicants and are accessible through their website. Applicants who are incorporated outside the U.K. must appoint an agent for service of process who is a body corporate incorporated in England and Wales. This is to ensure that in the event of a dispute CRESTCo is not prevented or hindered from serving notices on members incorporated outside the U.K. CRESTCo may restrict or remove access to the system but only on the basis that participation by a particular member could threaten the security, integrity, or reputation of the system. Suspension and termination of membership is covered in the CREST Terms and Conditions. This states the circumstances in which CREST may suspend a member, either with immediate effect or with effect from such time as CREST may specify. The CREST Reference Manual covers the practical aspects of such suspension. CREST does not and can not monitor the underlying clients of its members.
Assessment	Observed

Comments	
Recommendation 15 - Efficiency *While maintaining safe and secure operations, securities settlement systems should be cost-effective in meeting the requirements of users.*	
Key questions	CRESTCo regularly analyses its financials and tariffs in comparison with publicly available information from its peers and competitors. Such analysis shows that CREST is cost-efficient. Feedback from customers is obtained and acted on by CRESTCo's Relationship Management team. Stakeholder surveys are employed.
Assessment	Observed
Comments	
Recommendation 16 – Communication procedures and standards *Securities settlement systems should use or accommodate the relevant international communication procedures and standards in order to facilitate efficient settlement of cross-border transactions.*	
Key questions	Customers can communicate either using ISO 15022 standard messages or CREST proprietary standards. Generic and open interface and network protocols were to supplement the CREST proprietary standards during 2002. To communicate with other CSDs and ICSDs, international communications procedures and standards are used for cross-border securities transactions. The SWIFT FIN network is used and the messages conform to the ISO 15022 standard.
Assessment	Observed
Comments	
Recommendation 17 - Transparency *CSDs and CCPs should provide market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with using the CSD or CCP services.*	
Key questions	CRESTCo has completed the questionnaire set out in the CPSS/IOSCO disclosure framework and published it on its website. The rights and obligations of CREST participants arise primarily from a combination of the USR 2001, the CREST agreements entered into by CREST participants and the CREST Manual (which incorporates the CREST Rules). All members are informed directly of any changes to these rules and regulations. This is also published on the website. Periodic reviews are conducted to ensure the accuracy of disclosed material.
Assessment	Observed
Comments	
Recommendation 18 – Regulation and oversight *Securities settlement systems should be subject to transparent and effective regulation and oversight. Central banks and securities regulators should cooperate with each other and with other relevant authorities.*	

Key questions	The FSA are the supervisors of CRESTCo. FSA has four statutory objectives under the Financial Services and Markets Act 2000, which underpin its regulatory approach, including maintaining market confidence and protecting customers. FSA's supervision is based on the handbook – Recognized Investment Exchanges and Recognized Clearing Houses (June 01). According to CRESTCo, the BoE takes the lead in discussions about systemic risk, while FSA are more focused on supervisory issues. In addition, the Bank is reportedly the main speaking partner with CRESTCo on strategic issues. It is difficult to supervise an organization like CREST, where the financial risks are negligible, and instead reputational, operational and strategic business risks are in focus. But it is important that the FSA adapts their supervisory regime for those purposes: discussions with market participants suggest that this focus is not yet fully reflected in FSA supervision. The impression is that the supervision of clearinghouses and securities settlement systems (SSS) is perhaps more rule-based than for banks where the supervisory approach is more of a risk-based supervision. The MoU stipulates the cooperative framework for the FSA and the BoE . In practice, it seems like this cooperation works relatively well with all material issues discussed regularly and effectively. Until recently the Bank has not been very clear in its external communication of its role with respect to SSS and clearinghouses. In its Financial Stability Report of June 2002, this was for the first time published (in a very helpful box). There it explains its role from the overall financial stability interest and from a broader definition of payment system oversight, than previously used.
Assessment	Broadly observed
Comments	It is important that the FSA continues to adapt its supervisory regime to the risks inherent in institutions like CREST and LCH.(Indeed, it might be worth considering if it really is beneficial to have the same supervisory handbook—"the sourcebook" — for such diverging institutions as LCH and CREST.) Progress is being made in this area, however: e.g., FSA is considering lowering the capital requirement for CRESTCo, reflecting supervisory differentiation between it and LCH. There is currently no framework for cooperation with relevant authorities outside the U.K., which is a part of this Recommendation. Such a framework should be established, and the supervisory process further developed with respect to actual risks in CREST and LCH, to improve observance of this Recommendation. The current phase of consolidation of CSDs/SSSs and CCPs in both a European and a global context is a challenge not only for the institutions involved but also for the overseer/supervisors (Since the FSAP visit to the U.K., CRESTCo has merged with Euroclear). Issues to focus on include, e.g., whether internal controls can keep pace with business developments.
Recommendation 19 – Risks in cross-border links *CSDs that establish links to settle cross-border trades should design and operate such links to reduce effectively the risks associated with cross-border settlements.*	

Key questions	CREST links to other CSDs follow ECSDA standards and principles (disclosed at www.ecsda.com). These standards are designed to eliminate risk from the cross border settlement process, and the ECSDA principles mirror the recommendations of BIS, albeit at a lower level of detail. CRESTCo conducts extensive legal due diligence prior to the establishment of a link with another CSD. Obtaining necessary authorization from local authorities forms part of this process. Establishing when transactions in a CSD are final is also a crucial element of the due diligence process, as well as operational and risk management issues. This work is presented in detail in the document "International Legal Framework", which is posted on the website. In all CREST cross-border links, no settlement is initiated unless stock or cash has been blocked. The current DVP-link relies on clean payments being made, rather than credit being extended. There are no provisional transfers within the cross-border links, and consequently all transfers into CREST via these links are final and irrevocable.
Assessment	Observed
Comments	

Table 24. Recommended Actions to Improve Observance of CPSS/IOSCO—CREST

Reference recommendation	***Recommended action***
Pre-settlement risks *Rec. 2 – Confirmation of trades between direct market participants should occur as soon as possible after trade execution, but no later than trade date (T+0). Where confirmation of trades by indirect market participants (such as institutional investors) is required, it should occur as soon as possible after trade execution, preferably on T+0, but no later than T+1.*	CREST has together with exchanges been able to improve the performance with regard to confirmation, matching and settlement performance over the last year. This work needs to be continued in order to achieve full observance with this recommendation. Even though there is no formal requirement on the level of indirect participants the mission encourages the British authorities to work with market participants with the aim of improve the confirmation performance also at this level
Central counterparty *Rec.4 – The benefits and costs of a central counterparty should be evaluated. Where such a mechanism is introduced, the central counterparty should rigorously control the risks it assumes.* **Settlement risk** *Rec. 6 – Securities should be immobilized or dematerialized and transferred by book entry in CSDs to the greatest extent possible.*	Given the importance of LCH for the U.K. and the international financial market, high priority should be given to replacing the payments scheme with one based on settlement across the books of the BoE, for settlements in sterling and Euro. In addition, the placement of funds in the money market should be converted from the current unsecured basis to a collateralized basis, in order to limit unnecessary credit risk exposure of LCH. Losses from these particular risk exposures can not be covered by the default arrangements in place. Initiatives to address both these weaknesses were underway during the period of the FSAP exercise and when completed will significantly remove much of this risk. It is important that U.K. authorities give a very high priority to ensuring that the remaining legal uncertainties are rectified, especially with respect to the default fund. Most actively traded securities are dematerialized. However, MMIs are not. There are plans to introduce that in 2003 (legal amendments are necessary and are in hand) after which observance with this recommendation will be achieved. The fact that as much as 15% of the value of equities and still 1% of gilts are not dematerialized involves operational costs and risks for market participants. It would be beneficial for the market if steps were taken to lower these numbers. A mandatory dematerialization, as in many other countries (e.g., France and Sweden), could be considered.

Reference recommendation	*Recommended action*
Regulation and oversight *Rec. 18 - Securities settlement systems should be subject to transparent and effective regulation and oversight. Central banks and securities regulators should cooperate with each other and with other relevant authorities.*	It is important that the FSA continues to adapt its supervisory regime to the risks inherent in institutions like CREST and LCH. (Indeed, it might be worth considering if it really is beneficial to have the same supervisory handbook--"the sourcebook"--for such diverging institutions as LCH and CREST.) Progress is being made in this area, however:, e.g., FSA is considering lowering the capital requirement for CRESTCo, reflecting supervisory differentiation between it and LCH. There is currently no framework for cooperation with relevant authorities outside the U.K., which is a part of this recommendation. Such a framework should be established, and the supervisory process further developed with respect to actual risks in CREST and LCH, to improve observance of this Recommendation. The current phase of consolidation of CSDs/SSSs and CCPs in both a European and a global context is a challenge not only for the institutions involved but also for the overseer/supervisors. Issues to focus on include, e.g., whether internal controls can keep pace with business developments.

184. In addition to the above, some further technical improvements or refinements would be desirable in several areas where the U.K. arrangements are already considered to observe the RSSS. Specifically:

- *Rec. 7*: Even if USD transactions presently are small, it should be noted that there is an interbank credit risk stemming form the securities settlement mechanism. CRESTCo together with the U.K. authorities should evaluate alternative payment schemes that can reduce this exposure. If no such mechanism is found, it is important that supervisors are aware of this risk exposure and can discuss it with banks in their risk assessments.
- *Rec*. 10: Although CREST believes that larger members generally have arrangements for immediate finality, there is currently no specific information to verify this. The authorities should seek more specific information from CREST or its members about current payment finality arrangements between members and their banks, and examine whether and how they should ensure that the finality arrangements are appropriate.

  Even though USD transactions presently are small, it should be noted that there is an interbank credit risk stemming from the securities settlement mechanism. It is recommended that CREST together with the U.K. authorities explore this issue in more depth.

The high concentration of activities in two settlement banks should be noted by banking supervisors. Although these banks are very large and well-supervised banks, it is important that this particular dimension is carefully reflected in the supervisory process. In addition, the rules that settlement banks must approve new settlement banks before entering the scheme is of no relevance with today's RTGS DVP settlement and should therefore be removed, due to the risk of it limiting the competitive pressure on existing settlement banks.

- Rec. 12. There is a need to better communicate the safeguards and the legal support for the custodial activity to market participants, some of whom have expressed concern in this area.

G. The Assessment of the Observance with RSSS—The CMO System

Executive summary

185. A more limited, but still recommendation-by-recommendation assessment was made of the settlement system for money market instruments, the Central Money Markets Office system (CMO).

186. The CMO system settles trades in money market instrument, including treasury bills, bank bills, and CDs, and handles both sterling and Euro settlements. The CMO system has one major shortcoming, in that settlement is not on a full delivery versus payment basis. The securities leg of a transaction is settled gross on a real time basis and is irrevocable upon settlement. However, the payment leg of the transaction settles on a net basis at the end of day, in the settlement banks' accounts with the Bank of England. In contrast to the assured payments used for USD in the CREST system, banks are not obliged to make payments on behalf of their customers. Therefore, all participants in the money market are faced with a full principal risk from the settlement of the securities leg of the transaction intraday, until payments have been settled at the end of the day.

187. At the time of the assessment, work was underway to prepare for the migration of MMI from CMO to CREST. The suggested timetable was to complete this migration during 2003.Legislative changes are needed to change the status of money market instruments, which presently are bearer instruments and therefore not fungible, to make it possible to integrate CMO into the CREST system. This process is reportedly in hand, and no other changes are either planned or recommended for the CMO system in this assessment. It is important, however, that as long as the CMO system remains the U.K. authorities take account of this risk exposure in their work on financial stability and supervision of institutions.

Table 25. Summary Observance of CPSS/IOSCO Recommendations for Securities Settlement Systems—CMO

Assessment grade	***Recommendations grouped by assessment grade***	
	Count	***List***
Observed	6	Rec. 2, 3, 11, 12, 13, and 14
Broadly observed	3	Rec. 1, and 18
Partly observed	4	Rec. 5, 6, 8, 10, and 17
Non-observed	4	Rec. 7, 9, 15, and 16
Not applicable	2	Rec. 4 and 19

H. Recommendation-by-recommendation assessment

Table 26. Detailed Assessment of Observance of CPSS/IOSCO Recommendations for Securities Settlement Systems—CMO

Legal risk	
Recommendation 1 – Legal framework *Securities settlement systems should have a well founded, clear and transparent legal basis in the relevant jurisdictions.*	
Key questions	The legal framework relating to CMO is made up of a contractual framework involving issuers and CMO members. English law exclusively governs these contractual agreements. This legal environment is well-established, clear and predictable, and thus gives no reason for any legal uncertainties to arise. However, in being bearer instruments that are not fungible, money market instruments complicate the process of trading and settlement. This gives rise to a wide range of problem areas. Legal changes are needed to overcome these hurdles.
Assessment	Broadly observed
Comments	The legislative changes necessary to make the instruments fungible should be a high priority issue for the HMT, since this is necessary to include CMO fully within CREST and thereby achieve true DVP.
Pre-settlement risk	
Recommendation 2 – Trade confirmation *Confirmation of trades between direct market participants should occur as soon as possible after trade execution, but no later than trade date (T+0). Where confirmation of trades by indirect market participants (such as institutional investors) is required, it should occur as soon as possible after trade execution, preferably on T+0, but no later than T+1.*	

Key questions	CMO provides an electronic system for transfer of instruments by book entry between members. Agreements by both parties to the transaction is achieved by positive acceptance, i.e., the seller of the securities inputs details of the transaction and the buyer must input acceptance of this to the system. Settlement occurs on T+0. CMO has no information on trades that are not settled in the system on due date because of late confirmation.
Assessment	Observed
Comments	
Recommendation 3 – Settlement cycles *Rolling settlement should be adopted in all securities markets. Final settlement should occur no later than T+3. The benefits and costs of a settlement cycle shorter than T+3 should be evaluated.*	
Key questions	Trading of money market instruments is conducted for same-day (T+0) settlement. As noted above CMO can not see if trades are done if they not are entered into the system. In the case where settlement does not take place because the buyer does not send a positive acceptance, the transaction is deleted from the system at end-of-day. Detail on unsettled transactions is made available to the members concerned, for their bilateral discussion.
Assessment	Observed
Comments	
Recommendation 4 – Central Counterparty (CCP) *The benefits and costs of a CCP should be evaluated. Where such a mechanism is introduced, the CCP should rigorously control the risks it assumes.*	
Key questions	There is no counterparty service for CMO.
Assessment	N/A
Comments	
Recommendation 5 – Securities lending *Securities lending and borrowing (or repurchase agreements and other economically equivalent transactions) should be encouraged as a method for expediting the settlement of securities transactions. Barriers that inhibit the practice of lending securities for this purpose should be removed.*	
Key questions	There is no significant market for securities lending, reflecting the fact that money market instruments are bearer instruments, and therefore not fungible. There is an active market for repos and other form of collateralized borrowing, with 20 percent of the instruments within CMO being held as collateral or on repo.
Assessment	Partly observed
Comments	The prevalence of bearer instruments is a major shortcoming for developing the CMO system and developing an active securities lending market.

Settlement risk	
Recommendation 6 – Central Securities Depositories (CSDs) *Securities should be immobilized or dematerialized and transferred by book entry in CSDs to the greatest extent possible.*	
Key questions	All instruments that can be settled in CMO which are issued in physical, bearer form can be immobilized within CMO. The BoE acts as depository for immobilization of physical instruments. Once an instrument is introduced into CMO, transfers are carried out by book-entry. The present rules making it optional for issuers (and investors) to have securities in certificated form adds costs and operational risk for market participants. Instruments within CMO are not fungible and are not registered.
Assessment	Partly observed
Comments	A mandatory dematerialization for money market instruments would be beneficial for the market.
Recommendation 7 – Delivery versus Payment (DVP) *CSDs should eliminate principal risk by linking securities transfers to funds transfers in a way that achieves delivery versus payment.*	
Key questions	The securities leg of a transaction is settled gross on a real time basis in the CMO system. That part of the transaction is irrevocable at the time of settlement. The payment leg of the transaction settles on a net basis at the end of day, in the settlement banks' accounts with the BoE. CMO settles in both sterling and Euro. In contrast to the assured payments used for USD in the CREST system, banks are not obliged to make the payments on behalf of their customers. Therefore, all participants in the money market are faced with a full principal risk from the settlement of the securities leg of the transaction intraday until payments have been settled at the end of the day.
Assessment	Non-observed
Comments	Since principal risk is not eliminated, CMO is not currently compliant with international standards. A change, which involves amending the Uncertificated Securities Regulations, is planned for 2003, but an obstacle to be overcome is the fact that instruments are not fungible. With this change completed money market instruments can be moved into CREST, and consequently be settled on a DVP basis.
Recommendation 8 – Settlement finality *Final settlement should occur no later than the end of the settlement day. Intraday or real-time finality should be provided where necessary to reduce risks.*	
Key questions	See above.
Assessment	Partly observed
Comments	Comments as above. Settlement of the securities leg is in real time and settlement of the payments leg occurs at end-of-day.

<table>
<tr><td colspan="2">Recommendation 9 – CSDs risk controls
CSDs that extend intraday credit to participants, including CSDs that operate net settlement systems, should institute risk controls that, at a minimum, ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle. The most reliable set of controls is a combination of collateral requirements and limits.</td></tr>
<tr><td>Key questions</td><td>CMO does not take any risk on itself in that it does not extend intraday credit to any participants. Nor does it permit debit balances in securities.

CMO settles payments net at the end-of-day. Settlement banks are exposed to principal risk since securities are settled irrevocably in real time. Whether participants to the settlement banks also are exposed to principal risk depends on their bilateral agreements, but this is likely as settlement banks may not want to provide their participants with a true DVP when they can not limit that exposure for themselves.

CMO does not provide settlement banks with any facilities enabling them to monitor their customer and interbank payment obligations before end-of-day.</td></tr>
<tr><td>Assessment</td><td>Non-observed</td></tr>
<tr><td>Comments</td><td>CMO adds risk to the participants in the system and does not provide them with any means to manage those risks.</td></tr>
<tr><td colspan="2">Recommendation 10 – Settlement assets
Assets used to settle the ultimate payment obligations arising from securities transactions should carry little or no credit or liquidity risk. If central bank money is not used, steps must be taken to protect CSD members from potential losses and liquidity pressures arising from the failure of the cash settlement agent whose assets are used for that purpose.</td></tr>
<tr><td>Key questions</td><td>CMO operates an intermediated banking model. All members must have a CMO settlement bank. The settlement bank does not guarantee the obligations of its members.

The cash leg settles on a net basis at end-of-day in central bank money over the settlement banks accounts within the BoE.

Almost 50 percent of the interbank payments within CMO are concentrated in two settlement banks.</td></tr>
<tr><td>Assessment</td><td>Partly observed</td></tr>
<tr><td>Comments</td><td>At end-of-day, settlement takes place in central bank money. There are no procedures for managing the risk exposures connected with the settlement banks until then.

As with CREST, the high concentration of activities in two settlement banks should be noted by banking supervisors.</td></tr>
<tr><td colspan="2" align="center">Operational risk</td></tr>
<tr><td colspan="2">Recommendation 11 – Operational reliability
Sources of operational risk arising in the clearing and settlement process should be identified and minimized through the development of appropriate systems, controls and procedures. Systems should be reliable and secure, and have adequate, scalable capacity. Contingency plans and backup facilities should be established to allow for timely recovery of operations and completion of the settlement process.</td></tr>
</table>

Key questions	The CMO systems seem to be reliable. There was no failure of the key systems during last year. Hot backup ensures systems are available in minutes with full site switch availability within an hour. The CMO system is subject to only rather limited variations in operational capacity requirements. Current volumes are well within operational capability.
Assessment	Observed
Comments	
Custody risk	
Recommendation 12 – Custody risk *Entities holding securities in custody should employ accounting practices and safekeeping procedures that fully protect customers' securities. It is essential that customers' securities be protected against the claims of a custodian's creditors.*	
Key questions	The BoE acts as depository for immobilization of physical instruments. The Bank acts as bailee for each CMO member, maintaining instruments within their CMO Instruments Account. The Bank is required to keep instruments held by it properly identified or identifiable by reference to the CMO Instruments Account of a participating CMO member. Instruments are held on a non-fungible basis, identifiably separate from assets of other CMO members.
Assessment	Observed
Comments	
Recommendation 13 - Governance *Governance arrangements for CSDs and CCPs should be designed to fulfil public interest requirements and to promote the objectives of owners and users.*	
Key questions	The Annual Report and Accounts describe the system and disclose the ownership, board and management structure. It also contains a corporate governance section that states the responsibilities of the board, defines risk management procedures and the role of the board's committees including the Audit & Compliance Committee. All CREST shareholders are system users, with shares being rebalanced according to use of the system every two years. Feedback from customers is obtained and acted on by CRESTCo's Relationship Management team and through stakeholder surveys. The public interest is upheld through regular meetings between CREST and government, the BoE , the FSA, other authorities and key industry bodies.
Assessment	Observed
Comments	
Other issues	
Recommendation 14 - Access *CSDs and CCPs should have objective and publicly disclosed criteria for participation that permit fair and open access.*	

Key questions	Access to CMO is determined by the relevant CMO Membership Agreements. These are sent out to all potential applicants and are accessible through their website. Applicants who are incorporated outside the U.K. must appoint an agent for service of process who is a body corporate incorporated in England and Wales. This is to ensure that in the event of a dispute CRESTCo is not prevented or hindered from serving notices on members incorporated outside the U.K. . CRESTCo does not and can not monitor the underlying clients of its members.
Assessment	Observed
Comments	
Recommendation 15 - Efficiency *While maintaining safe and secure operations, securities settlement systems should be cost-effective in meeting the requirements of users.*	
Key questions	CMO is not a secure system and handles nonfungible instruments, which appears a burdensome activity. It also adds operational risk to participants. CMO is a manual system, which is perceived to be very costly for participants in an overall context. Feedback from customers is obtained by CRESTCo's Relationship Management team and through regular meetings with the CMO member liaison group.
Assessment	Non-observed
Comments	The current CMO system is expected to be replaced in 2003.
Recommendation 16 – Communication procedures and standards *Securities settlement systems should use or accommodate the relevant international communication procedures and standards in order to facilitate efficient settlement of cross-border transactions.*	
Key questions	CMO uses proprietary communications standards.
Assessment	Non-observed
Comments	As with other matters, the issue here will be solved when money market instruments can be properly included in the CREST system. The current CMO system is expected to be replaced in 2003.
Recommendation 17 - Transparency *CSDs and CCPs should provide market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with using the CSD or CCP services.*	
Key questions	CMO has completed the questionnaire set out in the CPSS/IOSCO disclosure framework and published it on its website. The complete rules and procedures of the CMO services are comprised of the CMO Membership Agreement and the CMO Reference Manual. External audit reports are not available for review by CMO participants.
Assessment	Partly observed

Comments	CRESTCo claimed (in both discussions and in their disclosure framework) that CMO provides DVP settlement, since a payment instruction is issued in real time when the securities leg of the transaction is settled. This is misleading (and has now been removed from the disclosure framework) since the rationale behind DVP is that it should eliminate principal risk. As noted above, this is not the case in the CMO system.
Recommendation 18 – Regulation and oversight *Securities settlement systems should be subject to transparent and effective regulation and oversight. Central banks and securities regulators should cooperate with each other and with other relevant authorities.*	
Key questions	As per Rec. 18 in the assessment for Crest (Table 1).
Assessment	Broadly observed
Comments	As per Rec. 18 in the assessment for Crest (Table 1).
Recommendation 19 – Risks in cross-border links *CSDs that establish links to settle cross-border trades should design and operate such links to reduce effectively the risks associated with cross-border settlements.*	
Key questions	CMO does not have any cross-border links.
Assessment	N/A
Comments	

188. The following table sets out the recommended actions to improve the observance of the CMO system with the CPSS/ IOSCO RSSS. As will be clear, most of these issues will be resolved once the current plans to shift MMI into the CREST system (along with the requisite underlying legal changes) are implemented. In a broader sense then, our recommendations in this area mainly reduce to one broad theme: encouraging the authorities to proceed as planned, and as soon as possible, with the migration to CREST.

Table 27. Recommended Actions to Improve Observance of CPSS/IOSCO—CMO

Reference recommendation	*Recommended action*
Rec. 1 – Securities settlement systems should have a well-founded, clear and transparent legal basis in the relevant jurisdictions. *Rec. 5 - Securities lending and borrowing (or repurchase agreements and other economically equivalent transactions) should be encouraged as a method for expediting the settlement of securities transactions. Barriers that inhibit the practice of lending securities for this purpose should be removed.*	The legislative changes necessary to make the instruments fungible should be a high priority issue for the HMT, since this is necessary to fully include CMO within CREST and thereby achieve true DVP. Being bearer instrument is a major shortcoming for developing the CMO system and developing an active securities lending market, which should be rectified. See also next recommendation.
Settlement risk *Rec. 6 – Securities should be immobilized or dematerialized and transferred by book entry in CSDs to the greatest extent possible*	A mandatory dematerialization, at least for gilts and money market instruments, would be beneficial for the market.
Rec. 7 – CSDs should eliminate principal risk by linking securities transfers to funds transfers in a way that achieves delivery versus payment.	Since principal risk is not eliminated CMO is not compliant with international standards. A fundamental change is planned for 2003 to bring CMO transactions fully into the CREST system: it is important that this change be pushed through on schedule, and it will need to be supported by action to address the fact that instruments are not fungible. In that regard, appropriate legislative changes should be made to allow achievement of DVP settlement. It is also important that these exposures receive supervisor's attention.
Rec. 8 - Final settlement should occur no later than the end of the settlement day. Intraday or real-time finality should be provided where necessary to reduce risks.	See above.
Rec. 9 - CSDs that extend intraday credit to participants, including CSDs that operate net settlement systems, should institute risk controls that, at a minimum, ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle. The most reliable set of controls is a combination of collateral requirements and limits.	See above.

Reference recommendation	*Recommended action*
Rec. 10 – Assets used to settle the ultimate payment obligation arising from securities transactions should carry little or no credit or liquidity risk. If central bank money is not used, steps must be taken to protect CSD members from potential losses and liquidity pressures arising from the failure of the cash settlement agent whose assets are used for that purpose.	As above, it is important that the planned fundamental overhaul of the CMO arrangement should be pushed through as scheduled. As per the CREST assessment, it is also important that the high concentration of interbank transaction in two settlement banks should be noted by banking supervisors.
Other issues *Rec. 15 – While maintaining safe and secure operations, securities settlement systems should be cost-effective in meeting the requirements of users.*	This should be addressed with the replacement of current CMO arrangements in 2003.
Rec. 16 – Securities settlement systems should use or accommodate the relevant international communication procedures and standards in order to facilitate efficient settlement of cross-border transactions.	This will also be solved when money market instruments can be included in the CREST system under the changes planned for 2003.
Rec. 17 – CSDs and central counterparties should provide market participants with sufficient information for them to identify and accurately evaluate the risks and costs associated with using the CSD or central counterparty services.	In the past, CMO has claimed that it provides DVP settlement, since a payment instruction is issued in real time when the securities leg of the transaction is settled. This was misleading since the rationale behind DVP is that it should eliminate principal risk. As noted above, this is not the case in the CMO system, and a correction to the CREST website in this regard has since been made. Pending the fundamental overhaul noted above, it is important that the risk in the current system is not understated. This is not prudent.
Rec. 18 – Securities settlement systems should be subject to transparent and effective regulation and oversight. Central banks and securities regulators should cooperate with each other and with other relevant authorities.	As per Rec. 18 under the assessment for CREST (Table 3)

Authorities' response to the assessments of CREST and CMO

189. **The authorities indicated that the assessment has been a valuable and effective review of the observance by U.K. SSSs of the CPSS/IOSCO recommendations**. They noted, however, a number of areas where they feel that some issues, while identified by the FSAP team and themselves as risks, can be effectively monitored (rather than removed) due to their relatively low impact (and especially when measured against the costs of remedial action). It is important to acknowledge the cost/benefit issues inherent in tackling low-impact

and non-material risks. This is relevant regarding the recommendation for the very low value of US$ settlement in Crest. The authorities, Crest and APACS have, since the assessment, discussed this issue and will continue to monitor the size of US$ flows, but feel that the values are currently too small to justify a significant and costly solution.

190. **The authorities were able to report progress on a number of areas highlighted by the IMF.** The recommendation relating to central counterparty arrangements notes that priority should be given to replacing LCH's payment scheme with one based primarily on settlement across the books of the Bank of England: detailed discussions are currently underway between the Bank and LCH. Furthermore, LCH has started to deposit its cash margin on a secured basis. The authorities and LCH are in discussion regarding how to provide further legal certainty to the small proportion of the default fund where there is currently some uncertainty regarding its treatment in the event of a member insolvency. Since the assessment was carried out, substantial progress has been made towards the implementation of money market instrument dematerialization. Most significantly, HM Treasury published a consultation paper on September 13, 2002 that incorporated detailed proposed changes to the relevant legislation (the Uncertificated Securities Regulations 2001). Comments were asked for by December 6, with the aim of achieving the necessary Parliamentary approval by end H1 2003, so that dematerialized money market instruments can start being issued and settled in CREST from September 2003 and CMO can be closed at end-2003. This high priority work will address the points raised in relation to Recommendation 6 of the Crest assessment (dematerialization of MMIs) and most of the recommended actions in the CMO assessment will become redundant.

191. **The authorities noted the IMF's observations on the supervisory regime in the U.K. and the application of the sourcebook to CREST and LCH**. They are satisfied that the FSA's current approach provides sufficient flexibility to be able to deal effectively and efficiently with the issues that arise at those institutions. They believe that this view is also shared by the institutions themselves. The FSA have taken the opportunity to compare their approach and regime to those of other European regulators as a result of the various initiatives and mergers being pursued by our exchanges and clearing houses and are satisfied that the FSA's approach compares very favorably in such circumstances.

192. Finally, the authorities also noted, in terms of a specific framework for international cooperation that the committee of European Securities Regulators provides a wide ranging mechanism for cooperation between securities commissions across the EU (and through it for cooperation with ECB on central bank/stability issues). The authorities have also been supplementing that arrangement with additional bilateral MoUs as necessary with certain EU authorities who have oversight responsibilities for clearing and settlement issues.

IX. Assessment of Anti-Money Laundering and Combating the Financing of Terrorism[22]

A. General

Information and methodology used for the assessment

193. A detailed assessment of the anti-money laundering (AML) and combating the financing of terrorism (CFT) regime of the United Kingdom was prepared by a team of assessors that included staff of the International Monetary Fund (IMF), an expert under the supervision of IMF staff, and an expert not under the supervision of IMF staff who was selected by the authorities to assess criminal law enforcement aspects of the U.K. AML/CFT regime. The assessment team examined the relevant AML/CFT laws and regulations, and supervisory and regulatory systems in place to deter money laundering (ML) and financing of terrorism (FT) among prudentially regulated financial institutions and among "money service businesses" ("MSBs", defined to include bureaux de change, money transmitters and check cashers). The assessment is generally based on the information available at the time it was completed on December 20, 2002.

194. A broad range of legal, regulatory and supervisory materials were examined in the context of the assessment, including:

- Various statutes, including the Proceeds of Crime Act 2002 ("PCA 2002"), Drug Trafficking Act 1994 ("DTA"), Criminal Justice Act 1988, as amended ("CJA"), Criminal Justice (International Cooperation) Act 1990 ("CJICA"), Terrorism Act 2000 ("Terrorism Act"), Anti-Terrorism, Crime and Security Act 2001 ("ATCS 2001"), Police Act 1997 ("Police Act"), Extradition Act 1989 ("Extradition Act"), Regulation of Investigatory Powers Act 2001 ("RIPA"), and Financial Services and Markets Act 2000 ("FSMA");

- Various statutory instruments, including the Money Laundering Regulations 1993 (the "1993 Regulations"), Money Laundering Regulations 2001 (the "2001 Regulations"), and the Terrorism (United Nations Measures) Order 2001; and

- Supervisory materials issued by the Financial Services Authority ("FSA"), including the FSA's Money Laundering Sourcebook (the "Sourcebook"), Money Laundering Theme Report, and FSA Handbook; as well as supervisory materials issued by Her Majesty's Customs and Excise ("HMCE") with respect to MSBs.

[22] Assessment of Anti-Money Laundering and Combating the Financing of Terrorism Pursuant to the October 11, 2002—AML/CFT Methodology Document.

195. In addition, discussions were held with officials and technical experts from a number of U.K. government departments and agencies, including the FSA, Her Majesty's Treasury ("HMT"), the U.K. Home Office, HMCE, the National Criminal Intelligence Service ("NCIS"), the Crown Prosecution Service, the Serious Fraud Office, City of London Police, and the Charity Commission. Discussions were also held with financial institution representatives, and with private sector experts that provide AML/CFT compliance advice to the regulated sector.

196. IMF staff members were John Abbott (MAE) and Rhoda Weeks-Brown (LEG). The team also included Paolo Constanza of the Ufficio Italiano dei Cambi, Italy, who worked under the supervision of the IMF staff; and Ted Greenberg of the U.S. Department of Justice, who handled issues related to implementation of criminal law provisions, served as the team's Independent Anti-Money Laundering Expert ("IAE") and did not work under the supervision of IMF staff.[23]

197. U.K.-wide AML legislation will be simplified in important respects once the PCA 2002 becomes effective, as the PCA would, among many other things, unify confiscation and ML provisions across England and Wales, Scotland and Northern Ireland in important respects. Nonetheless, a number of procedural differences remain (for example, owing to the fact of different court systems among U.K. jurisdictions). There are also some substantive differences (for example, the Director of the new Asset Recovery Agency provided for in the PCA 2002 generally has no role in criminal confiscation in Scotland). Nonetheless, the analysis of statutory matters in this assessment focus primarily on measures in force in *England and Wales*, as the assessors understand that comparable (even if not identical) legislation is generally in place in Scotland and Northern Ireland.

Overview of measures to prevent money laundering and terrorism financing

198. The U.K. has a strong and comprehensive legal, institutional and supervisory regime for AML/CFT. The system has been made more robust over the last few years, including through the recent passage into law of the PCA 2002 (which received Royal Assent in July 2002);[24] adoption of new legislation on terrorist financing (2000 and 2001); issuance of regulations providing a framework for the registration and limited supervision of MSBs (2001); and issuance of the FSA Money Laundering Sourcebook (2001). Further important improvements and refinements would be secured by other anticipated reforms, including the adoption of legal requirements concerning the inclusion of originator information on money

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[23] This report was prepared using the November 7, 2002 provisional version of the AML/CFT detailed assessment template. The report has not been reformatted to conform to the revised template subsequently agreed by the Fund/Bank and FATF. *Throughout this report, portions of the assessment prepared by the IAE rather than IMF staff are shown in italicized text.*

[24] As noted below, the PCA 2002 provisions concerning ML offences will become effective on February 24, 2003, while the remaining provisions of the law will become effective by May 24, 2003.

transfers originated in the U.K.; and expansion of the AML regime to cover a broader range of non-prudentially supervised entities and professions as provided for under the Second EU Directive on Money Laundering. The U.K. is compliant or largely compliant with all of the FATF 40+8 Recommendations, other than Special Recommendation VII concerning the inclusion of originator information on wire transfers.

199. The U.K.'s institutional arrangements for AML/CFT are complex. Relevant institutions include (1) the FSA, which not only has responsibility for regulatory and supervisory oversight, but also has power to initiate criminal proceedings against regulated persons for breach of the 1993 Regulations; (2) HMCE, which has recently been given responsibility for the oversight of MSBs, and additionally exercises a wide range of law enforcement and prosecution responsibilities; (3) HMT and the U.K. Home Office, each of which has responsibilities for aspects of the legal framework for AML/CFT; (4) NCIS, whose Economic Crime Unit serves as the U.K.'s FIU; (5) over 50 national and local law enforcement agencies; (6) agencies with responsibility for prosecution of ML/FT and for confiscation and other judicial proceedings, including the Crown Prosecution Service, the Serious Fraud Office and, as noted above, HMCE; and (7) a variety of additional governmental agencies and interagency groups with responsibility for various aspects of ML/FT and other serious crimes, including the National Crimes Squad and the Asset Recovery Agency provided for under the PCA 2002.

200. The multiplicity of institutions involved in AML/CFT could result in inefficiencies and in extreme cases even undermine the effective implementation of AML/CFT. For example, the government's November 2001 Asset Recovery Strategy cites poor interagency cooperation as a reason for underperformance in enforcing confiscation orders. A Money Laundering Advisory Committee ("MLAC") comprised of representatives of key government agencies, industry groups and consumer groups was recently established and is expected to significantly improve strategic level coordination between those involved in the AML/CFT regime. In addition, HMT is preparing a strategy document to set out its aims in tackling money laundering and to identify issues that need future attention. It is important that such efforts continue, in order to ensure effective, comprehensive and high-level coordination among all of the relevant departments and agencies.

201. The supervisory regime for AML/CFT applies to most persons and firms regulated by the FSA, with a notable gap resulting from the fact that general insurance companies are excluded from coverage. Enforcement of the supervisory regime was strengthened with the coming into force of the FSMA, which lists prevention of financial crime among the four statutory objectives of the FSA, and gives broad enforcement powers to the FSA including to bring criminal prosecution for breach of the 1993 Regulations.

202. Despite the strength and comprehensiveness of the U.K. AML/CFT regime, there is room for improvement and refinement in a number of the areas covered under the Fund/Bank AML/CFT Methodology. These issues, and a more detailed analysis of the U.K. system for AML/CFT, are discussed in greater detail below.

B. Detailed Assessment

203. The following detailed assessment was conducted using the October 11, 2002 version of the Methodology for assessing compliance with the AML/CFT international standard, i.e., the Financial Action Task Force (FATF) 40 Recommendations for Anti-Money Laundering and 8 Special Recommendations for Combating the Financing of Terrorism. In conformity with the Methodology, the AML/CFT framework was assessed on the basis of the following definitions.

204. A requirement is considered **compliant** whenever it is fully observed. A requirement is considered **largely compliant** whenever only discrete and non-systemic shortcomings are observed which do not raise major concerns and when corrective actions to achieve full observance with the requirement are readily identified and have been scheduled within a reasonable period of time. A requirement is considered **materially non-compliant** whenever discrete or non-systemic shortcomings are observed that are not addressed, or whenever numerous or systemic shortcomings are observed and corrective actions are identified and have been scheduled within a reasonable period of time. A requirement is considered **non-compliant** whenever the jurisdiction has not addressed the issue or has addressed it in a manner that cannot reasonably lead to substantial observance. A requirement is considered not applicable whenever, in the view of the assessor, the requirement does not apply, given the structural, legal and institutional features of a jurisdiction.

C. Assessing the Criminal Justice Measures and International Cooperation

Table 28: Detailed Assessment of the Criminal Justice Measures and International Corporation

Criminalization of ML and FT[25] **Detailed Assessment of Criteria 1-6** (Assessors are to describe and analyze each of Criteria 1-6)
Overall Description and Analysis
Recommendations and Comments
1. The U.K. should ratify as soon as possible the UN Convention Against Transnational Organized Crime 2000 (Palermo Convention). 2. The definition of ML under the 1993 Regulations (section 2(3)) should be updated to include references to the full range of ML laws that are currently in effect, as well as to the more recent laws on FT including in particular the Terrorism Act and the ATCS 2001; and to delete obsolete cross-references. *3. As there is no law enforcement entity that has as its mission the investigation of criminal acts and foreign counter-intelligence, the U.K. should seriously consider the creation of a national law enforcement organization which has both these elements.*

[25] Financing of terrorism (FT) includes the financing of terrorist acts, and of terrorist organisations.

<table>
<tr><td colspan="2">4. Consideration should be given to passing legislation that makes wiretap evidence admissible in judicial proceedings.

5. Special legislative considerations should be given to protecting national security information while balancing the defendant's right to have access (in some form) to relevant evidence.</td></tr>
<tr><td colspan="2">Criterion 1</td></tr>
<tr><td>Description and Analysis</td><td>The U.K. has signed and ratified the UN Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances 1988 (Vienna Convention), the UN International Convention for the Suppression of the Financing of Terrorism 1999, and the Strasbourg Convention. It has signed and is in the process of ratifying the Palermo Convention. The U.K. has also entered into force the 1990 Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds of Crime. Separately, the U.K. has implemented the United Nations Resolutions relating to the prevention and suppression of the financing of terrorist acts, including in particular UN Security Council Resolution 1373 (see the Terrorism (United Nations Measures) Order 2001)</td></tr>
<tr><td colspan="2">Criterion 2</td></tr>
<tr><td>Description and Analysis</td><td>U.K. law generally criminalizes money laundering on the basis of the Vienna and Palermo Conventions (in the latter case, despite the current non-ratification of the Palermo Convention noted earlier).

When it becomes effective, the PCA 2002 would update, unify and expand U.K. ML offenses, inter alia, by expanding the criminal intent requirement for failure to report in the regulated sector to include having reasonable grounds for knowledge or suspicion of ML (see discussion under Criterion 55). The PCA 2002 would also remove the distinctions between drug and non-drug ML and between one's own and another's proceeds of crime; and consolidate into one statute the dispersed provisions of U.K. law that currently govern criminalization of ML The PCA 2002 institutes new principal money laundering offenses related to (1) concealing, disguising, converting, transferring, or removal from jurisdictions within the U.K. of criminal property, (2) entering into arrangements to facilitate the acquisition, retention, use or control of criminal property by or on behalf of another person, and (3) acquiring, using or possessing of criminal property (sections 327-329). It also includes a tipping-off offense (section 333). (Separately, as discussed in detail below, the PCA 2002 also institutes new crimes for failure to disclose knowledge or suspicion of, or in some cases reasonable grounds for knowing or suspecting, money laundering (sections 330-332).) The PCA 2002 defines criminal conduct broadly to include any conduct that is a crime in any part of the U.K. or that would constitute an offense in any part of the U.K. if it were to occur there (section 340(2)). It also defines money laundering not only to include the three principal offenses summarized above, but also inchoate conduct related to these, including attempting, conspiracy or incitement to commit one of the principal ML offenses; and aiding, abetting, counseling or procuring the commission of one of the principal offenses (section 340 (11)).

The PCA 2002 provides that its provisions will generally come into force in accordance with provision made by the Secretary of State by order. Part 7 of the PCA 2002, which establishes the ML offences noted above, has not yet come into effect (the intention of the government is that these provisions will become effective on February 24, 2003, and the remaining provisions of the PCA will all be fully in effect by May 24, 2003). Because the new ML offences summarized above are not yet effective, the following discussion summarizes the pre-PCA 2002 statutory regime governing disclosure of suspicious transactions, which remains in force until Part 7 is effective.

The currently effective U.K. legislation criminalizing money laundering is contained in sections 49-53 of the DTA and sections 93A-93D of the CJA, as well as in the Terrorism Act. In general, the CJA makes it a criminal offense: (i) to assist another person to retain the benefit</td></tr>
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	of criminal conduct; (ii) to acquire, possess or use property that represents another person's proceeds of criminal conduct; (iii) to conceal, disguise, convert or transfer property that is or represents one's own or another person's proceeds of criminal conduct; or (iv) to "tip-off" another person by providing information about an actual or prospective money laundering investigation. Predicate crimes are defined to include both serious crimes ("indictable" offenses in the U.K. criminal system, which are capable of being tried in Crown Court) and also certain less serious summary offenses (CJA section 71(1E)). The DTA criminalizes the same ML conduct as the CJA, but in connection only with drug trafficking predicate offenses. (As discussed below, the DTA also contains an additional crime of failure to disclose knowledge or suspicion of drug trafficking-related money laundering where information comes to a defendant's attention in the course of his trade, profession, business or employment.) There are separate U.K. statutes that criminalize various inchoate offenses, including attempted crimes, counseling and procuring the commission of crimes, conspiracy to commit crimes, and aiding and abetting the commission of crimes. Conviction of a predicate offense is not a requirement for a ML prosecution. The ML offenses under U.K. law generally apply even where a predicate crime occurred extraterritorially, so long as such conduct would constitute a crime it they had occurred in the U.K. Separately, as discussed in detail below, the 1993 Regulations impose criminal liability on prudentially regulated financial institutions, MSBs and a broad range of other financial services providers that fail to maintain certain internal AML controls (Regulation 5). For purposes of these AML internal controls requirements and other provisions of the 1993 Regulations, "money laundering" is defined as any act that would constitute an offense under various criminal statutes (including most of the ML provisions of the CJA other than the section regarding tipping off). Some critically important ML criminal provisions appear to have been inadvertently excluded from this definition, however, including sections 49-54 of the Drug Trafficking Act (the primary provisions that currently govern drug ML, as noted above), and FT-related ML under recent statutes such as the Terrorism Act. This would suggest that the Regulations currently could not be applied where, for example, a financial institution's failure to adopt AML controls leads to perpetration of the offences under these statutes. The exclusion of FT-related ML raises a particular technical concern since, as discussed below, there is no parallel regulation similar to the 1993 Regulations that is applicable to CFT systems and controls.
Criterion 3	
Description and Analysis	The U.K. generally criminalizes FT on the basis of the Convention for the Suppression of the Financing of Terrorism. More specifically, the laws relating to FT make it a crime: (i) to invite another person to provide or receive money or other property for the purposes of terrorism; (ii) to use money or other property for the purposes of terrorism; or (iii) to be part of an arrangement as a result of which money or other property is made available to another for the purposes of terrorism. (Sections 15-17 of the Terrorism Act 2000). The Terrorism Act also makes laundering of terrorist property a further predicate crime for ML (TA section 18). For purposes of these provisions on criminalization of terrorism, the FT offence applies when the terrorists or terrorist organizations are located in another jurisdiction, and where the terrorist acts take place in another jurisdiction.
Criterion 4	
Description and Analysis	The state of mind for most U.K. ML and FT offenses is "knowledge" or "suspicion", the exceptions being for acquisition, possession and use of proceeds of crime (for which "knowledge" is the only standard); concealing or transferring proceeds of crime (for which the test is knowledge or having reasonable grounds to suspect); and FT under the Terrorism Act and ATCS 2001 (which can be triggered by either knowledge, suspicion or the existence of reasonable grounds for knowing or suspecting). This would continue to be the case after the

	PCA 2002's new ML offenses become effective, except that the criminal intent requirement for failure to report in the regulated sector will be expanded to include having reasonable grounds for knowledge or suspicion of ML. Under U.K. law, "knowledge" can be inferred from objective factual circumstances. Legal entities such as corporations and companies can be charged and convicted of both ML and FT. However, criminal liability for such "mens rea" crimes generally can be attributed to a legal person only in cases where an officer with a high level of authority within the company possessed the particular mental state required for the crime.
Criterion 5	
Description and Analysis	Breach of the DTA and CJA provisions concerning concealing or transferring proceeds of crime, assisting another person to retain the benefit of crime, and acquisition, possession or use of proceeds of crime is subject to sanctions ranging from a statutorily set fine and/or six months imprisonment (in cases of summary conviction) to an unlimited fine and/or imprisonment of up to 14 years (in cases of conviction on an indictment) (DTA section 54(1); CJA sections 93A(6), 93B(9), 93C(4)). A person convicted of FT is liable for substantially similar sanctions. Breach of the provisions governing tipping-off are subject to the same penalties as those described below for failure to report suspicion of DTA money laundering (i.e., for summary convictions, statutory fine and/or jail term of up to six months; for convictions on indictment unlimited fine and/or five years imprisonment) (DTA section 54(2); CJA section 93D(9)). Similar sanctions would apply under the PCA 2002 once Part 7 becomes effective. In addition to the statutes described above, a prudentially regulated financial institution or other financial services provider that fails to comply with the 1993 Regulations' requirements to maintain adequate AML controls may be punished by up to two years in prison and/or an unlimited fine (section 5(2)).
Criterion 6	
Description and Analysis	*All elements of U.K. legislation relating to ML and FT have been substantially reviewed in the last two years. This has led to the development of new legislation in the Terrorism Act, ATCS 2001, and the more recent PCA 2002. Reviews and reports preceding legislative changes have involved all the agencies and authorities with an interest in AML and CFT, and where deficiencies or barriers have been identified preventing effective implementation, these have been reviewed and addressed by the appropriate agency.* ***International:*** *The U.K. has fully implemented the provisions of the Vienna Convention. The enactment of the Terrorism Act enabled the U.K. to sign and ratify the Convention on the Suppression of the Financing of Terrorism. The U.K. has not yet ratified or supplemented the Palermo Convention but it is already fully compliant with the mandatory AML provisions of this Convention (which also requires that States consider a cross-border cash reporting system, which the U.K. does not have). Only changes to extradition capabilities (for which legislation is pending) are required to enable the U.K. to fully ratify the Convention.* *Under Schedule 4 of the Terrorism Act, amended by the ATCS 2001, terrorist assets can be frozen when a criminal investigation has been started and where it appears to a U.K. court that a forfeiture order may be made. A forfeiture order can be made by a court where a person is convicted of a terrorist financing offence and the money or other property was intended for the purposes of terrorism.* *The U.K. implements decisions of the UN Security Council under the United Nations Act 1946. UNSCR 1373 is implemented by the Terrorism (United Nations Measures) Order 2001. Where HMT has reasonable grounds for suspecting that the person by, for or on behalf of whom funds are held is or may be a person who commits or facilitates terrorist acts, or is controlled by such a person, or acts on behalf of such a person, HMT may direct that those funds are not*

	to be made available to any person. *<u>Analysis</u>: The U.K. is to be commended for being one of the first countries to ratify and implement the Convention for the Suppression of the Financing of Terrorism.* ***Domestic:** HMT (the U.K.'s Finance and Economics Ministry) leads for the U.K. in international bodies (e.g. the FATF, the European Union), issues the U.K.'s Money Laundering Regulations (1993 and 2001) and has joint government lead, with the Home Office, on AML policy. The Home Office (the U.K.'s Justice and Interior Ministry) is responsible for the U.K. primary legislation setting out the criminal law on money laundering and terrorist financing.* ***FIU**: NCIS is the U.K.'s central Financial Intelligence Unit and generally is the recipient of suspicious transaction reports. It also has a Terrorist Finance Unit to co-ordinate intelligence on terrorist financing.* ***Law Enforcement:** The Police and HMCE are responsible for investigating money laundering and terrorist financing cases, with assistance where necessary from the U.K.'s intelligence services. HMCE also operates the supervision of MSBs under the 2001 Regulations. The Crown Prosecution Service, Serious Fraud Office, HMCE and FSA are all prosecuting authorities.* ***Regulatory:** The FSA makes and enforces Rules to which financial firms it regulates (nearly 11,000 in total) are subject. It also has powers to bring criminal prosecutions for breaches of the 1993 Regulations (but not the primary money laundering law).* *<u>Analysis</u>: Given the overall resources that are available to the FSA, they did not make a compelling argument as to why more regulated financial institutions have not been subjected to an on-site ML compliance program review.* *Currently there are 43 Police Constabularies in England & Wales, 8 in Scotland and 1 in Northern Ireland. While the Metropolitan Police Service (MET) has some national functions, these are limited and the MET is in no sense the force with overall responsibility for dealing with ML or FT in the U.K.* *Some U.K. agencies also have 'national' remits, related to Ml and FT though without the 'national' designation: These include HMCE, Serious Fraud Office, FSA and the Secret Intelligence Service.* *It is unclear whether there are sufficient resources to investigate ML. There is no single law enforcement entity that covers all aspects of ML in the U.K. (The nearest is HMCE for drugs ML). In order for the regulatory approach to be used as a deterrent to ML the FSA should re-think its apparent total reliance on a risk-based approach. Also, there is no law enforcement entity that has as its mission the investigation of criminal acts and foreign counter-intelligence. The U.K. should seriously consider the creation of a national law enforcement organization which has both these elements.* *With the exception of the work done by HMCE at developing their own strategy to identify, target, disrupt, prosecute and forfeit the assets of drug money launderers there is no national strategy to attack ML and FT. The IAE understands, however, that one is in preparation.* *U.K. authorities were unable to provide statistics regarding ML or FT investigations or prosecutions generally. The only current statistics provided (2000) indicate 117 drug cases involving the proceeds of drug trafficking and 39 convictions. Confiscation order receipts for*

	2000-01 show a drop from 19,833,000 pounds from 25,0444,000 in 1999-2000. In 2000-2001, the U.K. froze ₤ 70 million of assets under the Taliban, Al-Qaeda and Terrorism (UN Measures) Orders. ***Investigative Techniques:*** *U.K. legislation allows for a wide range of investigative methods for conducting ML and FT investigations. In particular, RIPA provides for lawful authorization of interception of communications, access to communications data and use of covert surveillance and covert human intelligence sources by listed public authorities for specific statutory criteria (e.g. prevention of crime, national security etc). RIPA has so far not been successfully challenged under the European Convention on Human Rights and The Human Rights Act (there are applications pending at the ECHR).* *Analysis: The U.K. has all of the undercover means to conduct productive investigations. HMCE is particularly innovative in identifying targets for investigation and in executing investigations.* *However, wiretaps are carried out under Ministerial authorization and are not admissible as evidence in any judicial proceeding. This is an unnecessary impediment to successful prosecution of cases in court because it deprives the prosecutor of the best evidence - the voices of the witnesses and defendants. Equally important it undoubtedly adds additional burdens on the investigators and causes delays in investigation and prosecution because of the necessity of developing parallel sources to develop evidentiary information to substitute for what is on the wiretaps. Consideration should be given to passing legislation that makes wiretap evidence admissible in judicial proceedings. Special legislative considerations should be given to protecting national security information while balancing the defendant's right to have access (in some form) to relevant evidence.* ***Production of bank records, search and seizure:*** *Domestic legislation is fully compliant with this requirement and provides law enforcement with powers to serve summonses, judgments and other procedural documents, obtain witness statements on oath, obtain authenticated documentary evidence including banking evidence and financial transaction records through production orders, and to exercise search and seizure powers.* *The main provisions used to investigate accounts or records suspected of being associated with terrorism are customer information orders under Schedule 6 of the Terrorism Act and account monitoring orders under Schedule 2 of the ATCS 2001. Customer information orders require banks etc. to provide information on such matters as: whether bank accounts in specified names exist, relevant account numbers, customer addresses, evidence of identity and details of joint account holders. Account monitoring orders require banks etc. to provide law enforcement specified information at specified times in relation to specific accounts. This will generally mean in practice information in respect of various transactions which take place in an account over a set period of time.* *The 2001 Regulations allow HMCE to require MSBs to furnish it with documentation necessary to assess compliance with the 1993 Regulations. With respect to the 2001 Regulations—but not with respect to the 1993 Regulations—HMCE can levy a civil penalty on operators who fail to comply.* *When it becomes effective, the PCA 2002 will enable customer information and account monitoring orders to be obtained for all other offences which are the subject of a confiscation or money laundering investigation.* *Analysis: While the U.K. has the statutory means necessary to compel production of financial records the IAE was not provided with any examples of when and how the investigative tools*

	are pro-actively used to investigate ML or FT. Generally it appears that U.K. authorities have been totally reactive, rather than engaging in pro-active targeting of money launderers. *An important and innovative provision of the recent PCA 2002 is the provision for Account Monitoring Orders. Appropriate and consistent use of this tool should lead to a substantial increase in the investigation and prosecution of ML cases and the confiscation of assets.* ***Court Proceedings:*** *Under U.K. law, witnesses can be compelled to attend court in most cases involving ML and FT. However, the U.K. law recognizes a number of cases where it would not be appropriate to compel attendance, and these include cases involving privileged evidence, and the evidence of accused persons.* *Sanctions (such as contempt of court) are available against recalcitrant witnesses. Although a suspect or defendant must be reminded of his right not to testify before being asked questions, in some legal systems the fact of a suspect's refusal to testify is of evidential value. Assistance would be offered in such cases.*

Confiscation of proceeds of crime or property used to finance terrorism

Detailed Assessment of Criteria 7-16 (Assessors are to describe and analyze each of Criteria 7-16)

Overall Description and Analysis
Recommendations and Comments
1. The PCA 2002 provisions governing confiscation, seizure, assets recovery and civil recovery should be made effective as soon as possible, given the significant enhancements it makes to the U.K. regime (inter alia, by improving the procedures governing confiscation of the proceeds of crime; providing for the restraint (freezing) of assets at any time during a criminal investigation; expanding the scope for civil recovery of property obtained through unlawful conduct; and by making available in all criminal proceedings the more robust investigative tools of account monitoring orders and customer information orders).

Criterion 7

Description and Analysis	The DTA and CJA allow for the freezing (or "restraint") and confiscation of proceeds of all ML predicate crimes (DTA section 2 (confiscation), 25-26 (restraint); CJA section 71 (confiscation), 76-77 (restraint)). These laws provide courts with the power to confiscate the proceeds of predicate crimes following conviction, and also allow for restraint orders to be made where proceedings have been instituted for these same offenses. In calculating the amount to be confiscated, the court must determine whether the defendant has benefited from a crime and if so, order the defendant to pay the amount by which he has benefited. The law, however, also provides an "assumption" procedure that allows the court under certain circumstances to assume that all assets held by a defendant at any time since his conviction, or transferred to him at any time from six years before the proceedings began, were derived from crime, and that any expenditure during that period was also based on criminal proceeds; the confiscation order is set in the amount derived from these calculations (DTA section 4; CJA section 72AA). The PCA 2002 would enhance the scope of cases under which the assumptions procedure may be used by generally making the procedure mandatory (subject to certain exceptions). The Terrorism Act provides for forfeiture proceedings following a conviction for any of the FT offenses in the Act (Schedule 4), and also provides for the seizure of cash that is intended for use in terrorism, including FT. Similarly, the ATCS 2001 provides for the pre-proceedings seizure of terrorist cash and for the issuance of restraining orders in regard to such cash (Part 1, Schedules 1 and 2). The Terrorism (United Nations Measures) Order 2001, issued pursuant to UN Security Council Resolution 1373, provides parallel authority for HMT to freeze accounts of suspected terrorists where HMT has reasonable grounds for suspecting that the person by, for or on behalf of whom any funds are held is or may be involved directly or indirectly in the commission of acts of terrorism or may be acting on behalf of or at the

	direction of such a person. Separately, the authorities report that assets used in the commission of FT have also been caught under section 143 of the Criminal Courts Act 2000, which authorizes forfeiture of property that is used to perpetrate a crime;. Except for the FT-related crimes mentioned above for which pre-proceeding restraint orders can be obtained, U.K. law previously did not allow for issuance of restraint orders until criminal proceedings had been initiated or were imminent. However, the PCA 2002 would make it possible to obtain restraint orders at any time during a criminal investigation. In all cases, confiscation can take place only after conviction of the relevant crime. Separately, HMCE and the police have authority under the DTA (section 42) to seize cash being imported or exported if there is reasonable ground to suspect that such cash represents the proceeds of drug trafficking or is intended by any person for use in drug trafficking. Seized cash can be detained for a period of up to two years and can be forfeited by means of a judicial order where the Court is satisfied that the origin or intended use of the funds is drug trafficking. The PCA 2002 would expand these seizure powers to cover movements of suspect cash (broadly defined to include not only currency but also postal orders, cheques, bankers' drafts, bearer bonds and shares, and certain kinds of monetary instruments) within the U.K. (rather than only at the border). The PCA 2002 would also authorize the seizure of property related to crimes other than drug trafficking (section 289). The restraint and confiscation provisions of the U.K. laws apply to proceeds of and property derived from criminal activity and to assets related to FT as described above. There are also separate laws dealing with forfeiture of specific items used or intended to be used in the commission of certain crimes, including the Misuse of Drugs Act 1971, the Powers of Criminal Courts (Sentencing) Act 2000, the Customs and Excise Management Act 1979 and the Immigration and Asylum Act 1999. U.K. law has no specific provisions authorizing the freezing or confiscation of assets of organizations that are found to be primarily criminal in nature. However, companies can be prosecuted under the criminal laws including for conspiracy, and assets of these companies can be restrained and/or confiscated where the generally applicable requirements for restraint/confiscation are met. A U.K. confiscation order is a value order that makes no link between an asset subject to confiscation and its availability or otherwise. As such, a confiscation order can be enforced against any kind of property, regardless of whether it has been legally or illegally obtained. Current U.K. laws have only limited provisions for the confiscation of criminal assets pursuant to a civil process (including the DTA section 42 border forfeiture proceedings described above). However, the PCA 2002 provides for broader civil recovery powers, and for establishment of a new Asset Recovery Agency (ARA) with broad powers to seek civil recovery of property that has been obtained through unlawful conduct. Such civil recovery would not be conditional on any person having been convicted of a crime. The ARA would also exercise functions focused on increasing criminal confiscation and taxing the proceeds of crime (generally in cases where confiscation and civil recovery are not available).
Criterion 8	
Description and Analysis	Under U.K. law, a range of orders are available, upon application to a judge and on the satisfaction of certain conditions, to assist in identifying and tracing criminal assets. Under the ATCS 2001, a customer information order can be issued allowing an investigating officer to approach all (or a targeted sample of) financial institutions to find out if they have any accounts held by a person under investigation for FT; and an account monitoring order can be issued requiring financial institutions to provide transaction information on an FT-suspected

	account for a specified period of up to 90 days (Schedule 2). Separately, in any criminal investigation, a judge may issue a production order requiring named persons to produce specified material deemed valuable to the investigation (DTA section 55, CJA section 93H); and a search and seizure warrant can be issued where material is not produced pursuant to a production order or if it is impracticable to serve such an order (DTA section 56; CJA section 93I). The Serious Fraud Office (and under the PCA 2002, the Asset Recovery Agency) also has power to obtain a disclosure order requiring specified persons to explain information and produce documents during the course of an investigation. When the relevant provisions of the PCA 2002 become effective, the customer information and account monitoring orders described above (which previously were available only for FT and other terrorism investigations) would be available for use in all ML-related criminal investigations.
Criterion 9	
Description and Analysis	As regards protecting the rights of innocent or bonafide third parties, U.K. law allows any person affected by the making of a restraint order under the DTA or CJA to apply to the issuing court for the order to be varied or discharged (DTA section 26(6); CJA section 77(7)). More generally, third parties are protected throughout the criminal proceeding by so-called "legislative steer" provisions of the DTA and CJA, which require that third parties be allowed to recover their interest where any property in which they hold an interest is subject to restraint or realization action (DTA section 31(4), 62(5); CJA section 82(4), 102(7)). Furthermore, in cases where there is a victim of the criminal conduct concerned or third party claims to the funds involved, and the court is satisfied that civil proceedings have been instituted or will be instituted for recovery in connection with these matters, the criminal court is under a duty to consider issuance of a "compensation order" to enable eventual payment to such victim or other third party from the available funds (CJA section 71(1C)). Such a compensation order has first call on any funds that are confiscated in connection with the particular crime. Separately, Schedule 4 of the TA 2000 enables persons with an interest in any property that has been subject to a forfeiture or restraint order under the Schedule to apply to a court for compensation. Such compensation is to be granted where a restraint order has been discharged; where a restraint order is made in relation to expected proceedings that are not instituted; or where an organization proscribed as a terrorist organization under the Terrorism Act is subsequently "deproscribed". The Terrorism (United Nations Measures) Order 2001 also confers a right of appeal to the High Court by any person whose funds are frozen following a direction given by HMT pursuant to that Order (Article 4 (7)).
Criterion 10	
Description and Analysis	U.K. confiscation legislation provides that gifts may be recovered in satisfaction of a confiscation order, including any property that has been passed to another at undervalue by means of a contract. The PCA 2002 allows the new ARA to follow and recover tainted property that has been transferred (including by contract or gift), subject to appropriate safeguards for the rights of innocent third parties.
Criterion 11	
Description and Analysis	***Confiscation:*** *In U.K. legislation a restraint (freezing) order prevents an individual from dealing in any "realizable property" (i.e. any property held by the defendant or by a person to whom the defendant has made a gift). There is on the whole no assessment of the value of assets under restraint at this stage, although in many cases the court will appoint a receiver to take possession of, manage or deal with any property. In these and other cases the value of assets in question may be assessed. In investigations of ML and FT, simultaneous financial investigations will usually occur, which will detail assets believed to have resulted from the criminal activity/ies being investigated.* As the purpose of a restraint order is to preserve sufficient realizable property to satisfy any confiscation or forfeiture order that may be made against the defendant, the maximum amount

	of realizable property that can be restrained is the maximum amount in which any confiscation or forfeiture order can be made. At the restraint stage, in order to ensure that restraint order covers sufficient realizable property, an assessment of the value of the assets under restraint and of the likely amount of the confiscation order is made. There is no central record of the amounts of assets held under restraint. Analysis: *Confiscation has not been a priority of the U.K. Crown Prosecution Service (CPS). Even now the CPS has virtually no resources to handle confiscation matters. Of the 600 cases that were presented to the Central Confiscation Branch in ['91] only 300 were considered for enforcement and only when there was no likelihood that the case would be seriously contested or complicated. There is no government property management system so the confiscation of perishable items like air and water craft is not pursued.* ***Terrorist Financing:*** *The U.K. has fully implemented the terms of all UNSCRs relevant to the prevention and suppression of FT. The U.K. has listed over 100 organizations and over 200 individuals. Prior to the fall of Kabul, the U.K. froze a total of £70 million relating to the Taliban, Osama Bin Laden and Al-Qaeda. £7 million of this was frozen after the events of 11 September 2001. Details of the amounts of assets frozen and numbers of individuals or entities whose assets have been frozen are held by the Bank of England.*
Criterion 12	
Description and Analysis	*Selected individuals within law enforcement agencies currently receive a three phase training program in financial investigation, which includes aspects of money laundering. Upon completion they are included on a National List of Financial Investigators.* *As discussed in this assessment, when it becomes effective, the recent PCA 2002 would modernize and replace the existing criminal confiscation and ML laws presently contained in various pieces of legislation. The introduction of this legislation to Parliament prompted a national review of financial investigation training and created a Centre of Excellence with responsibility for its delivery.* Resources have been channeled into a number of training initiatives throughout the U.K. to prepare interested parties for the coming into effect of the PCA 2002. Key features of this program include: ➢ the setting up by the Government of a national Centre of Excellence in Financial Investigation. The Centre will be part of the new Assets Recovery Agency and its role will be to train financial investigators in the Police, HMCE and other Government bodies and to accredit them to perform various functions provided for in the PCA 2002; ➢ in-house training programs for staff in the Crown Prosecution Service, HMCE and other prosecutors; ➢ training initiatives for the judiciary in the implications for them of the new legislation. *The thinking behind these actions is that the training of those responsible for implementing the new legislation will be crucial to its success.* *Financial investigators operating within law enforcement were scheduled to receive training in the PCA 2002 between September and December 2002. The aim of this program is to ensure that all current financial investigators are fully equipped to use the confiscation, ML and restraint/freezing powers, which will be available to them following the implementation of the PCA 2002.* *A separate new training program is being developed for all newly appointed financial investigators, which will be delivered from December 2002. Training will also be available for accredited (certified) financial investigators working within other enforcement agencies.*

	The ARA provided for in the PCA 2002 possesses additional powers for the tracing of criminal assets. Individuals working within the ARA will be trained to a higher level in these competencies, which will be built on the training programs for both law enforcement and Accredited Financial Investigators. *The U.K. has had ML provisions, in one form or another, since 1986 which allows both police and customs investigators to investigate ML. As a matter of best practice only those that have undertaken specific training in this area have been placed on an 'approved' list of financial investigators (this list is overseen by NCIS). Changes in the PCA 2002 would place this 'best practice' on a statutory footing.* *Analysis: Apparently outside a core group in HMCE and the NCIS/ ECU, there is no current comprehensive training program that addresses ML or FT in the law enforcement agencies or the FSA. The proposed plans should rectify this situation and provide the U.K. with a full range of experienced officers to investigate and prosecute ML and FT.*
Criterion 13	
Description and Analysis	As noted above, in addition to the statutes authorizing FT-related restraint and confiscation, the Terrorism (United Nations Measures) Order 2001, issued pursuant to UN Security Council Resolution 1373, provides parallel authority for HMT to freeze accounts of suspected terrorists where HMT has reasonable grounds for suspecting that the person by, for or on behalf of whom any funds are held is or may be involved directly or indirectly in the commission of acts of terrorism, or may be acting on behalf of or at the direction of such a person.
Criterion 14	
Description and Analysis	As noted above, U.K. law authorizes the identification and restraint of the property of suspected terrorists, those who finance terrorism and terrorist organizations, even where the names of such persons do not appear on lists maintained by the relevant committees of the UN Security Council.
Criterion 15	
Description and Analysis	See discussion above.
Criterion 16	
Description and Analysis	U.K. law does not contain any express provisions prohibiting the sharing of confiscated property with other jurisdictions, and the authorities indicate that the government is free to enter into arrangements, on a case-by-case basis, for sharing the proceeds of an external confiscation order that has been successfully enforced in the U.K. In addition, the U.K. has specific arrangements with the United States and Canada for the sharing of confiscated assets that result from coordinated law enforcement actions.

The FIU and processes for receiving, analyzing, and disseminating financial information and other intelligence at the domestic and international levels

Detailed Assessment of Criteria 17-24 (Assessors are to describe and analyze each of Criteria 17-25)

Overall Description and Analysis
Recommendations and Comments
1. The PCA 2002 should be made effective as soon as possible, given its substantial enhancements to the arrangements under which NCIS exercises its functions (inter alia, by requiring all financial institutions and MSBs to file suspicious transactions reports only with NCIS; by providing for issuance of a standard form for suspicious transactions reporting and for the possibility for NCIS to receive additional information from filers; and by giving NCIS broader powers to prevent the carrying out of suspicious transactions where reports are filed with it before the transaction has been executed.) 2. NCIS (or another appropriate government agency) should be given authority to impose civil fines on reporting

parties—other than prudentially regulated financial institutions—that fail to comply with their reporting obligations under the 1993 Regulations. As it is now, the FSA has significant authority to impose civil sanctions on financial institutions, but the only STR-related sanctions for non-FSA firms is criminal. (HMCE can impose civil fines on MSBs only for a narrow range of matters that do not include STRs.)

3. Consideration should be given to providing NCIS with the power to get supporting documents (rather than only general information) from reporting parties that file STRs with it. The PCA 2002 does not seem to enable this limited additional power, which is an important analogue to NCIS' ability to investigate and gather intelligence concerning transactions reported to it.

Criterion 17

Description and Analysis	A national FIU was first established in the U.K. in 1987 with responsibilities focused on proceeds of drug trafficking. These functions have evolved in line with AML legislation and now cover matters relating to all ML predicate offences, including drug trafficking, terrorism and other serious crimes. The Economic Crimes Branch of NCIS currently functions as the U.K.'s FIU. The Police Act provides for establishment of NCIS. The functions of NCIS, as described in the Act, include gathering, storing and analyzing information in order to provide criminal intelligence; providing criminal intelligence to U.K. police forces, the National Crime Squad and other law enforcement agencies in the U.K.; and acting in support of these agencies in carrying out their criminal intelligence activities (Police Act section 2(2)). In practice, NCIS acts as the national point for receipt, analysis and dissemination of suspicious transaction reports. Among other related activities, it maintains a financial intelligence database; conducts strategic analysis of ML trends and issues within the U.K.; engages in proactive intelligence development of high-profile ML cases; acts as a technical advisor to Government departments on ML-related matters, and as a liaison to financial institutions; provides advice to HMT and other government departments on ML and FT policy and necessary amendments to legislation; provides training to law enforcement and the financial sector within the U.K. and abroad on ML issues; is responsible for the co-ordination of law enforcement input into the U.K.'s FATF delegation; and acts as the secretariat of the Egmont Group, in addition to chairing one of its sub-groups. NCIS also contributes to the production of case studies and other material that assist the government in reviewing AML policy, and industry in its production of guidance for the prevention and detection of money laundering (e.g. NCIS provides key advice and input during preparation of the typology sections of the JMLSG Guidance Notes discussed below). As discussed below, the 1993 Regulations do not currently require financial institutions and MSBs to file suspicious reports with NCIS, but rather with any "constable" in the U.K. (although FSA-regulated firms are expressly required under the FSA Sourcebook to file suspicious reports with NCIS). The PCA 2002 would change this by requiring that "nominated officers" in the regulated sector or otherwise file suspicious transactions reports only with a person authorized by NCIS to receive such reports. The statute does not per se mandate filings with NCIS, but the authorities have indicated that NCIS is likely to designate itself for purposes of receiving suspicious transactions reports once the relevant provisions of the PCA 2002 enter into force. Further, the authorities indicate that, even under the current regime, the vast majority of STRs are filed with NCIS and that, even when filed with other law enforcement agencies, STRs are usually forwarded to NCIS pursuant to informal arrangements between NCIS and the other agencies. As discussed below, there is currently no standard nationwide form in the U.K. for the reporting of suspicious transactions (although NCIS has a recommended reporting format that is reportedly used by most financial institutions and MSBs). This would change once the relevant provisions of the PCA 2002 enter into force, as the PCA authorizes the Secretary of

	State to prescribe the form and manner in which suspicious ML reports are to be made both by persons in the regulated sector or otherwise (section 339). The authorities expect that regulations to this effect, and a standard form for the reporting of suspicious transactions pursuant to the PCA 2002, will be issued shortly. Under the existing arrangements, high volume reporting institutions have electronic links to NCIS for reporting of suspicious transactions, and a project under development would expand electronic reporting to medium-level disclosing institutions. There is also a telephone 'hotline' for raising urgent queries with an NCIS desk officer.
Criterion 18	
Description and Analysis	Reporting parties are encouraged to provide detailed information in reports of suspicious transactions that are filed with NCIS. NCIS lacks authority to mandate the production of additional information or documentation needed to assist in its analysis of particular transaction(s). However, it can obtain additional information and documents from reporting parties, inter alia, by seeking a court order, where there are reasonable grounds to suspect ML, FT or other serious crimes. In addition, the PCA 2002 provisions authorizing the Secretary of State to prescribe the form and manner in which suspicious reports must be made also provides that the form may include a request to the discloser to provide specified additional information necessary to enable the person to whom the disclosure is made (presumably NCIS in most cases) to decide whether or not to start a ML investigation.
Criterion 19	
Description and Analysis	As noted above, the U.K. FIU is an integral part of NCIS, which co-ordinates all serious crime intelligence for the U.K. As such, the U.K. FIU has access to a wide range of data both for comparison with STRs and as an independent source of ML intelligence through which it may initiate cases and undertake analyses. NCIS has authority to access a broad range of data sources, including credit reporting records; business/corporate, real property and vehicle registries; police charge sheets and criminal records; and immigration and customs records.
Criterion 20	
Description and Analysis	NCIS lacks the power to order sanctions or penalties against reporting parties for failure to comply with their reporting obligations. Within the U.K. AML/CFT framework, however, these are not contemplated as powers of the FIU, but rather of other agencies. For example, the FSA and HMCE have inspection and sanctions powers over institutions supervised by them (although, as noted below, no similar agencies exercise such powers in respect of other financial services providers covered by the 1993 Regulations). As discussed earlier, criminal sanctions may be imposed for failure to observe the suspicious transactions reporting and other AML controls aspects of the 1993 Regulations. The ability to freeze or block transactions are currently treated as prerogatives to be exercised only by a limited number of law enforcement agencies (although the PCA 2002 has expanded the range of persons who can exercise some of these powers to include qualifying "financial investigators" approved by the new ARA). In cases where a regulated entity files a suspicious transaction report before a transaction takes place, the PCA 2002 also gives powers to NCIS either to issue a "consent" for the transaction or to withhold its consent; if consent is withheld, NCIS has 31 working days to seek a restraint order from a court concerning the transaction. Separately, NCIS gathers information on the quality of suspicious transaction reports, comparisons of institutions against peer group reporters, and evidence of non-reporting by specific institutions, and can pass on such information to the FSA and HMCE for appropriate sanctions and other regulatory action.
Criterion 21	
Description and Analysis	Dissemination of criminal intelligence and other information to U.K. law enforcement agencies is among the core statutory functions of NCIS. Such information can be disseminated either upon NCIS' own initiative or upon the request of other agencies (e.g., pursuant to the various arrangements that exist for collaboration and assistance between NCIS and domestic police forces). Information provided by NCIS may be used for more extensive investigations

	and appropriate follow-up action not only with respect to ML and FT, but also other serious crimes. NCIS and FSA have entered into an agreement (2001) aimed at defining the scope of cooperation among the two agencies in carrying out their respective tasks of fighting financial crime. The agreement is in the nature of a memorandum of understanding that does not supersede or modify either agency's existing legal obligations (e.g., existing restrictions on disclosure of information continue to apply). Under the agreement, among other things, NCIS is authorized to provide the FSA with information on the investigating agency to which NCIS has submitted information from STRs filed by the FSA, and also coordinates with the FSA when feedback on such reports is received from investigating agencies. Subject to applicable restrictions on disclosure of information, NCIS also informs the FSA of any matter coming to its attention that may be relevant to the FSA's functions (e.g., intelligence relating to matters that the FSA has authority to investigate and prosecute). In addition, NCIS routinely provides the FSA with general information regarding STRs it receives (including information on rates of reporting of suspicious transactions across different sectors of the financial services industry and different financial institutions, and evaluations of the quality of reports received). Apart from the reporting of suspicious transactions, the FSA's obligations include providing NCIS with up-to-date statistics and other information to assist NCIS in its analyses. The two agencies also cooperate in promoting and maintaining confidence within the financial services industry in the efficacy of U.K. AML requirements and in supporting training initiatives. Various legislative and administrative provisions (e.g. Data Protection Act 1998, Human Rights Act 1998, Official Secrets Act 1989) are intended to protect confidentiality and ensure proper use of the information that is disseminated by NCIS.
Criterion 22	
Description and Analysis	NCIS has authority to request intelligence and other information from, and to disseminate similar material to, foreign authorized government officials. The authorities report that such sharing of information is routinely undertaken with Egmont member counterparts and normally by way of Memoranda of Understanding (although MOUs are not a necessary condition for sharing of information). These MOUs normally contain provisions to ensure the proper use of information provided by NCIS, including that the information (i) shall be used only for the specific purpose for which the information or intelligence was sought or provided, (ii) shall not be shared with a third party without the FIU's prior consent, and (iii) shall not be used in an administrative, prosecutorial, or judicial purpose without its prior consent.
Criterion 23	
Description and Analysis	*See Description and Analysis under Criterion 24 below.*
Criterion 24	
Description and Analysis	*NCIS keeps statistics on the use, by law enforcement, of STRs. NCIS also records details of other financial investigations (not emanating from STRs) and other serious crime investigations being undertaken by law enforcement in the U.K.* *31,251 STRs were filed in 2001, including from 418 banks. The Police report that in 2000 there were 18,400 STR's; they provided feedback on 11,000 and 9,000 were of value. The CPS advises that there were 117 drug ML prosecutions 2000. There apparently have been no non-narcotic ML prosecutions in the U.K.* *The authorities indicate that NCIS is the only agency that receives the STRs in practice, and under no circumstance do they transmit the STRs directly to law enforcement. Rather they review and analyze the information in government data bases relevant to the STR, and then pass the summary information to the police. In many cases it can take NCIS up to three months to transmit their review of the STR's to the appropriate agencies, thereby significantly diminishing the usefulness, if any, of the disseminated reports. However, NCIS' interagency*

	work has resulted in a change of culture toward sharing information with relevant agencies. *Once disseminated to the most appropriate law enforcement agency NCIS then monitors progress, looks for new/ongoing links and where necessary reevaluates, and possibly re-allocates to a new investigator where subsequent intelligence shows need for such a change.* *NCIS keeps statistics on the number and types of requests for assistance received by the FIU, from both domestic and foreign authorities, as well as the number and types of responses provided to the requests received.* *Analysis: U.K. interlocutors were not able to provide the IAE with the total number of ML or FT investigations or in any fashion correlate the numbers that they did have. While the effectiveness of ML and FT regimes cannot be assessed by a statistical review alone, they are important as a factor in reviewing how individual and combined components of the system work.* *While highly relevant, statistics that are limited to ML prosecutions, seizures and forfeitures do not present an accurate view of the government's overall efforts and results. For example, they do not measure the effectiveness at disruption activities carried out by law enforcement and intelligence components.* *The authorities keep and publish records of the number of STRs submitted each year and break them down into considerable detail. All STRs submitted to the FIU are analyzed and disseminated to law enforcement agencies.* *NCIS does monitor progress of STRs and assesses their value as an intelligence tool that assists law enforcement in the fight against predicate crime and money laundering. The Home Office is responsible for monitoring prosecutions and confiscation statistics.* *The statistics also do not account for the impact that a properly implemented and supervised regulatory regime that makes it harder for money launderers to move their money and creates a better audit trail to use in investigating and prosecuting cases. All of these taken together are critical components of an effective regime.* *Ultimately however, the measure of success of the STR system is not just the number of ML cases brought or the amount of money confiscated, but the extent to which STRs assist with the investigation and prosecution of crime generally. The U.K. authorities were not able to supply any statistics on the extent to which STRs had been helpful in general criminal investigations.*

Law enforcement and prosecution authorities, powers and duties

Detailed Assessment of Criteria 25-33 (Assessors are to describe and analyze each of Criteria 26-34)

Overall Description and Analysis

Recommendations and Comments
1. T*here is no law enforcement entity that has as its mission the investigation of criminal acts and foreign counter-intelligence. The U.K. should seriously consider the creation of a national law enforcement organization which has both these elements.* *2. In order to be successful in using the new tools provided under the PCA 2002, and to more effectively fight ML in the United Kingdom, NCIS and others must undertake trend and vulnerability analysis on a regular basis to study inter alia, how and where money, especially cash, is being laundered in the U.K. and then to use that information to build a national strategy with targeted, time sensitive priorities.*

<table>
<tr><td colspan="2">3. Prosecutors and judges need to be trained on ML and asset confiscation law so that they can adequately apply U.K. legislation.</td></tr>
<tr><td colspan="2">Criterion 25</td></tr>
<tr><td>Description and Analysis</td><td>All elements of U.K. legislation relating to ML and FT have been substantially reviewed in the last two years. This has led to the development of new legislation in the Terrorism Act, the ATCS 2001, and the recent PCA 2002. Reviews and reports preceding legislative changes have involved all the agencies and authorities with an interest in ML and FT, and where deficiencies or barriers have been identified preventing effective implementation, these have been reviewed and addressed by the appropriate agency.

Currently there are 43 Police Constabularies in England & Wales, eight in Scotland and one in Northern Ireland. While the Metropolitan Police Service (MET), has some national functions, these are limited and the MET is in no sense the force with overall responsibility for dealing with ML or FT in the U.K.

Some U.K. agencies also have ‘national’ remits, related to ML and FT though without the ‘national’ designation: These include HMCE, Serious Fraud Office (SFO), FSA, Security Service, and the Secret Intelligence Service (SIS).

<u>Analysis</u>: It is unclear whether there are sufficient resources to investigate ML. There is no single law enforcement entity that covers all aspects of ML in the U.K. (The nearest is HMCE for drugs ML). Also, there is no law enforcement entity that has as its mission the investigation of criminal acts and foreign counter-intelligence. The U.K. should seriously consider the creation of a national law enforcement organization which has both these elements.

With the exception of the work done by HMCE at developing their own strategy to identify, target, disrupt, prosecute and forfeit the assets of drug money launderers, there is no national strategy to attack money laundering and terrorist financing. The IAE understands, however, that one is in preparation.

The FSA has authority to prosecute criminal cases based on breaches of the 1993 Regulations. However, it appears that this authority will be squandered unless the FSA begins to intensively train its examiners and a prosecution staff on how to investigate and prosecute these offenses. Even more important however, the FSA appears to have limited interest in using its criminal prosecution authority and intends to rely on it only as a last resort. Unless this special authority is aggressively used by the FSA in appropriate cases they will undercut the entire enforcement effort.

Illustrative of this conclusion is that the FSA must continue to address the establishment of standards upon which they would initiate criminal investigations, and use it in appropriate cases. Otherwise the FSA will squander a unique opportunity to enhance the compliance culture in the U.K. and—where appropriate—to identify individuals and institutions that should be criminally prosecuted for failing to follow the 1993 Regulations.</td></tr>
<tr><td colspan="2">Criterion 26</td></tr>
<tr><td>Description and Analysis</td><td>As discussed above, U.K. law provides the various law enforcement agencies with an adequate legal basis to use a wide range of investigative techniques, including controlled delivery and undercover operations.</td></tr>
<tr><td colspan="2">Criterion 26.1</td></tr>
<tr><td>Description and Analysis</td><td>The U.K. has all of the undercover means necessary to conduct productive investigations. HMCE is particularly innovative in identifying targets for investigation and in executing investigations. However, wiretaps are carried out under Ministerial authorization and are not admissible as evidence in judicial proceedings. This is an unnecessary impediment to successful prosecution of court cases because it deprives the prosecutor of the best evidence -</td></tr>
</table>

	the voices of the witnesses and defendants. Lack of an ability to use the tapes in court may be a reason why so few cases are prosecuted. Consideration should be given to passing legislation that makes wiretap evidence admissible in judicial proceedings.
Criterion 27	
Description and Analysis	As discussed above, U.K. law provides the various law enforcement agencies with a broad range of powers to conduct investigations of ML, FT and predicate offenses, including the power to compel production, through lawful process, of bank account records, financial transaction record, customer identification records, and other records maintained by financial institutions and other entities or persons. Once the PCA 2002 comes into force, the more robust investigative tools of account monitoring orders and customer information orders will become available for use in all ML investigations, rather than only in FT-related investigations as is currently the case.
Criterion 28	
Description and Analysis	*SEE DESCRIPTION AND ANALYSIS ABOVE*
Criterion 29	
Description and Analysis	*A wide range of law enforcement and prosecution agencies undertake the investigation and prosecution of ML and FT and the U.K. is committed to ensuring that its law enforcement, supervisory and judicial systems are properly resourced. The Government keeps the level of resources provided for ML and FT investigations and prosecutions under review and provides additional resources where required.* ***NCIS**: The recent investment in, and expansion of, NCIS' Economic Crime Unit is evidence of this. The Economic Crime Unit generally receives all suspicious transaction reports in the United Kingdom, and maintain links with all investigation (prosecution) units within the U.K. (police and otherwise). This is maintained electronically through the dissemination of reports and on a day-to-day basis in contacts with operators.* *NCIS also operates a Terrorist Financing Unit, which co-ordinates intelligence on terrorist financing.* *The PCA 2002 makes provision for the disclosure of information both to and from the Director of the new ARA. Several bodies, including law enforcement authorities, are designated under the Act as "permitted persons" who will be able to disclose information to the Director; and the Director will be able to disclose information for purposes specified in the PCA 2002.* ***National Crime Squad**: The National Crime Squad - the only national policing body within the U.K. - is made up of officers seconded from local police forces. One of its published strategic aims is "To work in partnership with other law enforcement agencies in the prevention and detection of serious crime".* *Examples of partnership and task force working include:* • *The NCS and HMCE have a joint unit working from Customs House that deals specifically with drug related ML. Discussions are underway to create further teams in different parts of the country.* • *The NCS is creating a new department to deal with all financial crime investigations under a Head of Profession. The remit of the department will be to develop partnership arrangements with local police forces to ensure that all aspects of the PCA 2002 are fully and efficiently implemented by the Police Service.*

	• *A strategic document has been agreed by the NCS, HMCE and the Association of Chief Police Officers (ACPO) that expresses the need to have a joint approach to ensure the success of the ARA. This document is also the basis for a working group that will develop the practical requirements of each agency's response to the PCA 2002, thereby ensuring a joined-up approach.* • *The NCS also has control of the joint immigration authorities and police Project Reflex team. This also has a financial investigation element that will target the proceeds of human trafficking.* *The NCS is developing its intelligence handling by creating a specific financial intelligence "desk" within its central intelligence unit. This "desk" will be tasked with identifying all cases that can be referred to the ARA.* *With the extra resources allocated by the Home Office – the budget for 2002-03 has been increased by 17.5% to £134 million - the NCS is increasing the number of staff carrying out financial investigations (although exact figures are not yet to hand, a sizeable percentage of this money will be spent on this purpose). This additional funding will complement the PCA 2002's provisions allowing the use of non-police "Accredited Investigator" staff to carry out investigations.* *Within this financial year the NCS will be able to show the number of staff who deal exclusively with all aspects of financial crime and provide statistics that show the effectiveness of the resources allocated to specific tasks.* *The ATCS 2001 also recently created new information-sharing gateways for the Inland Revenue and HMCE. They are now, subject to the provisions of the Human Rights Act, able to share information with other organizations (including foreign agencies) involved in criminal investigations and prosecutions* *<u>Analysis</u>: With the exception of HMCE operational multi-agency task forces are the exception rather than the rule. NCIS has gateways for access to other agency databases and has officers from the intelligence community and other law enforcement agencies detailed to assist them in analyzing the STRs that are filed.* *There is very limited use of task forces because of turf battles and a historical reluctance to share data. It appears that the investigative agencies and prosecutors do not routinely use the gateways nor do they use them effectively. Both the routine sharing of information and the use of interagency task forces are areas where the U.K. must significantly change the "police culture" in order to successfully investigate and prosecute ML and FT.*
Criterion 30	
Description and Analysis	*SEE ABOVE*
Criterion 31	
Description and Analysis	*NCIS has a team of analysts that produce typology reports. NCIS, on behalf of all U.K. law enforcement agencies also produces the U.K.'s response to the annual FATF Typologies exercise. There are also processes for exchanging information on typologies (e.g., the use of the 'EPI Centre' computer system, which has a wide range of uses in informing financial investigators of trends and legal judgments).* *<u>Analysis</u>: NCIS always makes interesting and compelling typologies presentations to FATF and in other international fora. They are focused on specific problems and very well presented. However, there does not appear to be any effort—other than at HMCE—to identify*

	on a national basis the U.K.'s vulnerabilities to ML and FT. NCIS and others must undertake a U.K. trend analysis and vulnerability study of how and where money—especially cash—is laundered in the U.K. to focus priorities and successfully use the new legislative and Assets Recovery Agency powers successfully.
Criterion 32	
Description and Analysis	*Selected individuals within law enforcement agencies currently receive a three phase training program in financial investigation, which includes aspects of money laundering. Upon completion they are included on a National List of Financial Investigators.* *As discussed in this assessment, when it becomes effective, the PCA 2002 would modernize and replace the existing criminal confiscation and ML laws presently contained in various pieces of legislation. The introduction of this legislation to Parliament prompted a national review of financial investigation training and created a Centre of Excellence with responsibility for its delivery.* Resources have been channeled into a number of training initiatives throughout the U.K. to prepare interested parties for the coming into effect of the PCA 2002. Key features of this program include: ➢ the setting up by the Government of a national Centre of Excellence in Financial Investigation. The Centre will be part of the new ARA and its role will be to train financial investigators in the Police, HMCE and other Government bodies and to accredit them to perform various functions provided for in the PCA 2002; ➢ in-house training programs for staff in the Crown Prosecution Service, HMCE and other prosecutors; ➢ training initiatives for the judiciary in the implications for them of the new legislation. *The thinking behind these actions is that the training of those responsible for implementing the new legislation will be crucial to its success.* *Financial investigators operating within law enforcement were scheduled to receive training in the new legislation between September and December 2002. The aim of this program is to ensure that all current financial investigators are fully equipped to use the confiscation, ML and restraint/freezing powers, which will be available to them following the implementation of the Act.* *A separate new training program is being developed for all newly appointed financial investigators, which will be delivered from December 2002. Training will also be available for accredited (certified) financial investigators working within other enforcement agencies.* *As noted earlier, the PCA 2002 will also create a new Assets Recovery Agency with additional powers for the tracing of criminal assets. Individuals working within the ARA will be trained to a higher level in these competencies, which will be built on the training programs for both law enforcement and Accredited Financial Investigators.* *The U.K. has had ML provisions, in one form or another, since 1986 which allows both police and customs investigators to investigate ML. As a matter of best practice only those that have undertaken specific training in this area have been place on an 'approved' list of financial investigators (this list is overseen by NCIS). Changes in the PCA 2002 would place this 'best practice' on a statutory footing.* Analysis*: Apparently outside a core group in HMCE and the NCIS/ ECU, there is no current comprehensive training program that addresses ML or FT in the law enforcement agencies or the FSA.*
Criterion 33	

Description and Analysis—

Problems experienced by authorities in achieving successful investigations, prosecutions and convictions have been recently assessed in a fundamental review of legislation and practice in this area. A nine-month study by the Cabinet Office led to the production of a report in June 2000 entitled "Recovering the Proceeds of Crime" ("PIU Study"). This report dealt with a number of issues including the adequacy of financial investigation and tightening the U.K.'s AML regime. This was followed by the production of draft legislation in March 2001 and a period of extensive consultation with practitioners and interested parties. The resulting PCA 2002 received Royal Assent in July 2002 and, once it becomes effective, will effect a wide range of measures to address the identified problems.

Analysis: In advance of the PIU Study and afterwards, HMCE was the only agency that assessed its deficiencies in investigating ML and as a result of that assessment constructed and implemented a strategy to address it. For example, HMCE will not open new investigations unless a ML component is opened with it. HMCE has also proposed a working group of itself, NCI and FSA to determine what is the best approach in cases involving financing institutions, i.e., arrest, examination or do both simultaneously.

The Crown Prosecution Service does not prosecute anything other than narcotic ML because they believe that prosecuting non-narcotic ML under existing law is too hard to prove. The view of U.K. interlocutors was that judges have difficulty understanding ML. The assessors did not meet with a U.K. jurist and no information was provided to the assessors regarding what training, if any, judges are given. Prosecutors and judges need to be trained on ML and asset confiscation law so that they can adequately apply U.K. legislation.

International Co-operation

Detailed Assessment of Criteria 34-42 (Assessors are to describe and analyze each of Criteria 35-42)

Overall Description and Analysis

Recommendations and Comments

1. Legislation to enhance the statutory provisions on extradition should be adopted as soon as possible.

Criterion 34

Description and Analysis	The U.K. has both laws and informal arrangements and procedures that allow provision of a broad range of mutual legal assistance in AML/CFT matters. The DTA (sections 39 and 40) and CJA (sections 96 and 97) addresses the government's powers to enforce external restraint and forfeiture orders in assistance of certain countries (generally those that have been designated for this purpose by the U.K. Parliament through an Order of Council). In addition, the Criminal Justice (International Cooperation) Act 1990 contains procedures for handling, among other things, (i) requests for service on a person in the U.K. of a summons or other process issued in a foreign jurisdiction or a decision issued by a foreign court (section 1); (ii) requests for assistance in obtaining evidence (including documents and other articles) in the U.K. in connection with criminal proceedings or investigations in a foreign jurisdiction (section 4); (iii) issuance of a warrant providing for a person serving a prison sentence in the U.K. to be transferred to a foreign jurisdiction (with the consent the prisoner) to give evidence in criminal proceedings in the foreign jurisdiction or to be identified in or otherwise assist in foreign criminal proceedings or investigations (section 5); and (iv) issuance of a warrant authorizing the search of premises in the U.K. in connection with certain overseas criminal investigations (sections 7 and 8). The CJICA also contains procedures for the enforcement of overseas forfeiture orders concerning the instrumentalities of specified drug trafficking and other serious crimes; however, such assistance is available only for countries that have been designated for this purpose in an Order of Council approved by the U.K. Parliament (section 9). Separately, the U.K. has in force 33 bilateral agreements covering restraint and confiscation of the proceeds and instruments of drug trafficking, and 13 bilateral agreements covering the proceeds and instruments of all crimes. In addition it has designated a range of countries for

	assistance under the terms of the Vienna Convention (162 countries) and the 1990 Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crimes (41 countries). Despite the existence of these formal procedures, the authorities report that the vast majority of the U.K.'s mutual legal assistance is provided through informal processes rather than through the formal routes embodied in the criminal statutes and international treaties. The assessors note that informal processes for the provision of mutual legal assistance are important and can provide considerable flexibility. At the same time, however, the general experience in this area is that mutual legal assistance is not always consistently applied under informal processes (e.g., there may be a tendency to provide more assistance to larger countries or to those with whom the assisting country has close political ties, and less assistance to smaller or politically less important jurisdictions). This points to the need to strengthen formal procedures and the effectiveness of cooperation thereunder even if informal routes also will be pursued. Other than in connection with the freezing and confiscation of proceeds of crime, the U.K. generally can provide mutual legal assistance to any country or territory without bilateral or international agreements. Such agreements are needed, however, for freezing/confiscation of criminal proceeds. Except as noted above with respect to CJICA section 9, the CJA and CJICA generally do not limit the kinds of crimes in which their procedures may be used, and thus would allow assistance in connection with both FT and ML and its predicate offenses. The U.K. generally can provide assistance regardless of whether there are different intent standards for the crime in the requesting state. However, dual criminality is required for requests involving search and seizure or use of the special investigation powers of the Serious Fraud Office in cases of serious or complex fraud; or in relation to requests involving fiscal matters from countries outside the Commonwealth or with which the U.K. does not have a bilateral or multilateral treaty; and for requests for restraint and confiscation. (CJICA sections 4(3), 9(6)).
Criterion 35	
Description and Analysis	*International co-operation in relation to suspicious transaction reports is coordinated by the Economic Crime Unit at NCIS through counterpart FIUs. Criminal investigations are undertaken by the individual police forces and HMCE will pursue enquiries through 'police' to 'police' channels which will be followed-up by letters of request when evidence is required. Exchange of information in suspicious transaction reports is dealt with on an FIU to FIU basis. Details of the principles for such exchanges are as established by the Egmont Group and between EU Member States as detailed in its Decision concerning exchange of information between FIU's. Both liaison officer networks and Europol are used in assisting officers undertaking criminal investigation. All such exchanges—number and purposes—are recorded, as is the outcome (where the authority in receipt of the information co-operates with the request for such information).* *The U.K. Government attaches great importance to assisting judicial and prosecuting authorities in other countries in combating national and international crime. The U.K. is able to provide a full range of legal assistance in criminal matters to judicial and prosecuting authorities in other countries under Part I of the CJICA, the U.K.'s principal mutual legal assistance legislation.* *In terms of responding to requests for assistance, the Home Office's U.K. Central Authority works exclusively on requests for legal assistance and is fully conversant with mutual legal assistance law and practice. The Home Office's published Code of Practice states:*

	"Requests to the United Kingdom for evidence: *The Home Office, being the central authority for the United Kingdom in mutual legal assistance in criminal matters, will:* • *acknowledge all requests for evidence upon receipt, giving the name of the Home Office officer handling the request, his or her telephone and fax numbers and a reference number for any queries;* • *respond to all enquiries about the execution of requests for assistance within 10 working days of receipt;* • *upon receipt of the request where the request is marked "urgent", or no later than 20 working days after receipt in other cases, either: provide the requesting authority with the assistance sought; or inform the requesting authority of the action being taken to obtain the assistance and provide, where possible, the name(s) and other contact details of the person(s) with responsibilities for executing the request, or provide the requesting authority with a full explanation why the request cannot be executed in its entirety or in part and where possible indicate how the assistance might otherwise be obtained;* • *if the requesting authority notifies the United Kingdom that it is necessary, provide within 20 working days of receipt of the notification a report on the progress of the request, and, where possible, indicate by when the request will be executed and update that report on a similar time scale;* • *endeavor to meet all reasonable time scales for the execution of requests, including urgent requests.* *Requests to the United Kingdom for service of process (summonses and other procedural documents):* *The Home Office will:* • *arrange for the execution of all requests for service of summonses within 10 working days of receipt;* • *execute all requests for service of process in the manner requested insofar as that is compatible with U.K. law, and where that is not possible provide the requesting authorities with a full explanation;* • *acknowledge simultaneously the receipt and the execution of requests for service of summonses (unless the Home Office has not received signed proof of service at least 10 working days before the hearing date, in which case the acknowledgement will confirm the arrangements made to execute the request);* • *acknowledge simultaneously the receipt and the execution of requests for service of judgments and other procedural documents at the same time (unless the Home Office has not received signed proof of service after 30 working days, in which case the acknowledgement will confirm the arrangements made to execute the request);*

	• *when acknowledging requests for service of procedural documents, provide the requesting authorities with the name and other contact details of the officer in the Home Office who has handled the request, including telephone and fax numbers and a reference number for any queries."* *The U.K.CA achieved its target to action outgoing requests in less than ten working days from receipt, in an average of 95% of cases between January and March 2002.* *During the same period, an average of 92% of incoming requests were actioned within 20 workings days of receipt.* *Analysis: The U.K. has a comprehensive system in place for the provision of mutual legal assistance and the arrangements, coordinated by the U.K.CA, operate effectively. The U.K. has improved its response rate and turnaround times by devoting extra resources to the activity.* *The extensive efforts undertaken by HMT in supporting the FATF and the regional style FATF's have been essential to their success in changing and enhancing the effectiveness with which the world addresses money laundering and now terrorist financing.*
Criterion 36	
Description and Analysis	See description and analysis under Criteria 34 and 40, for a summary of the bilateral and multilateral conventions, treaties, agreements and arrangements that the U.K. has entered into to support international cooperation.
Criterion 37	
Description and Analysis	As discussed above, U.K. law allows NCIS to share intelligence and other information with foreign law enforcement agencies. The FSMA authorizes the FSA to cooperate and share information with both national and foreign regulators and to cooperate with both domestic and foreign persons having functions related to the prevention and detection of financial crime (sections 348, 354). Section 348 of FSMA places a duty on the FSA not to disclose confidential information without the consent of the person who provided it, and if different the person to whom it relates. This prohibition is lifted when disclosure is made through a "gateway" contained in the Financial Services and Markets Act 2000 (Disclosure of Confidential Information) Regulations 2001, one of which is for "the purposes of criminal proceedings and investigations." This gateway includes coverage for facilitating a determination of whether criminal proceedings or investigations should be initiated and therefore covers suspected as well as actual criminal activities; the general conditions are that a criminal investigation/prosecution is already underway, or is being considered. These provisions enable the FSA, on its own initiative or upon request, to exchange information relating to suspicious transactions with other domestic and foreign financial supervisors and law enforcement agencies. No court authorization is required for such disclosure of information by the FSA. More generally, the ATCS 2001 provides broad "gateway" powers for the disclosure of information by HMCE and other U.K. public authorities, inter alia, to assist any criminal investigation or criminal proceedings in the U.K. or abroad, or to facilitate determinations of whether or not such investigations or proceedings should begin or end (sections 17, 19). Some limitations apply to such disclosures (for example, public authorities must ensure that their disclosure is proportionate to what is sought to be achieved by the disclosing, and certain disclosures for overseas purposes may be prohibited where there is reason to believe that the particular overseas investigation or proceeding would be more appropriately handled in the U.K. or a third country). The gateway legislation of the ATCS 2001 broadens the

	government's disclosure powers, but is not intended to limit any disclosure powers under other laws.
Criterion 37 (last sentence)	
Description and Analysis	*SEE ABOVE*
Criterion 38	
Description and Analysis	U.K. law enforcement agencies are authorized to engage in controlled delivery and other cooperative investigations with counterparts from other countries.
Criterion 39	
Description and Analysis	*A wide range of law enforcement and prosecution agencies undertake the investigation and prosecution of ML and FT and the U.K. is committed to ensuring that its law enforcement, supervisory and judicial systems are properly resourced. The Government keeps the level of resources provided for ML and FT investigations and prosecutions under review and provides additional resources where required. The recent investment in, and expansion of, NCIS' Economic Crime Unit is evidence of this.* *The National Crime Squad—the only national policing body within the U.K.—is made up of officers seconded from local police forces. One of its published strategic aims is "To work in partnership with other law enforcement agencies in the prevention and detection of serious crime".* *Examples of partnership and task force working include:* • *The NCS and HMCE have a joint unit working from Customs House that deals specifically with drug related ML. Discussions are underway to create further teams in different parts of the country.* • *The NCS is creating a new department to deal with all financial crime investigations under a Head of Profession. The remit of the department will be to develop partnership arrangements with local police forces to ensure that all aspects of the PCA 2002 are fully and efficiently implemented by the police service.* • *A strategic document has been agreed by the NCS, HMCE and the Association of Chief Police Officers (ACPO) that expresses the need to have a joint approach to ensure the success of the ARA. This document is also the basis for a working group that will develop the practical requirements of each agency's response to the PCA 2002, thereby ensuring a joined-up approach.* • *The NCS also has control of the joint immigration authorities and police Project Reflex team. This also has a financial investigation element that will target the proceeds of human trafficking.* *The NCS is developing its intelligence handling by creating a specific financial intelligence "desk" within its central intelligence unit. This "desk" will be tasked with identifying all cases that can be referred to the ARA.* *With the extra resources allocated by the Home Office – the budget for 2002-03 has been increased by 17.5% to £134 million - the NCS is increasing the number of staff carrying out financial investigations (although exact figures are not yet to hand, a sizeable percentage of this money will be spent on this purpose). This additional funding will complement the PCA 2002's provision allowing the use of non-police "Accredited Investigator" staff to carry out investigations.*

	Within this financial year the NCS will be able to show the number of staff who deal exclusively with all aspects of financial crime and provide statistics that show the effectiveness of the resources allocated to specific tasks.
Criterion 40	
Description and Analysis	The U.K. has laws and procedures for the extradition of individuals that are charged with ML, FT or a related offence. The U.K. is party to two multilateral extradition schemes, the European Convention on Extradition and the Commonwealth Scheme for the Rendition of Fugitives. These agreements cover virtually all Council of Europe states and the majority of the Commonwealth, respectively. If a ML or FT crime exists in equivalent form in both requesting and requested states and carries a sentence of at least 12 months in both states, it will be extraditable, subject to the provisions of the Extradition Act 1989. The U.K. has also entered into 23 bilateral treaties with countries not covered by the multilateral agreements mentioned above. In ratifying the International Convention for the Suppression of the Financing of Terrorism through the Terrorism Act 2000, the U.K. added the relevant FT offences to the list of offences for which extradition requests can be considered from bilateral treaty partners. In addition, once the International Convention for the Suppression of the Financing of Terrorism (which as noted above has been signed and ratified by the U.K.) becomes effective following ratification by a sufficient number of other States, extradition would be possible between the U.K. and other Convention States in connection with the crimes described in the Convention, and without the need for any further bilateral or multilateral agreements. Separately, current U.K. law allows for the establishment of ad hoc agreements between the U.K. and foreign states with which the U.K. lacks general extradition relations. (Extradition Act 1989, section 15) These one-off arrangements are designed to be used in individual cases, but the mandated procedures are generally recognized, including by the authorities, as being cumbersome. The assessment team understands that a bill to improve the procedures for extradition was recently submitted to Parliament. Separately, subject to the applicable criminal laws (including the dual criminality requirement applicable in respect of certain offenses as noted above), the U.K. also has authority to launch ML or FT prosecutions in cases where extradition is not possible.
Criterion 41	
Description and Analysis	*SEE ANSWERS ABOVE*
Criterion 42	
Description and Analysis	*SEE ANSWERS ABOVE*

D. Assessing the Preventive Measures for Financial Institutions

205. **The legal and institutional framework for all financial institutions and its effective implementation.**

206. **In order to assess compliance with the following criteria (43-67), assessors must verify that:**

(a) the laws and institutional framework are in place; and
(b) there are effective supervisory/regulatory measures in force that ensure that those criteria are being properly and effectively implemented by all financial institutions.

207. **Both aspects are of equal importance.**

Table 29. Detailed Assessment of the Legal and Institutional Framework for All Financial Institutions and its Effective Implementation

General Framework

Detailed Assessment of Criteria 43 and 44 (Assessors are to describe and analyze Criteria 43 and 44 for the (i) banking; (ii) insurance; (iii) securities; and (iv) other financial institutions, sectors)

Overall Description and Analysis	
a) Legal and Institutional b) Implementation	
Recommendations and Comments	
In light of the descriptions and analyses below, the following is recommended: 1. Financial institutions and MSBs should be cautioned against doing business with attorneys and accountants that are unable to provide information about the customers for whom they are opening accounts. 2. The 2001 Regulations' supervisory scheme for money services businesses represents a significant step in the government's efforts towards making the AML/CFT regime more effective for firms beyond those in the prudentially supervised financial sector. As discussed under Criterion 66, however, the self-financing scheme for HMCE supervision of MSBs should be kept under close review, to determine whether or not it can reasonably be expected to produce enough resources to enable HMCE to carry out effective AML/CFT oversight of MSBs under the 2001 Regulations.	
Criterion 43	
Description and Analysis	a) Legal and Institutional As discussed under Criterion 46, legal confidentiality requirements applicable to attorneys and accountants prevent financial institutions and MSBs from inquiring into (and preclude lawyers and accountants from divulging) the identity of the underlying clients when an attorney or accountant opens an account to hold clients' funds. As also discussed below, these rules could in certain circumstances prevent a financial institution from obtaining the customer identification and other information called for in the 1993 Regulations and FSA Sourcebook. This is a particular source of concern where the particular lawyer or accountant is not subject to FSA supervision or where, even if subject to FSA supervision, the activities conducted on behalf of the particular client are not supervised activities. (The 1993 Regulations and Sourcebook impose AML requirements only with respect to specific businesses that are subject to supervision, rather than all business of lawyers or accountants). Other than as described above, the assessors are not aware of any confidentiality or secrecy law or agreement, or any other law, that would inhibit implementation of the criteria set out in this Methodology. b) Implementation The assessors were unable to ascertain whether or not financial institutions and MSBs open accounts for attorneys and accountants who are unable to provide information concerning the customers for whom they are opening these accounts. If this is done, then these accounts would be a means of inhibiting implementation of the customer identification criteria set out in this Methodology (except for cases where the particular attorney, accountant or underlying client falls within one of the otherwise applicable exceptions to these customer identification requirements).
Criterion 44	
Description and Analysis	a) Legal and Institutional The FSA has responsibility for the supervision and regulation of banks, securities firms and insurance companies (collectively referred to herein as "financial institutions"). This includes authority to supervise and ensure financial institutions' compliance with governing law and supervisory requirements concerning AML/CFT.

	Monitoring compliance with AML/CFT requirements including customer identification requirements, is an integral component of FSA activities as a financial supervisor, which extends to FSA regulated firms and individuals. This encompasses banks, securities firms and insurance firms, (with the exception of general insurance). It also includes some activities of some individuals which require FSA authorization. The introductory section at Criterion 68 below provides a full discussion of the supervisory arrangements FSA has put in place to ensure compliance with the AML/CFT regime. These include on-site and off-site tools. FSA has a broad range of enforcement powers fully adequate to ensure compliance with the applicable legal requirements. Where applied, FSA oversight assures that the customer identifications called for in this criterion are fully implemented. The discussion at Criterion 68 discusses gaps in FSA AML/CFT oversight with respect to the securities and insurance sectors. Effective November 2001, HMCE has responsibility pursuant to the 2001 Regulations for the supervision of "money service businesses" in the United Kingdom, which as noted above are defined to include any business engaged in the activity of (i) operating a bureau de change; (ii) transmitting money or any representation of monetary value by any means (which is intended to cover informal remitters, such as *hawala* and *hundi*); or (iii) cashing checks that are made payable to customers. (Regulation 3(2)) Among other things, the 2001 Regulations: (i) required all MSBs to register with HMCE by June 1, 2002 (or in the case of existing MSBs at least to have an application pending by such date) (Regulation 5); (ii) require HMCE to maintain a register of MSBs and to allocate to every registered MSB a registered number (Regulation 4); (iii) give HMCE the authority to charge MSBs an application fee and an annual registration fee (Regulation 9); and (iv) give HMCE certain entry and inspection rights with respect to MSBs (Regulations 10-14). The scope of HMCE's supervision of MSBs under the 2001 Regulations is fairly limited, as the Regulations are intended to apply a "light touch" supervisory regime. For example, the HMCE can refuse to register an applicant "if and only if" the Regulations' requirements concerning providing of application or supplementary information to HMCE are not complied with, or if any of the information provided by an applicant is materially false or misleading (Regulation 7). Similarly, once registered, HMCE can cancel an MSB's registration only if it would have had grounds to refuse the registration under the terms of the Regulations (Regulation 8). HMCE implements no "fit and proper" requirement for MSBs; indeed, as discussed below, MSB applicants are required to disclose ML convictions in their applications, but the existence of such a conviction is not a basis for denial of an MSB's application for registration. As such, HMCE's primary powers under the 2001 Regulations relate to its ability to enter and inspect the premises of MSBs or suspected MSBs, inspect information found on the premises and/or request the MSB to furnish information to HMCE (in some cases pursuant to a judicial order). In addition, HMCE has limited civil money penalty powers under the Regulations, specifically, the ability to impose a penalty of up to £5,000 on any MSB that fails to comply with the Regulations' requirements concerning registration, provision of information, payment of fees, and entry and inspection rights of HMCE (Regulation 15). There is no provision for civil penalties where an MSB fails to comply with the AML systems and controls requirements of the Regulations, but HMCE can institute criminal prosecutions for such violations (Regulation 19). b) Implementation Banking: Fully implemented Securities: AML/CFT compliance checking by FSA of small, low impact securities firms is too limited to verify the compliance of these firms with customer identification requirements. Otherwise, implementation in the securities sector is satisfactory.

	Insurance: Exclusion of general insurance is a significant gap in the AML/CFT regime implemented by FSA. For the other parts of the insurance sector that are subject to FSA oversight, awareness of AML/CFT requirements appears to be low and FSA supervisory efforts are perfunctory. MSBs: The 2001 Regulations became effective just a short while ago, and HMCE has only recently begun to undertake supervisory activities pursuant to this new authority. As of early July 2002, total MSB registrations numbered 1,375, representing total premises of 28,183 (of which 17,436 were Post Office premises). HMCE has prepared and distributed to MSBs guidance and educational materials concerning their obligations under the 2001 Regulations, and also intends to organize training sessions in this area. HMCE has also begun a program of "assurance visits" to MSBs that are essentially spot-check compliance visits to ensure that MSBs are complying with their obligations. Given the recent effectiveness of the regulatory and supervisory scheme, it is too early to conduct a meaningful assessment of the extent to which HMCE will ensure that the criteria specified in this Methodology are being properly and effectively implemented by MSBs. Accordingly, HMCE MSB implementation issues are only addressed to a limited extent in this assessment.

Customer identification

Detailed Assessment of Criteria 45-48 (Assessors are to describe and analyze the (a) legal and institutional; and (b) implementation, aspects for each of Criteria 45-48 for the (i) banking; (ii) insurance; (iii) securities; and (iv) other financial institutions, sectors)

Overall Description and Analysis
NOTE: Sector specific detailed criteria on customer identification are found (i) for the banking sector in Criteria 68-83, (ii) for the insurance sector in Criteria 101-104, and (iii) for the securities sector in Criterion 111. The overall description and analysis should also consider the assessments of the sector specific criteria**.**

a) Legal and Institutional
b) Implementation

Recommendations and Comments

In light of the descriptions and analyses below, the following is recommended:

1. Financial institutions and MSBs should be required by law to include accurate and meaningful originator information on funds transfers and related messages that should be retained with the transfer or message through the payment chain. Any exclusions from such a requirement should be designed narrowly (e.g., not to exclude all ACH transfers, but rather only recurring transfers).

2. Procedures should be developed for systematically, even if on a randomized basis, verifying compliance with AML/CFT requirements by small, low impact securities firms. General insurance should be brought within the scope of the 1993 Regulations and FSA Sourcebook, with compliance verified by FSA. Compliance checking of the insurance sector by FSA should be intensified.

3. The "financial exclusion" provision of the FSA Sourcebook should be drafted more narrowly so as to cover financially disadvantaged persons (as intended), but not everyone else who "cannot reasonably be expected to produce detailed evidence that helps to confirm identity."

4. Existing legal constraints should be relaxed on the ability of attorneys and accountants to identify their clients when acting on behalf of those clients, and financial institutions and MSBs should be cautioned against doing business with attorneys and accountants that are unable to provide information about the customers for whom they are opening accounts.

5. Industry groups representing MSBs should be encouraged to prepare relevant and comprehensive guidance for

<table>
<tr><td colspan="2">their members as quickly as possible concerning customer identification and other AML requirements of the 1993 Regulations. If such detailed guidance is not forthcoming, consideration should be given to the feasibility of having HMCE provide detailed guidance on what MSBs should do to ensure observance of the high-level customer due diligence requirements of the 1993 Regulations.

6. Consideration should be given to limiting the cases in which financial institutions and MSBs are allowed to accept funds from applicants before satisfactory evidence of identity is obtained.
7. Consideration could be given to assigning a supervisory agency to ensure compliance with the 1993 Regulations by financial services providers that are not either financial institutions supervised by the FSA or MSBs supervised by HMCE. Under the current system, these entities are subject to the 1993 Regulations, but no agency is responsible for supervisory oversight to ensure the Regulations' requirements are followed.</td></tr>
<tr><td colspan="2">Criterion 45</td></tr>
<tr><td>Description and Analysis</td><td><u>a) Legal and Institutional</u>
As discussed under Criteria 46 and 47, U.K. law imposes broadly specified customer identification requirements on prudentially regulated financial institutions and MSBs. These requirements contain no exceptions that appear to authorize the holding of anonymous accounts or accounts in fictitious names. Nonetheless, as also discussed under Criterion 46, legal requirements applicable to attorneys and accountants may prevent financial institutions and MSBs from inquiring into (and preclude lawyers and accountants from divulging) the identity of the underlying clients when a lawyer or an accountant opens an account to hold clients' funds.

<u>b) Implementation</u>
The assessors were unable to ascertain whether or not financial institutions and MSBs open accounts for attorneys and accountants who are unable to provide information concerning the customers for whom they are opening these accounts. If this is done, however, these accounts could be considered as being, de facto, anonymous accounts or accounts in fictitious names (except for cases where the particular attorney, accountant or underlying client falls within one of the otherwise applicable exceptions to the customer identification requirements.

Monitoring compliance with AML/CFT requirements, including restrictions on anonymous accounts or accounts in fictitious names, is an integral component of FSA activities as a financial supervisor, which extends to FSA regulated firms and individuals. The introductory section at Criterion 68 below provides a full discussion of the supervisory arrangements FSA has put in place to ensure compliance with the AML/CFT regime. These include a wide range of on-site and off-site tools. FSA has a broad range of enforcement powers fully adequate to ensure compliance. Where applied, FSA oversight assures that the restrictions on anonymous accounts or accounts in fictitious names called for in this criterion are fully implemented. The discussion at Criterion 68 discusses gaps in FSA AML/CFT oversight with respect to the securities and insurance sectors.

<u>Banking</u>: Fully implemented

<u>Securities</u>: AML/CFT compliance checking by FSA of small, low impact securities firms is too limited to verify the compliance of those firms with restrictions on anonymous accounts or accounts in fictitious names. Otherwise, implementation in the securities sector is satisfactory.

<u>Insurance</u>: Exclusion of general insurance is a significant gap in the AML/CFT regime implemented by FSA. For the other parts of the insurance sector that are subject to FSA oversight, awareness of AML/CFT requirements appears to be low and FSA supervisory efforts are perfunctory.</td></tr>
<tr><td colspan="2">Criterion 46</td></tr>
</table>

Description and Analysis	a) Legal and Institutional The U.K.'s legal requirements for customer due diligence for financial institutions and MSBs are found in the 1993 Regulations, as amended and, for certain FSA-supervised firms, in the FSA's Money Laundering Sourcebook. The 1993 Regulations cover banks and other deposit-taking institutions; firms that engage in investment-related business such as dealing in, arranging deals in, managing, advising on, or safeguarding and administering investments; and life insurance companies. The 1993 Regulations apply to a range of other institutions, including MSBs and persons engaged in specified financial activities such as lending, financial leasing, securities trading, participation in securities issues and the provision of services related to such issues, money broking, portfolio management and advice, safekeeping and administration of securities, and safe custody services (Regulation 4); this includes persons (e.g., attorneys and accountants) that engage in the specified activities as an ancillary to other business. Other than prudentially-regulated financial institutions and MSBs, however, the other entities and persons subject to the 1993 Regulations are not subject to supervisory oversight by any government agency to ensure their observance of the Regulations. The authorities expect that the scope of the 1993 Regulations will be expanded by June 2003, pursuant to the Second EU Money Laundering Directive, to include other entities such as casinos and other high-value dealers and trust and company service providers, as well as to cover attorneys and accountants more broadly (i.e., even where not engaged in the financial services covered under the Regulation). The 1993 Regulations' customer due diligence requirements are stated in general terms that require covered entities, in the course of carrying on a relevant financial business in the United Kingdom, to maintain certain AML procedures and controls, including client identification procedures (Regulation 5(1)(a)). Failure to maintain these procedures is punishable as a criminal offense (Regulation 5(2)). A financial institution or MSB's identification procedures are deemed to be in accordance with the 1993 Regulations if they require the production by any applicant for business of "satisfactory evidence of his identity" or require the taking of such measures specified in the institution's AML procedures as will produce satisfactory evidence of identity (Regulation 7(1)). Evidence of identity is "satisfactory" if it "is reasonably capable of establishing that the applicant is the person he claims to be", and the firm who obtains the evidence is satisfied, in accordance with the firm's AML procedures, that the evidence does establish that the applicant is the person he claims to be (Regulation 11(1)). In all cases, satisfactory evidence of identity must be produced "as soon as is reasonably practicable" after contact is first made between a firm and an applicant for business; however, this does not preclude a firm from accepting money from applicants before satisfactory evidence of identify is obtained, so long as the firm returns any funds and proceeds no further with the business relationship if such evidence is not obtained (Regulations 7(1), 11(2)). The 1993 Regulations' identification procedures are applicable only to customers applying for a habitual or regular relationship with a financial institution or MSB in which the total amount of payments to be made in the course of the arrangement is not known or capable of being ascertained at the time the arrangement is made (Regulation 3(2), 7(2)). All other transactions are deemed to be "one-off" transactions and are covered only where there is an actual suspicion of ML, or where the transaction (either by itself or when combined with other linked one-off transactions) is for an amount of €15,000 or more (Regulation 7(3)-(5)). There are a number of exemptions to the identification requirements of the 1993 Regulations, including (i) for certain payments by post or electronic means that are debited from an account held in the applicant's name at certain other U.K. or European financial institution; (ii) where there are reasonable grounds to believe that the applicant is covered by the 1993 Regulations (other than MSBs) or the EU AML Directive; (iii) where a one-off transaction is carried out with a third party pursuant to an introduction effected by a person covered by the

	1993 Regulations or the EU AML Directive, or subject to overseas regulatory authority and based in a jurisdiction that has in force provisions at least equivalent to those required by the EU AML Directive, if that person provides assurance that evidence of the identity of all third parties introduced by him will have been obtained and recorded by the applicant; (iv) where the person who would otherwise be required to be identified in a one-off transaction is the person to whom the proceeds of that transaction are payable but no payment is made because those proceeds are directly reinvested on his behalf in another transaction of which a record is kept and which can result only in another reinvestment made on that person's behalf or in a payment directly to that person; (v) for employment related pension schemes, where the policy contains no surrender clause and may not be used as collateral for a loan; and (vi) for certain insurance transactions, where the premium does not exceed specified (relatively low) amounts (Regulation 8; Regulation 10(1)(a)-(g)). The FSA Sourcebook is intended to add a regulatory as opposed to criminal law focus on AML systems and controls, and as such is "parallel to, but separate from," the 1993 Regulations. The Sourcebook is mandatory and applicable to all FSA-regulated persons with certain exceptions (including general insurance and "pure protection" long-term insurance falling outside the scope of the EC First Life Insurance Directive). Similar to the 1993 Regulations, the client identification requirements in the Sourcebook are drafted in broad terms, requiring relevant firms to "take reasonable steps to find out who its client is by obtaining sufficient evidence of the identity of any client who comes into contact with the firm to be able to show that the client is who he claims to be" (section 3.1.3(1)). Where the client is or appears to be acting on behalf of another, the Sourcebook requires firms to obtain sufficient evidence of the identities of both parties (section 3.1.3(2)). The Sourcebook has exceptions from the identification requirements that are similar to the 1993 Regulations exemptions summarized above. The Sourcebook also contains an additional "financial exclusion" exemption, which provides that where a firm has reasonable grounds to conclude that an individual client is not able to produce detailed evidence of his identity and cannot reasonably be expected to do so, the firm may accept a letter or statement from a person in a "position of responsibility" (i.e., lawyers, doctors and religious ministers, among others) who knows the client that tends to show that the client is who he says he is and to confirm his permanent address if he has one (section 3.1.6). As described in the Sourcebook, this provision is intended to ensure that persons "who are at a disadvantage" or who otherwise cannot reasonably be expected to produce detailed evidence of identity are not denied access to financial services (section 3.1.5). Both the 1993 Regulations and the FSA Sourcebook contemplate that their broad customer identification and other AML systems and controls requirements will be supplemented by guidelines issued by the regulated firms themselves. Towards this end, the 1993 Regulations provide that, in determining whether a person has complied with the Regulations' AML systems and controls requirements, a court "may take account of" any relevant guidance issued by a "supervisory authority" (defined to include SROs and recognized professional bodies) or by a body that regulates or is representative of any trade, profession or business carried on by that person (Regulation 5(3)). The Sourcebook similarly provides that, in assessing compliance with the client identification duties under the Sourcebook, the FSA "will have regard to" the firm's compliance with the Guidance Notes for the Financial Sector ("Guidance Notes") that have been issued by a Joint Money Laundering Steering Group ("JMLSG") made up of the major trade associations representing financial services firms (section 3.1.4). The Guidance Notes are not recognized as establishing "legal requirements" for purposes of the parts of this assessment calling for an analysis of the legal framework for AML/CFT. First, the Guidance Notes are not mandatory, and indeed provide expressly that firms are free to adopt procedures other than those specified in the Guidance Notes where this is deemed

	appropriate for the business of a particular firm. The importance of the Guidance Notes would be enhanced once Part 7 of the PCA 2002 comes into force, as the PCA 2002 (Section 330) provides that, in deciding whether a person has committed a crime of failure to disclose knowledge or suspicion of ML, or failure to disclose reasonable grounds for knowledge or suspicion of ML, a court "must consider" whether the defendant followed any industry-issued guidance that has been approved by HMT. As a result of this provision, HMT has now approved the December 2001 version of the JMLSG Guidance Notes, following approval of the Guidance Notes by the interagency Money Laundering Advisory Committee. It must be noted, however, that HMT approval does not make the Guidance Notes mandatory, as firms still have discretion to adopt procedures other than those specified in the Guidance Notes. Further, it would seem that the "safe harbor" which the PCA 2002 provides to the Guidance Notes is limited. First, the PCA 2002 provision calling for consideration of the Guidance Notes applies only to the PCA's failure-to-disclose offense, and not to other applicable ML or FT offenses. Moreover, the fact that courts are required to "consider" observance of the Guidance Notes does not mean that the courts lack discretion in determining the weight to accord this factor. As with any other evidence, therefore, it is presumed that a court may decide to accord little weight, no weight, or great weight to observance of the Guidance Notes, depending on the facts and circumstances of any particular case. Neither the 1993 Regulations nor the FSA Sourcebook contain specific provisions concerning renewal of customer identification when doubts arise as to the identity of the customer in the course of a business relationship; or identification procedures to be used where the client is a legal entity. There are no exclusions in the 1993 Regulations and FSA Sourcebook related to the maintenance of numbered accounts. It would seem, therefore, that financial institutions would be allowed to hold numbered accounts only after the institution had observed the customer identification and recordkeeping requirements of the 1993 Regulations and Sourcebook. Despite the broad customer identification requirements of the 1993 Regulations and Sourcebook discussed above, the assessors understand that U.K. attorney-client privilege law and the professional code of conduct applicable to accountants prevents financial institutions and MSBs from inquiring into (and preclude lawyers and accountants from divulging) the identity of the underlying clients when a lawyer or an accountant opens an account to hold clients' funds. (See Guidance Notes section 4.143-4.145 for a discussion of this issue). The Guidance Notes recognize the risk in such cases and conclude that it is up to financial institutions to take a "commercial decision" on whether or not to conduct such business where the lawyer/accountant is not itself covered by the 1993 Regulations. <u>b) Implementation</u> <u>MSBs</u>: The general, high-level nature of the 1993 Regulations' requirements are a source of concern particularly for MSBs, as no guidance similar to the JMLSG Guidance Notes currently exists for the industries covered by the MSB definition (although some specific but limited parts of the JMLSG Guidance Notes may be applicable to certain MSB activities). The assessors understand that the Check Cashers Association is preparing its own version of the Guidance Notes. <u>Financial Institutions</u>: Monitoring compliance with AML/CFT requirements including the customer identification requirements called for in criteria 46, is an integral component of FSA activities as a financial supervisor, which extends to FSA regulated firms and individuals. For a full discussion the supervisory arrangements FSA has put in place to ensure compliance with the AML/CFT regime see the response to criterion 45 above and the introductory section at criterion 68 below. Where applied, FSA oversight assures that the customer identification requirements called for in criteria 46 are fully implemented. The

	discussion at Criterion 68 discusses gaps in FSA AML/CFT oversight with respect to the securities and insurance sectors. Banking: Fully implemented. Securities: AML/CFT compliance checking by FSA of small, low impact securities firms is too limited to verify the compliance of those firms with the customer identification requirements called for in criteria 46. Otherwise, implementation in the securities sector is satisfactory. Insurance: Exclusion of general insurance is a significant gap in the AML/CFT regime implemented by FSA. For the other parts of the insurance sector that are subject to FSA oversight, awareness of AML/CFT requirements appears to be low and FSA supervisory efforts are perfunctory.
Criterion 47	
Description and Analysis	a)Legal and Institutional The 1993 Regulations provide that, where an applicant for business appears to be acting other than as principal, a financial institution's or MSB's identification procedures must require "reasonable measures" to be taken for the purpose of establishing the identity of any person on whose behalf the applicant for business is acting (Regulation 9(1)). What constitutes "reasonable measures" in any particular case is to be determined based on the circumstances of the case and, in particular, to best practice which, for the time being, is followed in the relevant field of business and which is applicable to those circumstances (Regulation 9(2)). However, a firm may accept as satisfactory an applicant's written assurance that evidence of the identity of any principal on whose behalf the applicant is acting has been obtained and recorded by the applicant under procedures maintained by the applicant, in cases where the applicant acts in the course of a business over which an overseas regulatory authority exercises regulatory functions, and the applicant is based or incorporated in a country (other than an EU member state) that has in force provisions at least equivalent to those required by the EU AML Directive (Regulation 9(4), (5)). b) Implementation As noted above, the assessors were unable to ascertain whether or not financial institutions and MSBs, in practice, open accounts for attorneys and accountants who are unable to provide information concerning the customers for whom they are opening these accounts. Financial Institutions: Monitoring compliance with AML/CFT requirements including the customer identification requirements called for in criteria 47, is an integral component of FSA activities as a financial supervisor, which extends to FSA regulated firms and individuals. For a full discussion of the supervisory arrangements FSA has put in place to ensure compliance with the AML/CFT regime see the response to criterion 45 above and the introductory section at criterion 68 below. Where applied, FSA oversight assures that the customer identification requirements called for in criterion 47 are fully implemented. The discussion at Criterion 68 discusses gaps in FSA AML/CFT oversight with respect to the securities and insurance sectors. Banking: Fully implemented Securities: AML/CFT compliance checking by FSA of small, low impact securities firms is too limited to verify the compliance of those firms with the customer identification requirements called for in criterion 47. Otherwise, implementation in the securities sector is satisfactory.

	<u>Insurance</u>: Exclusion of general insurance is a significant gap in the AML/CFT regime implemented by FSA. For the other parts of the insurance sector that are subject to FSA oversight, awareness of AML/CFT requirements appears to be low and FSA supervisory efforts are perfunctory.
Criterion 48	
Description and Analysis	<u>a) Legal and Institutional</u> U.K. law does not currently require prudentially regulated financial institutions or MSBs to include originator information on funds transfers and related messages. In May 2002, the government issued a consultative document proposing to require all money remitters (whether regulated by FSA or HMCE) to include originator information (name, address and, where applicable, account information) on all money transfers sent from the U.K. to foreign or domestic destinations. As in the 2001 Regulations, money transfer would be defined for these purposes to include the transmission of money or any representation of monetary value by any means. The consultative document notes the option of having money remitters continue to include originator information on a voluntary basis, reinforced by industry guidance, but notes that it would be more desirable to make this a legally mandatory obligation. The consultative document also points out that the government is considering exempting payments to and from automated clearing houses (“ACHs”) from the requirements on a risk-assessment basis, on the grounds that “typical” ACH transactions include regular bill, credit card and salary payments that are likely to present a low money laundering risk and to be “outside the scope of the spirit” of FATF Special Recommendation VII. The FATF Interpretative Note on Special Recommendation VII was issued for comments after the U.K. consultative document described above. The authorities have indicated that they will await the final outcome of this FATF consultation in order to determine the precise nature of the U.K.’s obligations under Special Recommendation VII. The assessment team considers this to be a reasonable position in the circumstances. <u>b) Implementation</u>: Monitoring compliance with AML/CFT requirements including ensuring compliance with any originator information requirements that may become applicable to such firms and individuals in the future, is an integral component of FSA activities as a financial supervisor, which extends to FSA regulated firms and individuals. For a full discussion of the supervisory arrangements FSA has put in place to ensure compliance with the AML/CFT regime, see the response to criterion 45 above and the introductory section at criterion 68. For its part, HMCE is likely to be responsible for ensuring compliance with any originator information requirements that may become applicable to MSBs in the future. Per discussion above, however, originator information requirements called for under criterion 48 are not currently required to be implemented by either FSA supervised institutions or MSBs.

Ongoing monitoring of accounts and transactions

Detailed Assessment of Criteria 49-51 (Assessors are to describe and analyze the (a) legal and institutional; and (b) implementation, aspects for each of Criteria 49-51 for the (i) banking; (ii) insurance; (iii) securities; and (iv) other financial institutions, sectors)

Overall Description and Analysis NOTE: Sector specific detailed criteria on ongoing monitoring of accounts and transactions are found (i) for the banking sector in Criteria 84-87 and (ii) for the insurance sector in Criterion 105. The overall description and analysis should also consider the assessments of the sector specific criteria.
<u>a) Legal and Institutional</u> <u>b) Implementation</u>
Recommendations and Comments
In light of the descriptions and analyses below, the following is recommended: 1. The 1993 Regulations and FSA Sourcebook should be revised (or other appropriate legal instrument issued) to

<table>
<tr><td colspan="2">impose an affirmative legal obligation on financial institutions and MSBs to pay special attention to all complex, unusual large transactions, or unusual patterns of transactions that have no apparent or visible economic or lawful purpose.

2. The 1993 Regulations should be revised (or other appropriate legal instrument issued) to impose an affirmative legal obligation on financial institutions and MSBs to give special attention to business relations and transactions with persons in jurisdictions that do not have adequate systems in place to prevent or deter ML or FT. The Sourcebook could also be amended to include a more explicit and affirmative obligation in this regard, in lieu of the seemingly more limited “proper use” standard described below (Criterion 50).

3. The 1993 Regulations and FSA Sourcebook should be revised (or other appropriate legal instrument issued) to impose an affirmative legal obligation on financial institutions and MSBs to give enhanced scrutiny to wire transfers that do not contain complete originator information.

4. Procedures should be developed for systematically, even if on a randomized basis, verifying compliance with AML/CFT requirements by small, low impact securities firms. General insurance should be brought within the scope of the AML/CFT Regulations and FSA Sourcebook, with compliance verified by FSA. Compliance checking of the insurance sector by FSA should be intensified.</td></tr>
<tr><td colspan="2">Criterion 49</td></tr>
<tr><td>Description and Analysis</td><td><u>a) Legal and Institutional</u>
As discussed under Criterion 55, U.K. law imposes criminal liability on financial institutions and MSBs for failure to report knowledge or suspicion of ML or FT (in some cases, reasonable grounds for knowing or suspecting ML or FT). However, neither the criminal statutes, the 1993 Regulations nor the Sourcebook imposes an affirmative obligation on financial institutions and MSBs to pay special attention to all complex, unusual large transactions, or unusual patterns of transactions, that have no apparent or visible economic or lawful purpose, or otherwise to have specified procedures in place to recognize such transactions. U.K. law similarly imposes no affirmative obligation for financial institutions and MSBs to examine as far as possible the background and purpose of these kinds of transactions; or to set forth their findings in writing and keep such findings for review by the competent authorities.

<u>b) Implementation</u> Monitoring compliance with AML/CFT requirements including with respect to the analysis of complex transactions or unusual patterns of transactions, is an integral component of FSA activities as a financial supervisor, which extends to FSA regulated firms and individuals. For a full discussion of the supervisory arrangements FSA has put in place to ensure compliance with the AML/CFT regime see the response to criterion 45 above and the introductory section at criterion 68. Where applied, FSA oversight assures that account monitoring guidelines are implemented. The discussion at Criterion 68 discusses gaps in FSA AML/CFT oversight with respect to the securities and insurance sectors.

<u>Banking</u>: Fully implemented

<u>Securities</u>: AML/CFT compliance checking by FSA of small, low impact securities firms is too limited to verify the observance of those firms with the account monitoring guidelines. Otherwise, implementation in the securities sector is satisfactory.

<u>Insurance</u>: Exclusion of general insurance is a significant gap in the AML/CFT regime implemented by FSA. For the other parts of the insurance sector that are subject to FSA oversight, awareness of AML/CFT requirements appears to be low and FSA supervisory efforts are perfunctory.</td></tr>
<tr><td colspan="2">Criterion 50</td></tr>
<tr><td>Description and</td><td><u>a) Legal and Institutional</u></td></tr>
</table>

Analysis	Neither the criminal statutes nor the 1993 Regulations require financial institutions or MSBs to give special attention to business relations and transactions with persons in jurisdictions that do not have adequate systems in place to prevent or deter ML or FT. The Sourcebook requires financial institutions covered by the Sourcebook to obtain and "make proper use" of any U.K. government or FATF findings of material deficiencies in the approach to ML of individual countries or jurisdictions (Sourcebook section 5.1). "Proper use" is defined to include applying information concerning material deficiencies to "know your business" information; in awareness and training programs; and in certain circumstances where there are exceptions from customer identification requirements based on the assurance of a third party that he has obtained and recorded the customer identification evidence that would otherwise be required under the Sourcebook (section 5.1.2(2)(a). b) Implementation Monitoring compliance with AML/CFT requirements including the requirement to make proper use of findings of material deficiencies in particular countries or jurisdictions, is an integral component of FSA activities as a financial supervisor, which extends to FSA regulated firms and individuals. These requirements are effectively implemented via the Sourcebook requirement described above and various guidance provided in the JMLSG Guidance Notes. See the introductory section at criterion 68 for a fuller discussion of the supervisory arrangements FSA has put in place to ensure compliance with the AML/CFT regime. Where applied, FSA oversight assures that the requirement to make proper use of findings of material deficiencies in particular countries or jurisdictions, as described above, are fully implemented. The discussion at Criterion 68 discusses gaps in FSA AML/CFT oversight with respect to the securities and insurance sectors. Banking: Fully implemented Securities: AML/CFT compliance checking by FSA of small, low impact securities firms is too limited to verify the compliance of those firms with the requirement to make proper use of findings of material deficiencies in particular countries or jurisdictions, as described above. Otherwise, implementation in the securities sector is satisfactory. Insurance: Exclusion of general insurance is a significant gap in the AML/CFT regime implemented by FSA. For the other parts of the insurance sector that are subject to FSA oversight, awareness of AML/CFT requirements appears to be low and FSA supervisory efforts are perfunctory.
Criterion 51	
Description and Analysis	a) Legal and Institutional U.K. law does not currently require prudentially regulated institutions or MSBs to give enhanced scrutiny to wire transfers that lack complete originator information. Indeed, as discussed under Criterion 48, U.K. law does not currently require that originator information be included in wire transfers originating in the U.K. b) Implementation: As an integrated regulator FSA has supervisory authority for implementing the AML/CFT regime as it applies to FSA regulated firms and individuals. As noted in (a) above, originator information is not currently required to be included in wire transfers originating in the United Kingdom, and, hence, criterion 51 is not implemented.

Record keeping

Detailed Assessment of Criteria 52-54 (Assessors are to describe and analyze the (a) legal and institutional; and (b) implementation, aspects for each of Criteria 52-54 for the (i) banking; (ii) insurance; (iii) securities; and (iv) other financial institutions, sectors)

Overall Description and Analysis
NOTE: Sector specific detailed criteria on record keeping are found (i) for the banking sector in Criterion 88 (ii) for the insurance sector in Criteria 106 and 107, and (iii) for the securities sector in Criterion 112. The overall

description and analysis should also consider the assessments of the sector specific criteria.	
a) Legal and Institutional b) Implementation	
Recommendations and Comments	
In light of the descriptions and analyses below, the following is recommended: 1. The 1993 Regulations and Sourcebook should be revised to specify, as contemplated in the Methodology, the minimum information that financial institution and MSBs must include in their transaction records (i.e., the customer's (and beneficiary's) name, address (or other identifying information), the nature and date of the transaction, the type and amount of currency involved, and the type and identifying number of any account involved in the transaction). 2. Given the important *exceptions* to the customer due diligence requirements under the 1993 Regulations and FSA Sourcebook (see Criterion 46), consideration should be given to revising the Regulations and Sourcebook to require financial institutions and MSBs to keep records of the basis on which a particular customer or transaction was considered to be exempt from the customer identification requirements. (Such a requirement is already included in the Sourcebook, but only in connection with the Sourcebook's financial exclusion exception.) 3. Procedures should be developed for systematically, even if on a randomized basis, verifying compliance with AML/CFT requirements by small, low impact securities firms. General insurance should be brought within the scope of the AML/CFT Regulations and FSA Rules, with compliance verified by FSA. Compliance checking of the insurance sector by FSA should be intensified.	
Criterion 52	
Description and Analysis	a) Legal and Institutional With respect to records of customer identity, the Regulations provide that record keeping procedures are in accordance with the Regulations if, they require the keeping of certain records, including, in cases where customer due diligence procedures are required, a record that indicates the nature of the evidence obtained and either (a) comprises a copy of the evidence, or (b) provides such information as would enable a copy of the evidence to be obtained, or (c) in cases where "it is not reasonably practicable to comply" with either of the preceding two requirements, provides sufficient information to enable the details as to a person's identity contained in the relevant evidence to be re-obtained. (Regulation 12(1)) Records are generally required to be kept for a period of at least five years from the date on which the relevant business relationship or activity was completed. (Regulation 12(2)). The Sourcebook imposes substantially similar recordkeeping requirements. (Section 7.3.2(1)(a)) The Sourcebook also requires that firms keep records generally for a five-year period of (1) the reasons for which a conclusion is reached to treat a client as excluded under the Sourcebook's "financial exclusion" provisions; (2) actions taken under the Sourcebook provisions concerning internal and external reporting; and (3) suspicious transactions information or other matters that a money laundering reporting officer ("MLRO") has considered but not reported to the National Criminal Intelligence Service pursuant to the reporting obligations of the Sourcebook. Records maintained by financial institutions pursuant to these requirements are available for inspection by the FSA; MSB records are available for inspection by HMCE. b) Implementation MSBs: Given the recent adoption of the new supervisory framework for MSBs, it is too early to meaningfully assess the manner in which MSBs are implementing these requirements in practice, or the scope and effectiveness of HMCE's efforts to ensure that MSBs are observing the record keeping requirements of the 1993 Regulations.

	Financial Institutions: Monitoring compliance with AML/CFT requirements including the five year record keeping requirement discussed above, is an integral component of FSA activities as a financial supervisor, which extends to FSA regulated firms and individuals. For a full discussion of the supervisory arrangements FSA has put in place to ensure compliance with the AML/CFT regime see response to criterion 45 above and the introductory section at criterion 68. Where applied, FSA oversight assures that the record keeping requirement discussed above is fully implemented. The discussion at Criterion 68 discusses gaps in FSA AML/CFT oversight with respect to the securities and insurance sectors. Banking: Fully implemented Securities: AML/CFT compliance checking by FSA of small, low impact securities firms is too limited to verify the compliance of those firms with record keeping requirements. Otherwise, implementation in the securities sector is satisfactory. Insurance: Exclusion of general insurance is a significant gap in the AML/CFT regime implemented by FSA. For the other parts of the insurance sector that are subject to FSA oversight, awareness of AML/CFT requirements appears to be low and FSA supervisory efforts are perfunctory.
Criterion 53	
Description and Analysis	a) Legal and Institutional Regarding records of customer transactions, the 1993 Regulations provide that record keeping procedures are in accordance with the Regulations if they require the keeping of certain records, including a record containing details relating to all transactions carried out by the covered person in the course of a relevant financial business covered by the 1993 Regulations. (Regulation 12(1)) Records are generally required to be kept for a period of at least five years from the date on which all activities taking place in the course of the transaction were completed. (Regulation 12(2)). There are additional recordkeeping requirements where a covered person is an appointed representative acting on behalf of a principal; or where a covered person has grounds for believing that a customer has become insolvent (Regulation 13(4)-(6); 12(3)). As discussed under Criterion 52 above, the Sourcebook imposes substantially similar recordkeeping requirements to those applicable under the 1993 Regulations (Section 7.3.2(1)(a)), as well as certain additional requirements. Records maintained by financial institutions pursuant to these requirements are available for inspection by the FSA; MSB records are available for inspection by HMCE. Neither the 1993 Regulations nor the Sourcebook specify minimum information (such as customer name and address, and nature and date of the transaction) that is to be included in transactions records. b) Implementation MSBs: Given the recent adoption of the new supervisory framework for MSBs, it is too early to meaningfully assess the manner in which MSBs are implementing these requirements in practice, or the scope and effectiveness of HMCE's efforts to ensure that MSBs are observing the customer transactions record keeping requirements of the 1993 Regulations. Financial Institutions: Monitoring compliance with AML/CFT requirements including the record keeping requirement discussed above, is an integral component of FSA activities as a financial supervisor, which extends to FSA regulated firms and individuals. For a full discussion of the supervisory arrangements FSA has put in place to ensure compliance with the AML/CFT regime see the response to criterion 45 above and the introductory section at criterion 68 below. Where applied, FSA oversight assures that the record keeping standards discussed above is fully implemented. The discussion at Criterion 68 discusses gaps in FSA AML/CFT oversight with respect to the securities and insurance sectors. Banking: Fully implemented

	Securities: AML/CFT compliance checking by FSA of small, low impact securities firms is too limited to verify the compliance of those firms with the record keeping standards discussed above**.** Otherwise, implementation in the securities sector is satisfactory. Insurance: Exclusion of general insurance is a significant gap in the AML/CFT regime implemented by FSA. For the other parts of the insurance sector that are subject to FSA oversight, awareness of AML/CFT requirements appears to be low and FSA supervisory efforts are perfunctory.
Criterion 54	
Description and Analysis	a) Legal and Institutional The Financial Services and Markets Act gives the FSA broad authority to inspect and/or require the production of any documents reasonably required by the FSA in the exercise of its functions; as such, records maintained by FSA-regulated persons pursuant to the requirements summarized above are available to the FSA. HMCE is empowered under the 2001 Regulations to enter and inspect the premises of MSBs or suspected MSBs, and to inspect information found on the premises and/or request the MSB to furnish information to HMCE. b) Implementation MSBs: Given the recent adoption of the new supervisory framework for MSBs, it is too early to meaningfully assess the scope and effectiveness of HMCE's efforts to ensure that MSBs make available to it customer and transaction records and information for AML/CFT investigations and prosecutions. Financial Institutions: Monitoring compliance with AML/CFT requirements including the record retention and inspection requirement discussed above, is an integral component of FSA activities as a financial supervisor, which extends to FSA regulated firms and individuals. For a fuller discussion of the supervisory arrangements FSA has put in place to ensure compliance with the AML/CFT regime see the response to criterion 45 above and the introductory section at criterion 68 below. Where applied, FSA oversight assures that the record keeping standards discussed above is fully implemented. The discussion at Criterion 68 discusses gaps in FSA AML/CFT oversight with respect to the securities and insurance sectors. Banking: Fully implemented Securities: AML/CFT compliance checking by FSA of small, low impact securities firms is too limited to verify the compliance of those firms with the record keeping standards discussed above**.** Otherwise, implementation in the securities sector is satisfactory. Insurance: Exclusion of general insurance is a significant gap in the AML/CFT regime implemented by FSA. For the other parts of the insurance sector that are subject to FSA oversight, awareness of AML/CFT requirements appears to be low and FSA supervisory efforts are perfunctory.
Suspicious transactions reporting **Detailed Assessment of Criteria 55-57** (Assessors are to describe and analyze the (a) legal and institutional; and (b) implementation, aspects for each of Criteria 55-57 for the (i) banking; (ii) insurance; (iii) securities; and (iv) other financial institutions, sectors)	
Overall Description and Analysis NOTE: Sector specific detailed criteria on suspicious transaction reporting are found (ii) for the insurance sector in Criteria 101-104 and (iii) for the securities sector in Criterion 111. The overall description and analysis should also consider the assessments of the sector specific criteria.	
a) Legal and Institutional b) Implementation	
Recommendations and Comments	
In light of the descriptions and analyses below, the following is recommended: 1. Part 7 of the PCA 2002 should be made effective as soon as possible, given its significant improvements in the legal regime for suspicious transactions reporting (inter alia, by imposing broader criminal reporting obligations on the regulated sector, requiring all regulated entities to file STRs with NCIS (rather than any "constable" in the	

<table>
<tr><td colspan="2">U.K.), and providing for a uniform form to be used in the reporting of suspicious transactions).
2. Consideration should be given to revising the 1993 Regulations and Sourcebook to impose FT-related suspicious reporting obligations, or to drafting parallel regulations for this purpose. In addition, the 1993 Regulations and Sourcebook should be revised to include a more current range of FT-related ML predicate offenses, including those under the Terrorism Act and ATCS 2001.
3. Procedures should be developed for systematically, even if on a randomized basis, verifying compliance with AML/CFT requirements by small, low impact securities firms. General insurance should be brought within the scope of the AML/CFT Regulations and FSA Rules, with compliance verified by FSA. Compliance checking of the insurance sector by FSA should be intensified.</td></tr>
<tr><td colspan="2">Criterion 55</td></tr>
<tr><td>Description and Analysis</td><td><u>a) Legal and Institutional</u>
Financial institutions and MSBs are required to report suspicions of ML and FT under the criminal laws and the 1993 Regulations, as well as under the Sourcebook in the case of financial institutions subject to the Sourcebook.
When it enters into force, Part 7 of the Proceeds of Crime Act 2002 would make it a crime for persons in the regulated sector (defined, inter alia, to include financial institutions and MSBs) to fail to disclose knowledge or suspicion of ML, or reasonable grounds for knowing</td></tr>
</table>

	or suspecting ML, either to a "nominated officer" (compliance officer) of the financial institution or MSB, or directly to a person authorized by NCIS to receive such reports. Nominated officers working within or outside of the regulated sector who receive suspicious transactions reports may also be found criminally liable if they fail to disclose the information to a person designated for this purpose by NCIS. The "reasonable grounds" criterion amounts to a negligence standard for failure to report ML and is an expansion of the pre-PCA 2002 failure to report offense (which covered only actual knowledge or suspicion of ML). The requirement to report to a person designated by NCIS is also new (the pre-PCA 2002 statutory requirements allowed financial institutions and MSBs to make disclosure to any constable). The following discussion summarizes the pre-PCA 2002 statutory regime governing disclosure of suspicious transactions, as these provisions remain applicable until Part 7 of the PCA 2002 becomes effective. The DTA makes it a crime for any person to fail to report knowledge or suspicion of drug trafficking-related ML as soon as is reasonably practicable after the information comes to the attention of the person, where the information on which the knowledge or suspicion is based is acquired in the course of the person's trade, business, profession or employment (DTA section 52(1)). It also provides that disclosure of such information to a constable or an appropriate person ("compliance officer") designated by an employer to receive such disclosures shall not be treated as a breach of any restriction imposed by statute or otherwise (DTA sections 50(3), 52(4), (6)). Similar requirements apply under the Terrorism Act 2000 for financial institutions and MSBs to report knowledge or suspicion of FT-related activities that come to their attention in the course of a trade, profession, business or employment (section 19). In addition, the Terrorism Act (as amended by the ATCS 2001) broadens the disclosure obligation by making it a crime for a person in a regulated sector (defined to include financial institutions and MSBs) not to file a suspicious transaction report if he has reasonable grounds for knowing or suspecting that another person is engaged in FT (section 21A(2), Schedule 2, Part 3). The DTA and CJA provide further incentives for reporting of suspicious activity by making disclosure (and even intended disclosure) to a constable or compliance officer of knowledge or suspicion of money laundering a defense against criminal prosecution for certain money laundering offenses (DTA sections 50(3)-(5); 51(5)-(8); CJA sections 93A(3)-(5); 93B(5)-(8)). Finally, the DTA, CJA and Terrorism Act 2000 make it an offense to "tip-off" a suspect that a suspicious transactions report has been filed with a government agency. The 1993 Regulations provide that the internal reporting procedures of a financial institution or MSB are in accordance with the Regulations if, inter alia, they designate an "appropriate person" to whom reports of knowledge or suspicion of ML are to be made, and include provision for ensuring that information or other matter contained in such internal reports are disclosed to a "constable" in cases where the designated appropriate person knows or suspects that another person is engaged in ML (Regulation 14). The 1993 Regulations do not currently require that suspicious transactions reports be filed with the NCIS, but rather with any "constable" in the U.K. (which includes NCIS but also a large number of other law enforcement agencies, including local police forces). As noted above, however, the PCA 2002 requires that nominated officers in the regulated sector or otherwise file suspicious transactions reports only with a person authorized by NCIS to receive such reports, and the authorities have indicated that NCIS is likely to designate itself for purposes of receiving these reports once the relevant provisions of the PCA 2002 enter into force. For its part, the Sourcebook requires financial institutions to take reasonable steps to ensure that internal reports of knowledge or suspicion of ML made by any staff member are considered by the MLRO (or his authorized delegate) and promptly reported to NCIS whenever the MLRO or delegate suspects that a person has been engaged in ML (section 4.3.2R.). Persons subject to the Sourcebook generally must permit the MLRO to have access to any "know your business" or other information that could be relevant, and should ensure

	that the MLRO or his designate is able to report suspicion of money laundering without having to obtain consent or approval of any other person (section 4.3.3E). The Sourcebook also requires that a record be kept where an MLRO has considered information concerning knowledge or suspicion of ML, but decides not to make a report to the NCIS (section 7.3.2). The current duty under U.K. law to report suspicions of terrorist financing are statutory but not regulatory, as neither the 1993 Regulations nor Sourcebook require the reporting of suspicions of FT as such (but rather only reporting of ML, including ML related to an FT predicate crime). This raises a concern, as it is doubtful that this obligation can be read to require reporting of FT in cases where no ML is involved (e.g., where the source of funds used for the FT is legitimate). The fact that there is a separate statutory requirement somewhat minimizes this concern, but it nonetheless would be useful to incorporate FT suspicious transactions reporting into the 1993 Regulations and Sourcebook (especially given the non-criminal law focus of the Sourcebook). Separately, the FT predicate crimes currently covered by the 1993 Regulations and Sourcebook are limited: they include only terrorist financing offenses as defined under older legislation (the Prevention of Terrorism (Temporary Provisions) Act 1989), rather than under the recent, broader definitions of FT such as those found in the Terrorism Act and ATCS 2001.As discussed earlier, the PCA 2002 authorizes the Secretary of State to prescribe the form and manner in which the suspicious transactions reports required under the statute are to be made both by persons in the regulated sector or otherwise (section 339). Until this provision enters into force, however, there is no standard nationwide form in the U.K. for the reporting of suspicious transactions (NCIS has a recommended but not mandatory reporting format that reportedly is used by most financial institutions and MSBs) The authorities expect that a standard form for the reporting of suspicious transactions pursuant to the PCA 2002 will be issued in 2003. b) Implementation MSBs: Even under the pre-PCA 2002 statutory regime, the authorities report that the vast majority of STRs were filed with NCIS. Bureaux de change accounted for 14% of all suspicious reports that were filed with NCIS in 2001. High volume reporting institutions have electronic links to NCIS for reporting suspicious transactions, and a project under development would expand electronic reporting to medium-level disclosing institutions. There is also a telephone 'hotline' for raising urgent queries with an NCIS desk officer. Given the recent adoption of the new supervisory framework for MSBs, it is too early to meaningfully assess the scope and effectiveness of HMCE's efforts to ensure that MSBs are observing the suspicious transactions reporting requirements of the criminal laws and 1993 Regulations. Financial Institutions: Monitoring compliance with AML/CFT requirements including the suspicious transactions reporting requirements described above, is an integral component of FSA activities as a financial supervisor, which extends to FSA regulated firms and individuals. For a fuller discussion of the supervisory arrangements FSA has put in place to ensure compliance with the AML/CFT regime see the introductory section at criterion 68. Where applied, FSA oversight assures that the requirement that financial institutions promptly report suspicious transactions to NCIS, as described above, is fully implemented. The discussion at Criterion 68 discusses gaps in FSA AML/CFT oversight with respect to the securities and insurance sectors. Banking: Fully implemented Securities: AML/CFT compliance checking by FSA of small, low impact securities firms is too limited to verify the compliance of those firms with the suspicious transactions reporting requirement described above. Otherwise, implementation in the securities sector is

	satisfactory. <u>Insurance</u>: Exclusion of general insurance is a significant gap in the AML/CFT regime implemented by FSA. For the other parts of the insurance sector that are subject to FSA oversight, awareness of AML/CFT requirements appears to be low and FSA supervisory efforts are perfunctory.
Criterion 56	
Description and Analysis	<u>a) Legal and Institutional</u> As noted above, the DTA provides that disclosure of knowledge or suspicion of drug trafficking-related ML to a constable or a compliance officer designated to receive such disclosures shall not be treated as a breach of any restriction imposed by statute or otherwise (DTA sections 50(3), 52(4), (6)). Similar provisions apply under the PCA 2002 (section 337), CJA (sections 93A(3), 93B(5), ATCS 2001 (Section 21B), and Terrorism Act (Section 19). <u>b) Implementation</u>: Implemented via legislation.
Criterion 57	
Description and Analysis	<u>a) Legal and Institutional</u> As discussed under Criterion 55, the PCA 2002, DTA, CJA and Terrorism Act make it an offense to "tip-off" a suspect that a suspicious transactions report has been filed with a government agency. <u>b) Implementation</u>: Monitoring compliance with AML/CFT requirements including the prohibitions on tipping-off described above, is an integral component of FSA activities as a financial supervisor, which extends to FSA regulated firms and individuals. For a fuller discussion of the supervisory arrangements FSA has put in place to ensure compliance with the AML/CFT regime see the introductory section at criterion 68. Where applied, FSA oversight assures that the prohibitions on tipping off described above**,** is fully implemented. The discussion at Criterion 68 discusses gaps in FSA AML/CFT oversight with respect to the securities and insurance sectors. <u>Banking</u>: Fully implemented <u>Securities</u>: AML/CFT compliance checking by FSA of small, low impact securities firms is too limited to verify the compliance of those firms with the prohibitions on tipping-off described above**.** Otherwise, implementation in the securities sector is satisfactory. <u>Insurance</u>: Exclusion of general insurance is a significant gap in the AML/CFT regime implemented by FSA. For the other parts of the insurance sector that are subject to FSA oversight, awareness of AML/CFT requirements appears to be low and FSA supervisory efforts are perfunctory.

Internal controls, Compliance and Audit

Detailed Assessment of Criteria 58-61 (Assessors are to describe and analyze the (a) legal and institutional; and (b) implementation, aspects for each of Criteria 58-61 for the (i) banking; (ii) insurance; (iii) securities; and (iv) other financial institutions, sectors)

Overall Description and Analysis NOTE: Sector specific detailed criteria on internal controls, compliance, and audit are found (i) for the banking sector in Criteria 89-92 (ii) for the insurance sector in Criteria 109 and 110, and (iii) for the securities sector in Criterion 113. The overall description and analysis should also consider the assessments of the sector specific criteria.
<u>a) Legal and Institutional</u> <u>b) Implementation</u>
Recommendations and Comments

In light of the descriptions and analyses below, the following is recommended:

1. Consideration should be given to requiring financial institutions and MSBs to adopt internal controls and procedures, and designate an appropriate compliance person, to prevent their institutions from being used for FT as such (rather than only for ML and the FT-related predicate offenses covered thereby).

2. Consideration should be given to expressly requiring that the AML/CFT programs of financial institutions and MSBs must include an audit function.

3. The 1993 Regulations should be revised to expressly require that the "appropriate person' required under the Regulations to handle the internal and external reporting requirements of the Regulations must be at management level.

4. MSBs should be required to put in place adequate screening procedures to ensure high standards when hiring employees.

5. Procedures should be developed for systematically, even if on a randomized basis, verifying compliance with AML/CFT requirements by small, low impact securities firms. General insurance should be brought within the scope of the AML/CFT Regulations and FSA Rules, with compliance verified by FSA. Compliance checking of the insurance sector by FSA should be intensified.

Criterion 58	
Description and Analysis	<u>a) Legal and Institutional</u> As noted above, the main thrust of the FSA Sourcebook is to bring a regulatory systems and controls focus to AML, by requiring financial institutions to have effective AML systems and controls, and to ensure that the MLRO and other approved persons exercise appropriate responsibilities in relation to these AML systems and controls. The Sourcebook requires financial institutions to designate a senior-level MLRO with overall responsibility for the oversight and implementation of the firm's AML strategy. The MLRO's responsibilities include, inter alia, receiving internal reports of knowledge or suspicion of ML; taking reasonable steps to access relevant "know your business" information maintained by the firm; making external reports to the NCIS where appropriate; taking reasonable steps to maintain adequate arrangements for employee awareness and training; and making annual reports to the firm's senior management on the firm's compliance with the Sourcebook and other aspects of AML systems and controls (sections 7.1, 7.2). The 1993 Regulations prohibit financial institutions and MSBs from forming a business relationship or carrying out a one-off transaction unless they maintain appropriate AML procedures and controls for customer identification, record keeping, suspicious transactions reporting, employee awareness and training, and other aspects of ML prevention. (Regulation 5) Financial institutions and MSBs also must identify an "appropriate person" with responsibility for receiving and considering reports of knowledge or suspicion of ML, and reporting such information where the appropriate person knows or suspects that another person is engaged in ML (Regulation 14). The 1993 Regulations also require financial institutions and MSBs to take appropriate measures to make employees aware of the ML laws and the internal AML systems and controls in place at the institution, and to provide employees with training in recognizing and handling suspicious transactions (Regulation 5(1)(b), (c)). Neither the 1993 Regulations nor the Sourcebook expressly require that financial institutions and MSBs establish an audit function as part of their AML/CFT compliance systems. The authorities argue, however, that an audit function is implicit in all AML systems and controls, and that the absence of a specific requirement does not detract from this.

	Further, because the 1993 Regulations and Sourcebook are limited by their terms to AML, they cover ML offenses related to certain FT predicate crimes, but do not per se require financial institutions to adopt internal controls and procedures to prevent their institutions from being used for FT purposes as such. This raises concerns, as it is doubtful that the obligation to have AML systems and controls can be read as requiring CFT systems and controls in cases where no ML is involved (e.g., where the source of funds used for FT is legitimate). The assessors recognize that there is as yet no comprehensive best practices or agreed upon approach concerning CFT controls, but the U.K. may be an appropriate jurisdiction to take a lead in this area. A requirement for CFT internal controls and procedures could usefully be added not only to the 1993 Regulations or similar criminal provisions, but also to non-criminal requirements such as the FSA Sourcebook. b) Implementation The provisions of the 1993 Regulations and Sourcebook governing internal systems and controls to prevent ML are comprehensive (other than with respect to the failure to specifically require an AML audit function as noted above). Further, while there are no express parallel provisions governing controls against FT, the assessors understand that the JMLSG is currently working on the development of typologies that will address specific issues related to internal systems and controls to prevent FT. Financial Institutions: Monitoring compliance with AML/CFT requirements including the requirement discussed above for internal procedures to prevent financial institutions being used for ML purposes, is an integral component of FSA activities as a financial supervisor, which extends to FSA regulated firms and individuals. For a full discussion of the supervisory arrangements FSA has put in place to ensure compliance with the AML/CFT regime see the introductory section at criterion 68. Where applied, FSA oversight assures that the requirement discussed above for internal procedures to prevent financial institutions being used for ML purposes is fully implemented. The discussion at Criterion 68 discusses gaps in FSA AML/CFT oversight with respect to the securities and insurance sectors. Banking: Fully implemented Securities: AML/CFT compliance checking by FSA of small, low impact securities firms is too limited to verify the compliance of those firms with the requirement discussed above for internal procedures to prevent financial institutions being used for ML purposes. Otherwise, implementation in the securities sector is satisfactory. Insurance: Exclusion of general insurance is a significant gap in the AML/CFT regime implemented by FSA. For the other parts of the insurance sector that are subject to FSA oversight, awareness of AML/CFT requirements appears to be low and FSA supervisory efforts are perfunctory.
Criterion 59	
Description and Analysis	a) Legal and Institutional The Sourcebook requires financial institutions to designate a “senior” level MLRO to serve as the focal point within the institution for the oversight of all activity relating to AML. In addition, the MLRO position is a “controlled function”, which means that persons proposed as MLRO must be individually reviewed and approved by the FSA. (Section 7.1.1) The 1993 Regulations oblige financial institutions and MSBs to identify an “appropriate person” to be responsible for receiving and considering reports of knowledge or suspicion of ML and reporting such information to a constable. The Regulations do not, however, require that the person designated for this purpose be at management level.

	Neither the Sourcebook, the 1993 Regulations nor the criminal laws call for the designation of a high-level *CFT* compliance officer as such. As FT is an AML predicate crime, the functions exercised by the AML compliance officer designated pursuant to these Regulations, Sourcebook and general criminal laws would be expected to cover FT and other predicate crimes (but does not strictly speaking cover FT as such). b) Implementation Monitoring compliance with AML/CFT requirements including the MLRO requirement discussed above, is an integral component of FSA activities as a financial supervisor, which extends to FSA regulated firms and individuals. The introductory section at Criterion 68 below provides a full discussion of the supervisory arrangements FSA has put in place to ensure compliance with the AML/CFT regime. Where applied, FSA oversight assures that the MLRO requirement discussed above is fully implemented. The discussion at Criterion 68 discusses gaps in FSA AML/CFT oversight with respect to the securities and insurance sectors. Banking: Fully implemented Securities: AML/CFT compliance checking by FSA of small, low impact securities firms is too limited to verify the compliance of those firms with the MLRO requirement discussed above. Otherwise, implementation in the securities sector is satisfactory. Insurance: Exclusion of general insurance is a significant gap in the AML/CFT regime implemented by FSA. For the other parts of the insurance sector that are subject to FSA oversight, awareness of AML/CFT requirements appears to be low and FSA supervisory efforts are perfunctory.
Criterion 60	
Description and Analysis	a) Legal and Institutional As discussed under Criterion 62, the FSA has detailed suitability and "fit and proper" tests for persons subject to its "approved persons" regime. In addition, a financial institution has broad obligations to assess the suitability of anyone who acts for it, including the individual's honesty and competence, and this assessment should normally be made at the point of recruitment. The 1993 Regulations require MSBs to adopt internal AML procedures governing employee awareness and training, but do not address issues related to the screening of MSB employees. b) Implementation: Monitoring compliance with AML/CFT requirements including the employee screening procedures described above, is an integral component of FSA activities as a financial supervisor, which extends to FSA regulated firms and individuals. The introductory section at Criterion 68 below provides a full discussion of the supervisory arrangements FSA has put in place to ensure compliance with the AML/CFT regime. Where applied, FSA oversight assures that the employee screening procedures described above are fully implemented. The discussion at Criterion 68 discusses gaps in FSA AML/CFT oversight with respect to the securities and insurance sectors. Banking: Fully implemented Securities: AML/CFT compliance checking by FSA of small, low impact securities firms is too limited to verify the compliance of those firms with the employee screening procedures described above. Otherwise, implementation in the securities sector is satisfactory. Insurance: Exclusion of general insurance is a significant gap in the AML/CFT regime implemented by FSA. For the other parts of the insurance sector that are subject to FSA

	oversight, awareness of AML/CFT requirements appears to be low and FSA supervisory efforts are perfunctory.
Criterion 61	
Description and Analysis	a) Legal and Institutional The FSA's systems and controls requirements apply in a prudential context to U.K. firms with respect to activities wherever they are carried out. (Handbook, SYSC 1.1.9 R) As such, the AML systems and controls in place in a financial institution's overseas branches would need to be appropriate and effective in the same way that they are within the U.K. For firms subject to consolidated supervision, the AML systems and controls in place in overseas subsidiaries must meet the higher of the local standards or U.K. standards. The Sourcebook's requirements apply only to activities conducted from an establishment in the U.K. Financial institutions are required, however, to notify the FSA of any matter that could have a significant impact on their reputation (Handbook, SUP 15.3.1 R (2)), which would include notifying the FSA if any regulated firm's foreign branches or subsidiaries were unable to observe the applicable U.K. AML standards. The 1993 Regulations do not address issues related to foreign branches and subsidiaries of persons subject to the Regulations. This shortcoming does not appear to be significant in the case of MSBs, however, given that most MSBs—unlike prudentially regulated financial institutions—do not have foreign locations. b) Implementation Monitoring compliance with AML/CFT requirements including the requirement that overseas branches and subsidiaries comply with AML/CFT procedures as described above, is an integral component of FSA activities as a financial supervisor, which extends to FSA regulated firms and individuals. For FSA procedures for insuring that overseas branches and subsidiaries comply with AML/CFT requirements, see the response to criterion 91 below. For a fuller discussion of the supervisory arrangements FSA has put in place to ensure compliance with the AML/CFT regime see the introductory section at criterion 68. Where applied, FSA oversight assures that the requirement that overseas branches and subsidiaries comply with AML/CFT procedures as described above are fully implemented. The discussion at Criterion 68 discusses gaps in FSA AML/CFT oversight with respect to the securities and insurance sectors. Banking: Fully implemented Securities: AML/CFT compliance checking by FSA of small, low impact securities firms is too limited to verify the compliance of those firms with the requirement that overseas branches and subsidiaries comply with AML/CFT procedures as described above. Otherwise, implementation in the securities sector is satisfactory. Insurance: Exclusion of general insurance is a significant gap in the AML/CFT regime implemented by FSA. For the other parts of the insurance sector that are subject to FSA oversight, awareness of AML/CFT requirements appears to be low and FSA supervisory efforts are perfunctory.
Integrity standards **Detailed Assessment of Criteria 62 and 63** (Assessors are to describe and analyze the (a) legal and institutional; and (b) implementation, aspects for Criteria 62 and 63 for the (i) banking; (ii) insurance; (iii) securities; and (iv) other financial institutions, sectors)	
Overall Description and Analysis **N**OTE: A sector specific detailed criterion on integrity standards is found (iii) for the securities sector in Criterion 114. The overall description and analysis should also consider the assessments of this sector specific criterion.	
a) Legal and Institutional b) Implementation	

<table>
<tr><td colspan="2">Recommendations and Comments</td></tr>
<tr><td colspan="2">In light of the descriptions and analyses below, the following is recommended:

1. The 1993 Regulations, Sourcebook or other appropriate legal provisions should be revised to expressly prohibit criminals from holding or controlling a significant investment in financial institutions and MSBs.

2. The 2001 Regulations should also be revised to give HMCE powers to deny or cancel the registration of MSBs for integrity-related factors (e.g., convictions for ML, FT or similar serious crimes of the MSB, its controlling shareholders or managers).</td></tr>
<tr><td colspan="2">Criterion 62</td></tr>
<tr><td>Description and Analysis</td><td><u>a) Legal and Institutional</u>
U.K. law contains broad requirements concerning the suitability and other qualifications of legal entities and individuals that control financial institutions, as well as concerning persons that exercise management responsibilities in such institutions. The FSMA provides that, in giving or varying permission to carry out regulated activities, the FSA must be satisfied that the applicant will meet, on an ongoing basis, five Threshold Conditions (“TC”). TC5 (Suitability) requires the applicant firm to satisfy the FSA that it is “fit and proper” to have FSMA Part IV permission, having regard to all the circumstances. These circumstances include its connections with other persons, the range and nature of its proposed regulatory activities and the overall need to be satisfied that its affairs will be conducted soundly and prudently. The FSA Handbook (COND, 2.5.6G) sets out matters to be taken into account in determining whether a firm will meet TC5 in respect of conducting its business with integrity and in compliance with proper standards. One such matter is “whether the firm has been convicted, or is connected with a person who has been convicted, of any unspent offence involving fraud, corruption, perjury, theft, false accounting or other dishonesty, money laundering, market abuse or insider dealing, offenses under legislation relating to insurance, banking or other financial services, companies, insolvency, consumer credit or consumer protection, or any significant tax offence”.

In addition to assessing the suitability of the firm itself, the suitability of each person who performs a “controlled function” is assessed by the FSA under the “approved persons” regime. In certain circumstances, the FSA may consider that the firm is not suitable because of doubts about the individual or collective suitability of persons associated with the firm. SYSC 3.2.6 requires that a firm “take reasonable care to establish and maintain effective systems and controls for compliance with applicable requirements and standards under the regulatory system and for countering the risk that the firm might be used to further financial crime.” SYSC 3.2.13G provides guidance on SYSC 3.2.6 by stating that “a firm’s systems and controls should enable it to satisfy itself of the suitability of anyone who acts for it.” Under SYSC 3.2.14 G, this includes “assessing an individual’s honesty and competence. This assessment should normally be made at the point of recruitment.” A further aspect of the satisfaction of TC5 in terms of the employment of individuals, is that those employees who will be undertaking “controlled functions” must be assessed as “fit and proper” by the FSA before they can undertake that controlled function. In making this assessment of fitness and propriety, FSA will have regard to the “honesty, integrity and reputation; competence and capability; and financial soundness” of the person (Handbook, FIT 1.3.1 G).

There is nothing in the FSMA, Sourcebook or other law that per se prohibits persons with criminal records from holding or controlling a significant investment in prudentially regulated financial institutions, or from holding management functions. Thus, while in practice the FSA routinely reject applications filed in connection with such persons, it cannot be said that the FSA is required by law to do so, and it could well decide to approve such an application in a particular case.</td></tr>
</table>

	There are no "fit and proper" requirements concerning MSB controlling shareholders or managers, and no laws prohibiting criminals from holding or controlling a significant investment in or from carrying out management functions for an MSB. MSB applicants must provide HMCE with information, inter alia, on whether any person involved in the management, control or operation of the MSB has been convicted of ML. (Regulation 5(3)(b)(vii)) However, HMCE has no authority to deny an MSB application on the basis of such a conviction (as discussed above, it can deny an application "if and only if" an applicant fails to comply with the Regulations' information requirements, or if any of the information provided is materially false or misleading. (Regulation 7(1))). Similarly, once registered, HMCE cannot cancel an MSB's registration on integrity grounds, but rather can cancel only where there would have been grounds to reject the registration in the first place. (Regulation 8(1)) <u>b) Implementation</u> Monitoring compliance with AML/CFT requirements, including the fit and proper requirements described above, is an integral component of FSA activities as a financial supervisor, which extends to FSA regulated firms and individuals. The introductory section at Criterion 68 below provides a full discussion of the supervisory arrangements FSA has put in place to ensure compliance with the AML/CFT regime. Where applied, FSA oversight assures that including the fit and proper requirements described above are fully implemented. Although there are gaps in FSA oversight of securities and insurance firms for AML/CFT purposes, the requirements of this criterion are satisfied by more general prudential requirements. <u>Banking</u>: Fully implemented <u>Securities</u>: AML/CFT compliance checking by FSA of small, low impact securities firms is limited. However, even for these firms the fit and proper requirements described above are effectively implemented via the FSA Approved Persons Regime, which requires positive action by FSA**.** <u>Insurance</u>: Exclusion of general insurance is a significant gap in the AML/CFT regime implemented by FSA. However, even for these firms the fit and proper requirements described above are effectively implemented via the FSA Approved Persons Regime, which requires positive action by FSA**.**
Criterion 63	
Description and Analysis	<u>a) Legal and Institutional</u> U.K. law has various provisions that should help to minimize the risks of unlawful use of entities that are vulnerable to being used as conduits for criminal proceeds or FT. There is, however, no fit and proper test for the persons that own or manage such entities, and more generally no AML/CFT supervisory scheme to which they are subject. Public and private companies (including shell companies) are required to identify their directors annually and to update this information on a regular basis. Information on significant shareholders is not routinely disclosed, but is required under certain circumstances (e.g., where ownership in public companies exceed a specific percentage threshold, or upon request of a public company for information on the beneficial ownership of shares in the company). The Registrar of Companies can close a company or fine individual directors for failure to supply accounts. The Registrar also publishes a list of individuals, available to the public, who have been banned for any reason from operating as a director of a company. Charities in England and Wales are regulated by the Charity Commission and are required to provide the Commission with details of the names and addresses of their trustees; the Commission requests annual updates of this information. In addition, names of trustees are

	required to be specified on the charities' accounts which, if the income of the charity is over £10,000, are sent to the Charity Commission annually. The Charity Commission has additional powers that could aid investigations of abuse of charities, including the ability to direct a person to furnish accounts and statements in writing; to return answers in writing to questions or inquiries addressed to the person by the Commission; to furnish copies of documents in his or her custody or control; to furnish the Commission with information relating to any charity; and to attend, give evidence and produce documents at a specified time and place. The Commission can also order persons not to part with charity property; order debtors not to make payments to the charity; restrict charity transactions (effectively to freeze the activities of a charity); suspend trustees, officers, agents, and employees; appoint additional trustees; appoint a Receiver or Manager; and remove trustees, officers, agents, and employees. b) Implementation: As noted above, there is generally no AML/CFT supervisory scheme for shell corporations, charitable organizations and other entities vulnerable to use as conduits for criminal proceeds or FT. However, the responsible agencies are generally viewed as implementing well those legal requirements that do apply to such entities.
Enforcement powers and sanctions **Detailed Assessment of Criterion 64** (Assessors are to describe and analyze the (a) legal and institutional; and (b) implementation, aspects of Criterion 64 for the (i) banking; (ii) insurance; (iii) securities; and (iv) other financial institutions, sectors) NOTE: Sector specific detailed criteria on enforcement powers and sanctions are found (i) for the banking sector in Criteria 93-96 and (iii) for the securities sector in Criteria 115-117. Detailed assessment of criterion 64 should also consider the assessments of the sector specific criteria.	
Criterion 64	
Description and Analysis	a) Legal and Institutional The 1993 Regulations do not provide for the imposition of civil penalties. However, as discussed above, violation of the Regulations' requirements to adopt appropriate AML procedures and controls for customer identification, record keeping, suspicious transactions reporting, employee awareness and training, and other aspects of ML prevention are punishable as a criminal offense. Penalties include an unlimited fine, up to two years imprisonment, or both (Regulation 5(2)). Punishment may be imposed both on a financial institution or MSB that is a legal entity and on designated officers of such entities under certain circumstances (Regulation 6). The FSA has criminal prosecution powers over FSA-supervised persons that violate the 1993 Regulations, while HMCE has similar criminal prosecution powers for violations of the 1993 Regulations by MSBs. Violations of the 1993 Regulations can also be prosecuted by the Crown Prosecution Service and the Serious Fraud Office. No criminal sanctions apply for violation of the regulatory requirements established in the Sourcebook. However, the FSA has a broad range of enforcement tools at its disposal to deal with breach of those requirements, including power to publicly censure firms, impose monetary penalties, issue disqualification orders, and vary or cancel FSA permission (licenses) granted to a particular firm or individual. In addition to bringing criminal prosecutions, HMCE can deny the application of an MSB operator that fails to comply with the 2001 Regulations' requirements to provide information to HMCE, or that provides information that is materially false or misleading (Regulation 7(1)). It can also cancel an existing registration on similar grounds (Regulation 8(1)), and can impose a fine of up to £5,000 on any MSB that fails to comply with the 2001 Regulations' requirements concerning registration, provision of information to HMCE, payment of fees, and entry and inspection rights of HMCE (Regulation 15). As there is no fit and proper standard for MSBs, as noted above, the issue of sanctions for failure to

	comply with such standards is not applicable for these entities. b) Implementation: MSBs: The assessors understand that HMCE has not yet imposed any fines or undertaken any criminal actions for failure to observe the requirements of the 2001 and 1993 Regulations, respectively. Given the recent adoption of the new supervisory framework for MSBs, however, it is too early to meaningfully assess whether HMCE will effectively apply its powers to impose sanctions under the 1993 and 2001 Regulations.
Recommendations and Comments	The 1993 Regulations should be revised to provide for civil penalties (administrative fines), in addition to the existing criminal penalties, for failure to observe the Regulations' requirements to adopt appropriate AML procedures and controls. This point is especially important for MSBs, as the only existing civil fine option is for a limited £5,000 maximum fine that can be imposed only for limited procedural violations such as failure to register and to file information, but not failure to maintain adequate AML systems and controls. (Despite this limitation in the 1993 Regulations, the FSA can pursue a broad range of civil remedies against prudentially regulated institutions under its general enforcement authority.) The availability of only criminal sanctions for MSB systems and controls violations has a risk that in many cases no sanctions will be possible, as there could well be a lack of evidence to support a criminal proceeding in many cases (given the difficulty of demonstrating criminal intent for matters involving inadequate systems and controls; the high-level nature of the requirements imposed under the Regulations (which would make specific criminal intent and demonstration of a breach even more difficult to prove); and the higher standards of proof required for criminal convictions in general compared to civil enforcement.)

Cooperation between supervisors and other competent authorities

Detailed Assessment of Criteria 65-67 (Assessors are to describe and analyze the (a) legal and institutional; and (b) implementation, aspects for each of Criteria 65-66 for the (i) banking; (ii) insurance; (iii) securities; and (iv) other financial institutions, sectors)

Overall Description and Analysis
NOTE: Sector specific detailed criteria on cooperation between supervisors and other competent authorities are found (i) for the banking sector in Criteria 97-100 and (iii) for the securities sector in Criteria 118-120. The overall description and analysis should also consider the assessments of the sector specific criteria.

a) Legal and Institutional
b) Implementation

Recommendations and Comments

In light of the descriptions and analyses below, the following is recommended:

1. The self-financing scheme for HMCE supervision of MSBs should be kept under close review, to determine whether or not it can reasonably be expected to produce enough fees to enable HMCE to carry out its functions under the 2001 Regulations. It was not clear to the assessors how many activities—and in particular how many assurance visits—HMCE would be able to support on the basis of a £100 per premises fee. If this fee is enough to allow only a very limited number of visits each year (i.e., to only a small portion of total MSB premises), then it should be increased or if that is not practicable (e.g., due to the burden on smaller companies), then alternative non self-financing schemes should be considered as soon as possible.

Criterion 65

Description and Analysis	a) Legal and Institutional As noted under Criterion 44, the scope of HMCE's oversight over MSBs is fairly limited, as the 2001 Regulations are intended to apply a "light touch" supervisory regime. Nonetheless, as discussed above, the HMCE has important powers to enter and inspect the premises of MSBs or suspected MSBs, inspect information found on the premises and/or request the MSB to furnish information to HMCE (in some cases pursuant to a judicial order). HMCE

	has already begun to conduct limited scope "assurance visits" to MSBs that are essentially spot-check compliance visits to ensure that MSBs are complying with their obligations. HMCE has significant experience in ML and law enforcement matters and therefore should have adequate technical expertise to ensure effective implementation of its new MSB oversight role. Regarding financial resources and staffing, however, HMCE'S budget has not been augmented to reflect its new responsibilities under the 2001 Regulations. Rather, the government expects that the supervisory scheme will be self-financing (i.e., HMCE will impose sufficient fees on MSBs to enable it to meet the expenses incurred in carrying out its new functions). The 2001 Regulations expressly authorize HMCE to charge fees on this basis (Regulation 9(2)), and HMCE has for now proposed fees of £100 for each branch or premise of an MSB. b) Implementation MSBs: As noted above, there are questions as to whether HMCE's funding arrangements are sufficient to support a sufficiently robust program of assurance visits. Given the recent adoption of the new supervisory framework for MSBs, however, it is too early to form firm conclusions about the extent to which issues related to the structure, funding, staffing, and resources of HMCE will in practice affect its ability to fully perform its authorized AML/CFT functions over MSBs. Financial Institutions: FSA's staffing, structure and skills to implement its responsibilities under the AML/CFT regime are discussed at the introductory section to criterion 68. As described above, FSA is adequately structured, funded and staffed and has adequate expertise to satisfy the requirements of criterion 65.
Criterion 66	
Description and Analysis	a) Legal and Institutional As discussed above, U.K. law authorizes the FSA to cooperate and share information with both national and foreign regulators and to cooperate with both domestic and foreign persons having functions related to the prevention and detection of financial crime. Similarly, as a major law enforcement agency, HMCE has broad powers to cooperate and share information with domestic and international authorities, and to lend expertise with respect to AML/CFT analysis, investigations and prosecutions. b) Implementation: Financial Institutions: Based on the description above of the legal and institutional arrangements and discussions with other U.K. competent authorities, FSA co-operates spontaneously, or upon request, with other domestic competent authorities with respect to AML/CFT analysis, investigations, and prosecutions. MSBs: Given the recent adoption of the new supervisory framework for MSBs, it is too early to meaningfully assess the scope and effectiveness of HMCE's efforts to cooperate with other domestic authorities in AML/CFT analyses, investigations and prosecutions related to HMCE's supervision of MSBs.
Criterion 67	
Description and Analysis	a) Legal and Institutional As discussed earlier, the FSMA authorizes the FSA to cooperate and share information with both national and foreign regulators and to cooperate with both domestic and foreign persons having functions related to the prevention and detection of financial crime (sections 348, 354). Section 348 of FSMA places a duty on the FSA not to disclose confidential information without the consent of the person who provided it, and, if different, the person to whom it

	relates. However, this prohibition is lifted when disclosure is made through a "gateway" contained in the Financial Services and Markets Act 2000 (Disclosure of Confidential Information) Regulations 2001, one of which is for "the purposes of criminal proceedings and investigations." This gateway includes coverage for facilitating a determination of whether criminal proceedings or investigations should be initiated and therefore covers suspected as well as actual criminal activities as well; the general conditions are that a criminal investigation/prosecution is already underway, or is being considered. These provisions enable the FSA, on its own initiative or upon request, to exchange information relating to suspicious transactions with other domestic and foreign financial supervisors and law enforcement agencies. No court authorization is required for such disclosure of information by the FSA. More generally, the ATCS 2001 provides broad "gateway" powers for the disclosure of information by HMCE and other U.K. public authorities, inter alia, to assist any criminal investigation or criminal proceedings in the U.K. or abroad, or to facilitate determinations of whether or not such investigations or proceedings should begin or end (sections 17, 19). Some limitations apply to such disclosures (for example, public authorities must ensure that their disclosure is proportionate to what is sought to be achieved by the disclosing, and certain disclosures for overseas purposes may be prohibited where there is reason to believe that the particular overseas investigation or proceeding would be more appropriately handled in the U.K. or a third country). The gateway legislation of the ATCS 2001 broadens the government's disclosure powers, but is not intended to limit any disclosure powers under other laws. b) Implementation Financial Institutions: The laws and procedures described above satisfy the requirements of this criterion for provisions for the widest possible international co-operation among supervisors and regulators. For FSA, gateways are in place and based on discussions with U.K. authorities and with foreign counterparts, there are no unduly restrictive conditions on such exchanges. MSBs: Given the recent adoption of the new supervisory framework for MSBs, it is too early to meaningfully assess the extent to which HMCE will carry out effective cooperation and exchange of information on AML/CFT in connection with its MSB oversight functions.

E. Specific Criteria for the Banking, Securities, and Insurance Sectors

208. The core assessment criteria for the legal and institutional framework of an AML/CFT system for financial institutions are set out in 2.2.1 above. These criteria are largely drawn from the FATF Recommendations, and are broadly applicable to all financial institutions. However, for the banking, insurance, and securities sectors, the AML/CFT elements and assessment criteria also draw from the supervisory and regulatory principles issued by the Basel Committee (Part A: Assessing the Banking Sector based on Sector-Specific Criteria); the IAIS (Part B: Assessing the Insurance Sector based on Sector Specific

Criteria); and IOSCO (Part C: Assessing the Securities Sector based on Sector Specific Criteria).[26] These additional criteria are set out below.[27]

209. As with section 2.2.1 above, assessors must not only check that all the legal and institutional requirements in sections 2.2.2, 2.2.3 and 2.2.4 have been imposed or exist, but must also verify that there are effective supervisory/regulatory measures in force that ensure that those criteria are being properly and effectively implemented in the banking, insurance and securities sectors.

210. The assessments of sector specific criteria should be considered when drafting the relevant overall description and analysis parts of the core criteria assessments.

Introduction to U.K. Sector Specific Assessment

The Financial Services Authority functions as an integrated regulator of the U.K. financial services sector. Accordingly, most of the sector specific AML/CFT criteria for the banking, securities, and insurance sectors identified in Section 2.2.2 of the methodology have common applicability across all three sectors. This introductory section provides an overview of FSA's role as the AML/CFT supervisor of the three sectors and describes FSA policies and procedures for ensuring compliance by the three sectors with the AML/CFT regime. This overview, particularly the sections describing how the AML/CFT regime is implemented throughout FSA, supports individual conclusions in the assessments that follow of criteria 68-120. However, since the methodology calls for the sector specific criteria to me met by the relevant sector, but not necessarily by all sectors, criteria 68-120 are evaluated on the basis of whether the criteria are or are not met for the banking, insurance and securities sectors, respectively.

Authorities. As elaborated in above, FSA's AML/CFT authority extends over the banking, securities and insurance sector, except for general insurance, plus some activities of professional practitioners that require FSA authorization. General insurance is currently not subject to the 1993 Regulations nor to prudential oversight by the FSA for compliance with anti-money laundering laws. The U.K. authorities noted that the EU Money Laundering Directive, which forms the basis of the U.K.'s AML regime, does not include general insurance. FSA noted that under the predecessor regulatory regime, general insurance had been subject only to prudential regulation, not conduct of business regulation. Nor had general insurance been brought under the 93 AML Regulations. FSA specifically considered whether to include general insurance business within the scope of the ML Sourcebook, and concluded that the costs of imposing the Sourcebook's requirements could not be justified, given that the Directive and the Regulations do not include general insurance within their scope. The U.K.'s view is that, while it may be possible to launder criminal funds in the high-value, wholesale general insurance business, the potential in retail transactions is minimal. FSA indicated that policy with respect to inclusion of general insurance will be

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[26] It should be understood that the sector-specific information in the AML/CFT methodology will not replace any of the individual core principles of the standards issued by the Basel Committee, IAIS and IOSCO.

[27] As with section 2.2.1 above, assessors must not only check that all the legal and institutional requirements in Parts A, B and C have been imposed or exist, but must also verify that there are effective supervisory/regulatory measures in force that ensure that those criteria are being properly and effectively implemented in the banking, insurance and securities sectors. Assessors should pay particular attention when there are increased risks of ML or FT due to factors such as a high usage of cash or cash equivalents in a jurisdiction or financial sector; or a the prevalence of financial products that can be more vulnerable to ML, e.g., single premium life insurance policies.

kept under review. (In the ML Sourcebook and in the JMLSG Guidance Notes, reference is made to "relevant" firms and "relevant" insurance firms to indicate that some parts of the insurance industry are not subject to FSA oversight for AML/CFT purposes.) The assessors recommend that general insurance be brought within the coverage of the 1993 Regulations and the Sourcebook.

The laws, regulations and supporting not legally mandatory industry JMLSG Guidance Notes on AML/CFT are applied across all entities and persons subject to FSA supervision (apart from the exclusion of general insurance noted above.) As elaborated above, with certain exceptions, the legal and institutional framework administered by FSA generally addresses all the core requirements for financial service providers: organizational and administrative arrangements, customer due diligence, suspicious transactions reporting, record keeping and controls, information sharing and cooperation; and licensing and authorizations.

FSA Legal Framework. For the financial sector, the multi-level legal framework is founded on a general statutory framework in which the fundamental objectives and requirements are established in laws and regulations, and on a flexible set of industry-produced guidance, the JMLSG Guidance Notes, which provide operational, not legally mandatory guidelines for persons regulated by the FSA.

Under FSMA prevention of financial crime is one of the four statutory objectives of FSA. Both the 1993 Regulations (Regulation 5) and the FSA's Money Laundering Sourcebook require regulated firms to have effective AML systems and controls in place. These cover: (a) adequate processes for identifying customers, (b) procedures for internal and external reporting of suspicious transactions (to the NCIS), and (c) training of relevant staff.

A variety of other FSA Rules underpin the more specific anti-money laundering requirements of the ML Sourcebook. The systems and controls requirements set out in the FSA's Handbook apply in a prudential context to U.K. firms with respect to activities wherever they are carried on. [Handbook, SYSC 1.1.9 R]. Accordingly, the FSA would expect that the AML systems and controls in place in firms' overseas branches should be appropriate and effective in the same way that they should be within the U.K. For firms subject to consolidated supervision, FSA would expect that the AML systems and controls in place in overseas subsidiaries should meet the higher of the local standards or U.K. standards.

The Sourcebook's requirements apply only to activities conducted from an establishment in the U.K. Firms are required, however, to notify the FSA of any matter that could have a significant impact on their reputation. (Handbook, SUP 15.3.1 R (2)) Accordingly, FSA would expect to be informed if any regulated firm's foreign branches or subsidiaries were unable to observe the appropriate U.K. AML standards.

The FSA's Threshold Conditions require firms to satisfy the FSA that they are fit and proper to have permissions to carry out regulated activities. This would extend to qualifications and integrity of staff. Prior law violations and disqualifications are considered in relation to (but are not dispositive of) satisfaction of Threshold Condition 5 (Suitability). In determining satisfaction of TC 5 FSA considers whether the firm has competent and prudent management and exercises due skill, care and diligence (FSA Handbook, COND 2.5.4 G). COND 2.5.7.G provides guidance that the governing body of the firm should be "organized in a way that enables it to address and control the regulated activities of the firm, including those carried on by managers to whom particular functions have been delegated" and that "the firm has made arrangements to put in place an adequate system of internal control to comply with the requirements and standards under the regulatory system." In determining compliance, the FSA will consider whether the firms have procedures in place to ensure that employees are made aware of the requirements and standards under the regulatory system that apply to the firm and its regulated activities.

The 1993 Regulations (Regulation 5(1)(b) and (c)) require regulated firms to carry out appropriate AML awareness and training of staff. The Sourcebook (6.1.1G) similarly states that staff in relevant firms should be (i) made aware of; and (ii) given regular training about what is expected of them in relation to prevention of money laundering, and what the consequences are – for both themselves and the firm – if they fail to meet that expectation. Firms are required to insure that staff are aware of their responsibilities and of the legal and regulatory framework and to provide appropriate AML training for all their staff who handle, or are managerially

responsible for the handling of, transactions that may involve money laundering. This training must be given at least every 2 years. In addition, the not legally mandatory JMLSG Guidance Notes deal with Awareness and Training.

Firms are required to comply with the FSA's Principles for Businesses, which are a general statement of fundamental obligations under the regulatory system. Breaching a Principle makes a regulated firm liable for disciplinary sanctions. Principle 1 states that a firm "must conduct its business with integrity" and Principle 2 states that it "must conduct its business with due skill, care and diligence." There is no specific FSA requirement that these Principles be communicated to all members of a regulated firm's staff.

Implementation. Assuring compliance with AML/CFT requirements is an integral component of FSA activities as a financial supervisor. Compliance is insured through a range of supervisory tools. These include: fit-and-proper evaluations of key personnel as part of the authorized persons regime, on-site monitoring of systems and controls, theme supervision involving horizontal evaluations of a sampling of firms for AML/CFT compliance, off-site reviews of internal reports filed by a sample of firms, risk mitigation programs applied at individual firms, public censure, fines and disciplinary actions, and outreach activities to increase awareness within the financial industry and among consumers.

The FSA operates a risk-based approach to assessing the AML controls maintained by regulated persons. This is designed to concentrate resources on those areas that pose the greatest threat to the FSA's regulatory objectives, with reduction in financial crime being the key objective considered for this purpose. Key AML priorities for FSA are established based on a comprehensive industry-wide risk assessment. The assessment draws together information on: scale of the sector, number of customers, nature and complexity of products, perceived quality of control environment, capability of sector, number of NCIS referrals, and the nature of the customer base. Priorities for supervision are then established based on judgments about vulnerabilities and the probability that these could pose risks that would negatively impact FSA's ability to meet its statutory objectives. Scale of business activity is an important factor in determining the impact of identified vulnerabilities. For the current year the money laundering theme has identified six clusters of activities for priority attention. These are: international banking, domestic banking, independent financial advisers handling client money from abroad, on-line broking, spread betting, and credit unions.

The FSMA gives the FSA power effectively to test the internal systems of firms. However, the extent to which the FSA seeks to confirm an individual firm's compliance with the Sourcebook and other regulatory requirements will depend on the FSA's risk assessment of the firm, which would generally have regard to: the firm's regulatory history; information made available by other sources, including the firm's own notifications; and other information obtained by the FSA.

An FSA examination of an intermediary for compliance with the AML/FSA regime might address: client classification, terms of business and client agreements, "know your customer" information, customer suitability information, disclosure, dealing and managing rules, customer reports and client assets. The FSA may also examine the internal measures that the firm has in place to check its own compliance, including internal audit and compliance arrangements, risk management systems, and AML controls, as well as escalation procedures.

In addition to line supervisors and relationship managers, to aid in assessing regulated firms compliance with the Regulations and the Sourcebook, FSA has:

- A Risk Review Team that includes approximately eleven staff with expertise in both AML and fraud issues;
- An Intelligence and Records Department which liaises with national and international law enforcement agencies;
- A Financial Crime Policy Unit, which, among its activities, provides advice on AML compliance issues and guidance on the requirements of the Sourcebook.

In addition, FSA has the power to appoint what are termed "skilled persons" to investigate compliance issues

(SUP 5).

FSA has a very wide range of enforcement powers to take actions against a regulated entity and its management, and directors for noncompliance with supervisory, regulatory, or legal requirements for deterring ML. Based on a risk assessment, for firms deemed to pose a ML risk to FSA's objectives, a risk mitigation program to address weakness may be applied. Under the authorized persons regime, the MLRO in each firm must meet fit and proper requirements on an ongoing basis. FSA has authority to withdraw or vary permission to carry out regulated activities based on non-compliance. It may also impose fines or public censure on firms and individuals. Under the FSMA, the FSA also has criminal prosecution powers for violation of the 1993 Regulations. Except for criminal prosecution, FSA provided concrete examples of the application of these authorities in specific cases.

As described above, FSA uses a variety of on-site and Off-site techniques to monitor and Enforce compliance with its risk-based customer identification requirements. In line with its own Risk Based Approach to Supervision, intensity of FSA oversight varies across sectors. The following general observations were made with respect to FSA implementation of the AML/CFT regime in the three different sectors:

<u>Banking:</u> FSA oversight of AML/CFT requirements in the banking sector, including KYC requirements, is active and comprehensive. Banking industry awareness is high. No significant issues were identified with respect to FSA implementation of the AML/CFT regime as it applies to the banking industry.

<u>Securities.</u> FSA Oversight of AML/CFT requirements, including KYC requirements, is active and comprehensive among the securities firms of any significant size and, Among these firms, AML/CFT awareness is high. However, under the FSA's risk based approach to supervision, compliance checks among the large number of very small, low impact securities firms are limited and, for this sector of the securities industry, awareness is likewise less well developed. The assessment mission considers the low level of compliance checking among these small, low impact firms is a significant gap in the overall implementation of the AML/CFT regime. This gap is significant since the overall AML/CFT framework assumes that persons and entities regulated by FSA for AML/CFT purposes may place some reliance on the fact that other counterparts subject to FSA oversight are similarly supervised.

<u>Insurance</u>. As noted in the introductory section, the exclusion of general insurance is a significant gap in the U.K. AML/CFT regime. The standards on which the methodology is based anticipate that the entire insurance industry will be subject to supervision for AML/CFT purposes.

Joint Money Laundering Steering Group Guidance Notes. The JMLSG Guidance Notes are a basic reference work for identifying the standards that are expected of financial sector firms regarding AML requirements. As noted under criterion 46 above, the Guidance Notes are comprehensive and provide detailed guidance on a very broad range of AML/CFT issues firms face in implementing the AML/CFT regime. As discussed above, the JMLSG Guidance Notes are not legally mandated. However, the 1993 Regulations provide that a court may "take account" of such guidance. Likewise, the ML Sourcebook states that FSA "will have regard to" a firms compliance with the JMLSG Guidance Notes in assessing compliance with AML/CFT. While the Guidance Notes are not mandatory, FSA follows a "comply or explain" approach to the Guidance Notes. The authorities report that, in practice, the Guidance Notes are treated as a "safe harbor," and that financial services firms are expected to provide justification where they follow procedures other than those recommended in the Guidance Notes; as a result, it is reported that most firms follow the Guidance Notes strictly. This understanding was confirmed in discussions with trade associations and with a number of individual firms.

Therefore, in evaluating below whether individual, sector specific criteria for banking, securities and insurance are satisfied we have looked for evidence that the specific subject matter is addressed either in the 1993 Regulations, FSA Rules or in the JMLSG Guidance Notes. In addition, we have considered whether the general FSA supervisory regime described above is applied to the individual, sector specific criterion.

Part A: Assessing the banking sector based on sector specific criteria

211. The Basel Committee's Core Principles for Effective Banking Supervision (BCP) set out the necessary foundations of a sound supervisory system. The following principles are relevant to AML/CFT: BCP1 on arrangements for sharing information between supervisors; BCP3-5 on licensing and structure; BCP14 on adequate internal controls; BCP15 on adequate policies to prevent use by criminal elements; and BCP23-25 on co-operation between home and host supervisors. In October 2001, the Basel Committee issued detailed AML/CFT recommendations in its "Customer due diligence for banks" paper. The specific criteria for banks in this section are drawn extensively from this paper and should be interpreted with reference to the corresponding paragraphs in this paper. There are no additional criteria for sections I (General framework), V (Suspicious transactions reporting), VII (Integrity standards). The additional specific criteria for banks are as follows:

Table 30. Detailed Assessment of the Banking Sector Based on Sector-Specific Criteria

Customer identification **Detailed Assessment of Criteria 68-83** (Assessors are to describe and analyze each of Criteria 67-83)	
Criterion 68	
Description and Analysis	Customer identification requirements are specified in sections 7-9 of the 1993 Regulations. The duty to identify clients is addressed in Chapter 3 of the FSA Money Laundering Sourcebook. The JMLSG Guidance Notes provide for a risk based approach to customer identification. Firms are required to establish satisfactory "Know your Customer" procedures to identify the users of financial services, the principle beneficial owners and the origin of the funds being deposited or invested. Other than one-off transactions, the procedures must include knowing the nature of the business that the customer normally expects to conduct and being alert to transactions that are abnormal within the relationship. The Guidance Notes state that the extent of information required, both at the outset and on an ongoing basis, will vary based on the nature of business to be conducted. It is recognized that the requirements will vary from sector to sector and between firms within any sector. It will also depend on the nature of the product or service being offered and whether personal contact is maintained. The Guidance Notes recognize that there will be circumstances when it will be both necessary and permissible to apply commercial judgment to the extent of the identity requirements, both on an initial and ongoing basis. Higher Risk products and accounts require more extensive checks on the identity and source of wealth of customers. The Guidance notes provide numerous examples of higher risk products and accounts as well as illustrations of the additional identity checks they could be warranted to deal with these risks. The 1993 Regulations and FSA Rules require firms to have effective anti-money laundering systems and controls, including for customer identification. The Guidance Notes (3.22) state that firms should tailor their individual policies and procedures to the different risks and vulnerabilities of the products and services they offer. FSA Guidance 3.1.4 states that in assessing a relevant firm's compliance with its duty to identify a client in accordance with ML 3.1.3R, the FSA will have regard to the relevant firm's compliance with the Joint Money Laundering Guidance Notes for the financial sector and with the guidance on financial exclusion at ML 3.1.5G.

	Implementation of this criterion by FSA follows the procedures outlined in the introduction to this section.
Criterion 69 Description and Analysis	Business relationships with higher risk individuals is addressed in the JMLSG Guidance Notes. E.g., section 2.30 calls for "senior management approval for the opening of an account for a "politically exposed person" (see paragraph 2.28), and regular oversight of the relationship by senior management, including any causes for concern, and, close scrutiny of unusual features including receipts of large sums from government bodies, state owned activities, or government and central bank accounts." Implementation of this requirement by FSA follows the procedures outlined in the introduction to this section.
Criterion 70	
Description and Analysis	The requirement for customer identification is set out in the 1993 Money Laundering Regulations, sections 7-11. The requirement covers both persons and entities, beneficial owners and transactions on behalf of others. Exceptions to the requirement are provided for in section 10. Chapter 3 of the FSA Money Laundering Source book also specifies in general terms the customer identification requirement of relevant firms subject to FSA supervision. The JMLSG Guidance Notes (Chapter 4) provide detailed guidance on customer identification procedures for private individuals, trusts, nominees and fiduciaries, powers of attorney and third party mandates, executorships accounts, client accounts opened by professional intermediaries, corporate customers, unincorporated businesses/partnerships, and several additional entities. It also provides guidance with respect to reliance on intermediaries or third parties. The need for extra vigilance with respect to higher risk business is a recurrent theme throughout the Guidance Notes. Sections 1.6-1.12 provides guidance on factors to be taken into consideration in developing money laundering risk assessments. Implementation of this requirement by FSA follows the procedures outlined in the introduction to this section.
Criterion 71	
Description and Analysis	FSA Rule 2.1.1 requires that a relevant firm must set up and operate arrangements which are designed to ensure that it, and any appointed persons that act on its behalf, are able to comply, and do comply, with the requirements of the FSA Money Laundering Sourcebook. Section 7 of the 1993 Money Laundering Regulations provides that satisfactory customer identification must be made "as soon as is reasonably practicable after contact is first made between that person and an applicant for business concerning any particular business relationship or one-off transaction." The procedures should require "that where that evidence is not obtained the business relationship or one-off transaction in question shall not proceed further." The 1993 Regulations and FSA rules require that customer identification records must be maintained for five years. Chapter 4 of the JMLSG Guidance Notes provides guidance on a variety of circumstances that would trigger a need for a firm to confirm and update its customer identification documentation. Among others, these include when a change in the pattern of transactions occurs, when exceptional transactions occur, when dormant accounts are reactivated, when notification is received of a change in trustees, etc. The Guidance Notes also describe circumstances in which firms may rely on original identification without further updating.

	Implementation of this requirement by FSA follows the procedures outlined in the introduction to this section.
Criterion 72	
Description and Analysis	Vigilance with respect to non-resident customers is required by FSA Rules and the Guidance Notes. Chapter 5 of the FSA Money Laundering Source Book requires relevant to firms to be aware of and make use of U.K. or Financial Action Task Force findings with respect to Regulatory deficiencies in foreign jurisdictions. The JMLSG Guidance Notes provide detailed Guidance and calls for extra VIGILANCE with respect to customer identification procedures for offshore trusts (4.120-4.126), International Business Companies (4.169), non-EU regulated credit and financial institutions (4.170-4.173), introductions from non-EU regulated intermediaries and corporate introducers (4.198, 4.201), business conducted by non-EU agents that are not subject to regulation equivalent to U.K. standards (4.210), and foreign correspondent relations (4.216-4.221). Caution is recommended when dealing. Implementation by FSA of these rules and guidance follows the procedures outlined in the introduction to this section.
Criterion 73	
Description and Analysis	Private Banking is not, per se, identified in the guidance notes as a high risk activity. However, various activities typically conducted on behalf of private clients are identified as requiring additional vigilance. As noted above, these would include overseas trusts, use of agents, identification of beneficial owners, use of international business corporations, transactions with overseas accounts, unusual one-off transactions, etc. Oversight by FSA of firm's private banking activities generally follows the procedures outlined in the introduction to this section. In its latest budget documents FSA has reported that private banking will be a subject for theme supervision during the upcoming fiscal year.
Criterion 74	
Description and Analysis	The JMLSG Guidance Notes do not appear to explicitly address the situation in which a customer is for any reason believed to be being refused banking facilities. However, the need for enhanced due diligence in such circumstances is implicit in other material in the guidance. For example, section 5.9 identifies several questions staff might consider in determining whether an established customer's transactions might be suspicious. These include deviations from normal transactions patterns. Definitions of knowledge are provided in sections 5.4 and definitions of suspicion are presented in sections 5.5 and 5.6. Implementation by FSA of these policies follows the procedures outlined in the introduction to this section.
Criterion 75	
Description and Analysis	Procedures for dealing with difficulties in verifying customer identification information are addressed in different sections of the regulations and the Guidance Notes. Section 7 of the 1993 Money Laundering Regulations provides that satisfactory customer identification must be made "as soon as is reasonably practicable after contact is first made between that person and an applicant for business concerning a particular business relationship or one-off transaction." The procedures should require "that where that evidence is not obtained the business relationship or one-off transaction in question shall not proceed further." Sections 5.47-51 of the Guidance Notes address the handling of customer accounts, including termination of a business relationship following reporting of a suspicious transaction. 4.43 states that "The failure or refusal by an applicant to provide satisfactory identification evidence within a reasonable timeframe and without adequate explanation may lead to a suspicion that the depositor or investor is engaged in money laundering. In such circumstances, firms should consider making a suspicion report to NCIS based on the information in their possession and, following this, should obtain NCIS consent before any

	funds are returned to where they came from." The procedures allow for the firm to exercise a commercial judgment to terminate a business relation but recommends that the firm liaise with NCIS to be sure that termination does not result in tipping off or prejudice an investigation. Implementation by FSA of these policies follows the procedures outlined in this section.
Criterion 76	
Description and Analysis	Procedures for establishing identity in the case of trusts, nominees and fiduciaries is addressed in sections 4.116-4.134 of the JMLSG Guidance Notes. The guidance addresses a variety of types of trusts with a range of vulnerabilities to money laundering. A risk based approach is recommended in which both customer identification and "know your business" procedures should be set and managed according to perceived risk. 4.118 stresses the necessity "to verify the identity of the provider of funds, i.e., the settlor, those who have control over the funds, i.e. the trustees, and any controllers who have the power to remove the trustees. ascertaining the "the nature and purpose of the trust and the original source of funding is also stressed. Implementation by FSA of these policies follows the procedures outline in the introduction to this section.
Criterion 77	
Description and Analysis	Sections 4.9-4.11 of the JMLSG Guidance Notes address the requirement to obtain satisfactory information on the nature of the business that the customer expects to undertake, and any expected, or predictable pattern of transactions, both at account opening and on an ongoing basis. Among other things, this includes identifying the expected origins of funds to be used. The special risks associated with corporate vehicles are addressed in several sections. Section 4.120 calls for particular care to be exercised " when trusts, special purpose vehicles, or International Business Companies connected to trusts, are set up in offshore locations with strict bank secrecy or confidentiality rules. Sections 4.150- 4.169 deal with the complexities of customer identification in the case of corporate customers. Procedures are discussed for high risk and low risk corporates and for publicly registered and private companies. Section 4.150 highlights the need to confirm that the company is not merely a "brass plate company" where the controlling principals cannot be identified. In the case of high risk, private companies, the guidance notes provide that "where the principal owner is another corporate entity or trust, the objective is to undertake measures to look behind that company or vehicle and verify the identity of the beneficial owner(s) or settlors." For guidance with respect to nominees, see the discussion above under criterion 76. Implementation by FSA of these policies follows the procedures outlined in the introduction to this section.
Criterion 78	
Description and Analysis	Reliance on intermediaries or other third parties to verify identity or to introduce business is addressed in sections 4.191-4.215 of the JMLSG Guidance Notes. 4.46 states that 'Where reliance is being placed on any third party to identify or confirm the identity of any applicant, the overall legal responsibility to ensure that the procedures and evidence obtained are satisfactory rests with the account holding firm." Section 4.198, dealing with introductions from non-EU regulated intermediaries, states that "the identification checks must be undertaken to U.K. standards and an intermediary certificate completed in respect of each introduced applicant together with certified copies of identification documents. 4.192-4.197 deals with procedures when the introducer is a U.K. or EU regulated financial intermediary. The Guidance notes address procedures that firms may use in a variety of circumstances to satisfy themselves that the customer due diligence procedures of the introducer are as rigorous as those which the bank would have conducted itself for the customer. This includes checking that the identification systems used by the introducer are robust. Identification

	certifications should be completed by the introducing firm or person in respect of each applicant. The certification must either be accompanied by certified copies of the identification evidence or permit the actual evidence obtained to be re-obtained at a later stage. (4.192). Implementation by FSA of these policies follows the procedures outlined in the introduction to this section.
Criterion 79	
Description and Analysis	Identification procedures in the case of client accounts are dealt with in sections 4.141-4.145 of the JMLSG Guidance notes. 4.143 provides that "unless the professional intermediary is himself regulated under the U.K. money laundering regulations or their equivalent, the Regulations and FSA Rules require the firm not only to verify the identity of the professional intermediary, but also to verify the person on whose behalf the professional intermediary is acting. 4.142 allows these procedures to be waived if the U.K. or EU intermediary is itself covered by the Money Laundering Regulations or their equivalent. Section 4.42 of the JMLSG Guidance notes states that, "However, unless the professional intermediary is himself regulated under the U.K. Money Laundering Regulations or their equivalent, the Regulations and FSA rules require the firm not only to verify the identity of the professional intermediary, but also to verify the person on whose behalf the professional intermediary is acting. Identification for the underlying clients related to transactions in solicitors' general omnibus accounts may be difficult because these intermediaries may not be regulated under the money laundering regulations and the transactions may not be designated as relevant financial business and Section 85 of the Solicitors' Act precludes firms from making any enquiries as to the identity of the underlying client. The accountant's professional code may similarly preclude a firm from divulging information to banks or building societies concerning their underlying clients. JMLSG 4.144). The guidance Notes provide that in such circumstances the relevant firm will need to make a commercial JUDGMENT based on its knowledge of the intermediary and the nature of business that intermediary is prepared to conduct. See discussion under criterion 45 above. Implementation by FSA of these policies follows the procedures outlined in the introduction to this section.
Criterion 80	
Description and Analysis	Sections 2.26-2.31 of the JMLSG Guidance Notes deals with the handling of the proceeds of corruption. Section 2.29 calls for enhanced identification procedures at the onset of a business relationship, and on an ongoing basis, where the firm knows, suspects, or is advised, that the business relationship is with a senior political figure or related party. Section 2.28 defines senior political figure, immediate family, and close associate. Verification of the source of wealth, and of source of funds transacted, and close monitoring of accounts is emphasized. Senior management approval of such accounts and regular senior management oversight of such accounts is called for in section 2.30. Implementation by FSA of these policies follows the procedures outlined in the introduction to this section.
Criterion 81	
Description and Analysis	The Guidance Notes strongly imply, but do not specifically state, that relevant firms should not accept or maintain a business relationship if the bank knows or must assume that the funds derive from corruption or misuse of public assets, without prejudice to any obligation the bank has under criminal law or other laws or regulations. For example, in addition to the

<table>
<tr><td></td><td>guidance with respect to enhanced customer identification and risk management practices in the case of politically exposed persons, Section 2.27 warns that “financial firms that handle the proceeds of corruption will often face a major reputational risk and in some cases criminal charges can arise.”

Implementation by FSA of these policies follows the procedures outlined in the introduction to this section.</td></tr>
<tr><td colspan="2">Criterion 82</td></tr>
<tr><td>Description and Analysis</td><td>The need for effective identification procedures for non-face-to-face business, including the need for additional risk mitigation procedures, is addressed in several sections of the Guidance Notes. 4.153-4.155 address non-face-to-face business with corporate customers. 4.49 states that the procedures for private individuals should be sufficiently robust whether the procedures are being undertaken face to face or remotely. 4.114 provides for special attention to accounts opened on behalf of a minor. Procedures for telephonic or electronic applications are referenced in 4.196.

Implementation by FSA of these policies follows the procedures outlined in the introduction to this section.</td></tr>
<tr><td colspan="2">Criterion 83</td></tr>
<tr><td>Description and Analysis</td><td>Procedures for handling correspondent accounts are addressed in sections 4.216-4.221 of the JMLSG Guidance Notes. 4.216 provides that the relevant firm will need to ascertain whether the correspondent bank or counterparty is regulated for money laundering prevention and, if so, whether the correspondent is required to verify the identity of its customers to FATF standard. Where this is not the case, additional due diligence will be required to ascertain and assess the correspondent’s internal policy on money laundering prevention and its know your customer procedures. Close monitoring of transactions through correspondent accounts against expected levels, as well as checking of any material variances, is called for in 4.217.

The guidance notes do not specifically call for relevant firms to identify and monitor the use of correspondent accounts that may be used as payable-through accounts. However, Appendix B, which summarizes a variety of money laundering typologies and cases, does describe the use of ‘payable through accounts as a practice vulnerable to money laundering abuse. (see appendix b, section 1). Section 4.219 of the Guidance Notes states that banks should guard against establishing correspondent relationships with high risk foreign banks, e.g., shell banks with no physical presence in any country or with correspondent banks that permit their account to be used by such banks.

Implementation by FSA of these policies follows the procedures outlined in the introduction to this section.</td></tr>
<tr><td colspan="2">On-going monitoring of accounts and transactions

Detailed Assessment of Criteria 84-87 (Assessors are to describe and analyze each of Criteria 84-87)</td></tr>
<tr><td colspan="2">Criterion 84</td></tr>
<tr><td>Description and Analysis</td><td>Section 7.11 of the JMLSG Guidance Notes provides that “internal procedures need to ensure that <u>all transactions</u> undertaken on behalf of an existing customer are recorded within the customer’s records. The injunction does not provide for considerations of whether the balances and activities are on-shore or off-shore, on balance sheet or off balance sheet or held under management or on a fiduciary basis.

Implementation by FSA of these policies follows the procedures outlined in the introduction to this section. FSA policies and practices with respect to consolidated supervision of banks reinforce its oversight of banks’ ability to aggregate and monitor significant balances on a worldwide consolidated basis beyond what is required specifically as a part of the anti-money laundering requirements.</td></tr>
</table>

Criterion 85	
Description and Analysis	The requirement for banks to have adequate systems in place to detect unusual or suspicious activities is embedded in FSA's overall requirements with respect to systems and controls. As observed in the Basel Core principles assessment: Banks are required to maintain systems and controls that are appropriate to their business (IPRU SYSC 3.1.1R). According to the Threshold Condition on Suitability, regulated firms (including banks) are expected to have identified fully, and considered, the various risks they will encounter in conducting their business and installed appropriate control systems to manage them prudently at all times. It is considered to be the responsibility of a bank's directors and management to take reasonable care to establish and maintain such systems and controls as are appropriate to the nature, scale and complexity of its business. The FSA has provided banks with guidance on adequate controls and records (IPRU Banks Chapter AR Section 3). Among other things, the guidance states that banks should design and operate a system of internal controls that provides reasonable assurance that all the bank's revenues accrue to its benefit, all expenditure is properly authorized and disbursed, all assets are adequately safeguarded, all liabilities are recorded, and statutory and supervisory requirements are met. Management information should be prepared to show the bank's state of affairs and its exposure to each type of risk, compared to the relevant limits set by management. In addition, the Guidance Notes at numerous points discuss the necessity of the relevant firm to be able to identify unusual and suspicious patterns of activity. Section 4.9 states that relevant firms should ensure that sufficient information is obtained on the nature of the business that the customer expects to undertake, and any expected, or predictable, pattern of transactions. Staff training in the recognition of unusual or suspicious activity is a requirement of the 1993 Money Laundering Regulations (5(1) (c). FSA Rule 6.3.1 also addresses the requirement that staff receive training in money laundering prevention. Implementation by FSA of these policies follows the procedures outlined in the introduction to this section.
Criterion 86	
Description and Analysis	FSA policy and the guidance notes stress a risk based approach to prevention of money laundering, including intensified monitoring of high risk accounts. As noted above, the guidance notes provide explicitly for enhanced vigilance, including intensified monitoring, in the case of non-resident accounts and off-shore trusts (see criteria 72), in the case of corporate vehicles (see criterion 77), in the case of politically connected persons (see criteria 80), and in the case of correspondent accounts (see criteria 83). In addition, the guidance notes identify numerous other higher risk accounts and transactions and emphasis the necessity for enhanced scrutiny of them. Implementation by FSA of these policies follows the procedures outlined in the introduction to this section.
Criterion 87	
Description and Analysis	Chapter 5 of the Money Laundering Sourcebook contains the requirement to make use of national and international findings on countries with inadequacies. FSA Guidance 5.1.1 states that the purpose of this chapter is to enable government and Financial Action Task Force findings of inadequacy, concerning the approach to money laundering, of individual countries or jurisdictions to be brought to bear on relevant firm's decisions and arrangements. Section 1.11 of the guidance notes calls for enhanced vigilance in dealing with customers located in countries: • "without adequate anti-money laundering strategies, or • where cash is the normal medium of exchange, or • where there is a politically unstable regime with high levels of public or private

	corruption,...,or, • that are known to be drug producing or drug transit countries; or • that have been classified as countries with inadequacies in their anti-money laundering strategies,..." Implementation by FSA of these policies follows the procedures outlined in the introduction to this section.

Record keeping

Detailed Assessment of Criterion 88 (Assessors are to describe and analyze Criterion 64)

Criterion 88	
Description and Analysis	With respect to record keeping, FSA SYNC 3.2.20 requires a firm to take reasonable care to make and keep adequate records (including accounting records) which are appropriate to the scale, nature and complexity of its business. Regulation 12 and FSA Rule 7.3.2 require firms to retain records concerning customer identification and transactions for use as evidence in any Investigation into money laundering. The JMLSG Guidance Notes (section 7.3) specify the expected standards for firms record keeping as follows: • requirements of legislation and FSA Rules are fully met; • competent third parties will be able to assess the effectiveness of the firm's observance of money laundering policies and procedures; • any transactions effected via the firm on behalf of any individual customer can be reconstructed; • any customer can be properly identified and located; • all suspicion reports received internally and those made externally can be identified; and • the firm can satisfy, within a reasonable time, any enquires or court orders from the appropriate authorities as to disclosure of information. Further detailed guidance on record keeping is provided in sections 7.5-7.32 of the Guidance Notes. Implementation by FSA of these policies follows the procedures outlined in the introduction to this section.
Recommendations and Comments	

Internal controls, compliance and audit

Detailed Assessment of Criteria 89-92 (Assessors are to describe and analyze each of Criteria 89-92)

Criterion 89	
Description and Analysis	FSA policies require banks as a general matter to have adequate internal controls to manage their risks. In addition, Regulations and FSA Rules and the Guidance Notes specify the requirement for appointment of a Money Laundering Control Officer and elaborate on the responsibilities of the MLRO. The FSA expects banks' high level controls to include the setting of strategy and plans and the establishment and review of the organizational structure and the system for delegation (including segregation of duties). In addition, management should approve the bank's risk policies, review its high level management information and maintain the framework for monitoring and detailed periodic review of risk management and control systems. The implementation of action points following such a review should be monitored by management. Internal control systems should provide reasonable assurance that management is able to monitor on a timely basis the adequacy of a bank's capital, liquidity, profitability and the quality of its assets. They should enable management to monitor and control the

	bank's risk and to make appropriate provisions for bad and doubtful debts. The FSA expects banks to have an internal audit function (but in some cases it may be outsourced) and an audit committee. Implementation by FSA of these policies follows the procedures outlined in the introduction to this section.
Criterion 90	
Description and Analysis	Financial sector firms are required by Regulation 5 to establish clear responsibilities and accountabilities to ensure that policies, procedures, and controls are introduced and maintained which deter criminals from using their facilities for money laundering, thus ensuring that they comply with their obligations under the law. The FSA's financial crime objective and the Money Laundering Rules have a similar purpose. FSA Rule 2.1.1 requires that a relevant firm must set up and operate arrangements, including the appointment of a Money Laundering Reporting Officer, which are designed to ensure that it, and any appointed persons that act on its behalf, are able to comply, and do comply with the requirements of the FSA Money Laundering Sourcebook. The function, responsibilities, and procedures to be followed by the MLRO are spelled out in further detail in other sections of the regulations and FSA Rules, as well as section 3 of the JMLSG Guidance Notes. These include preparation of an annual report that (a) assesses the relevant firm's compliance with the money laundering sourcebook, (b) that the report is considered by the firms senior management, (c) that any necessary action are taken to remedy deficiencies identified by the report. Implementation by FSA of these policies follows the procedures outlined in the introduction to this section.
Criterion 91	
Description and Analysis	Sections 3.29-3.31 of the JMLSG Guidance Notes address the issue of the global application of KYC standards for internationally active groups. Section 3.29 emphasizes that U.K. regulations and policies do not have extraterritorial applicability. However, it goes on to state that, "where a U.K. financial institution has overseas branches, subsidiaries or associates, where control can be exercised over business carried out outside the United Kingdom, or where elements of U.K. business have been outsourced to offshore locations, a U.K. firm should consider putting in place a group money laundering strategy to protect its global reputation and its U.K. regulated business." Section 3.30 recommends that a group policy be established to ensure that all overseas branches and subsidiaries undertake identification and record keeping procedures at least to the standards required under U.K. law or, if the standards in the host country are more rigorous, to those higher standards. Implementation by FSA of these policies follows the procedures outlined in the introduction to this section, reinforced by FSA practices with respect to consolidated supervision of U.K. banks.
Criterion 92	
Description and Analysis	An expectation that banks will have routine procedures testing for compliance against both home and host country KYC standards is implicit in guidance presented in the Guidance Notes, although it is not explicitly called for. For example, section 3.30 notes that " reporting procedures and the offences to which the money laundering legislation in the host country relates must nevertheless be adhered to in accordance with the local laws and procedures." Implementation by FSA of these policies follows the procedures outlined in the introduction to this section.

Enforcement powers and sanctions **Detailed Assessment of Criteria 93-96** (Assessors are to describe and analyze each of Criteria 93-96)	
Criterion 93	
Description and Analysis	Assuring compliance with AML/CFT requirements is an integral component of FSA activities as a financial supervisor. Compliance is insured through a range of supervisory tools. These include: fit-and-proper evaluations of key personnel as part of the authorized persons regime, on-site monitoring of systems and controls, theme supervision involving horizontal evaluations of a sampling of firms for AML/CFT compliance, off-site reviews of internal reports filed by a sample of firms, risk mitigation programs applied at individual firms, public censure, fines and disciplinary actions, and outreach activities to increase awareness within the financial industry and among consumers. The examination of any intermediary might address: client classification, terms of business and client agreements, "know your customer" information, customer suitability information, disclosure, dealing and managing rules, customer reports and client assets. The FSA may also examine the internal measures that the firm has in place to check its own compliance, including internal audit and compliance arrangements, risk management systems, and AML controls, as well as escalation procedures.
Criterion 94	
Description and Analysis	FSMA gives the FSA broad and comprehensive powers to require banks to provide any information needed to carry out its supervisory responsibilities. The FSA has the authority under FSMA section 165 to obtain any information or documents from banks. If deemed necessary, the FSA can request copies of internal audit reports and minutes of audit committee meetings. The FSA may also obtain information through the use of an authorized person under section 166. The FSA may also appoint investigators into a bank's affairs under FSMA sections 167 through 176. The FSA's authority and the processes for obtaining information are set out in the enforcement manual (ENF) section of the FSA Handbook
Criterion 95	
Description and Analysis	The FSMA gives the FSA broad powers to take action against banks that do not comply with the requirements of the FSMA, or its secondary legislation or rules. The FSA may withdraw a bank's authorization, limit a bank's ability to take deposits, or require a bank to cease certain activities. The FSA can take remedial action with immediate effect under FSMA Section 45, using a supervisory notice. These notices are subject to referral by an independent FSM Tribunal. Procedures relating to the Tribunal are found in Part IX of the FSMA. FSA is also a criminal prosecuting authority under the Regulations. The FSMA Part XIV provides the FSA with the power to fine or publicly censure a bank that fails to comply with a requirement imposed by the FSA or the FSMA. This is accomplished through the issuance of a decision notice. These actions are also referable to the Tribunal, generally within 28 days of the date of the notice. The FSA may not take the action specified in these notices until after the referral period has ended, or if the matter is referred, until after the Tribunal disposed of the appeal. In addition to formal sanctions, FSA may take a range of informal actions to discipline financial institutions and to obtain compliance with internal procedures and regulatory due diligence requirements.
Criterion 96	
Description and Analysis	FSA carries out consolidated supervision of banks. The international dimension places particular emphasis on insuring that banks have information systems and controls to manage

	risks in all business units, wherever they are located. FSA insures that overseas activities are structured in a way that can be properly supervised and, where it is not satisfied, imposes restrictions or limits activities. If, as part of the risk assessment process, the FSA determines that an overseas operation of a U.K. banking group is presenting significant unmitigated risks the FSA would initiate discussions with the bank's senior management. These discussions could ultimately require the closure of a bank's overseas operation.
Co-operation between supervisors and other competent authorities **Detailed Assessment of Criteria 97-100** (Assessors are to describe and analyze each of Criteria 97-100)	
Criterion 97	
Description and Analysis	FSMA provides authority for the FSA to share supervisory information with foreign supervisors subject to confidentiality safeguards. All home country supervisors are permitted to conduct on-site visits and examinations of U.K. branches and subsidiaries and FSA encourages this practice. Access to customer files and sampling of accounts is permitted. In addition, FSA informs home country supervisors of risk assessments and supervisory actions that it is taking in relation to the operations of banks from their countries. Urgent remedial actions are promptly communicated.
Criterion 98	
Description and Analysis	See Description and analysis of Criterion 97.
Criterion 99	
Description and Analysis	There are no barriers to sharing of consolidated reporting of deposit or borrower concentration information or notification of funds under management if this information is needed by the home country supervisor.
Criterion 100	
Description and Analysis	Information on individual accounts obtained through co-operative arrangements with overseas supervisors is required to be used only for lawful supervisory purposes and to be protected in a satisfactory manner.

Part B: Assessing the insurance sector based on sector specific criteria

212. Insurance entities[28] are expected to adopt and enforce AML/CFT policies that will govern the activities of their staff. They also need to ensure that their internal control systems are such as to ensure that policies adopted by their boards and management for preventing and deterring ML and FT are fully implemented, and that prompt follow-up action, such as reporting suspicious transactions to the FIU or other competent authority is taken.

213. The IAIS Core Principles of Insurance Supervision (Insurance Core Principles or ICP). Principles 1, 2, 3, 4, 5, 10, and 16, contain criteria that are relevant for AML/CFT efforts. Most important among these principles for AML/CFT purposes are internal controls. That said, experience with ICP assessments has revealed that in many cases internal control procedures within insurance entities are not well established and supervisors have been weak in promoting their development. If management and supervisors are not able to rely on

[28] Insurance entities includes insurance companies and, where relevant, insurance intermediaries and reinsurers (as set out in the IAIS Guidance Notes).

internal control systems for general operating purposes, it will be unlikely that company management and staff will have effective AML/CFT controls.

214. The sector-specific criteria draw extensively from the IAIS "AML Guidance Notes for insurance supervisors and insurance entities" as of January 2002. There are no additional criteria for sections I (General framework), VII (Integrity standards), VIII (Enforcement powers and sanctions), and IX (Financial Supervisors). The additional specific criteria for insurance entities are as follows:

Table 31. Detailed Assessment of the Insurance Sector Based on Sector Specific Criteria

Customer identification **Detailed Assessment of Criteria 101-104** (Assessors are to describe and analyze each of Criteria 101-104)	
Criterion 101	
Description and Analysis	Relevant Insurers and insurance intermediaries are subject to all the customer identification requirements summarized in the discussion above under criteria 68-83. The Regulations (10 (1)(e)) and FSA Rule 3.2.2 provide for waivers of identification requirements in the case of some small long term life insurance contracts and some long term policies of insurance in connection with pension schemes. As noted in the introductory section, the U.K. AML/CFT regime has not been applied to general insurance. In Addition, based on discussions with the industry, insurance industry awareness of AML/CFT requirements is limited. Also, FSA oversight of relevant insurance firms for compliance with AML/CFT requirements has been less active than it is in the banking sector, reflecting, in part a perception that money laundering risks are low in the insurance sector. FSA indicated that ensuring compliance by the relevant insurance industry with AML/CFT requirements is being given a higher priority. While the possibility of bringing general insurance under the AML/CFT regime is being kept under review, there are no immediate plans to do so.
Criterion 102	
Description and Analysis	Relevant Insurers and insurance intermediaries are subject to all the customer identification requirements summarized in the discussion above under criteria 68-83. This includes the requirement to know enough about a customer's business in order to recognize transactions or a series of transactions that are unusual. As noted in the introductory section, the U.K. AML/CFT regime has not been applied to general insurance. In Addition, based on discussions with the industry, insurance industry awareness of AML/CFT requirements is limited. Also, FSA oversight of relevant insurance firms for compliance with AML/CFT requirements has been less active than it is in the banking sector, reflecting, in part a perception that money laundering risks are low in the insurance sector. FSA indicated that ensuring compliance by the relevant insurance industry with AML/CFT requirements is being given a higher priority. While the possibility of bringing general insurance under the AML/CFT regime is being kept under review, there are no immediate plans to do so.
Criterion 103	
Description and Analysis	Relevant Insurers and insurance intermediaries are subject to all the customer identification requirements summarized in the discussion above under criteria 68-83. This includes verification in respect of the parties entering into insurance contracts. This also includes identifying underlying principals where nominees are involved and establishing the true relationship between the nominee and the principals.

	As noted in the introductory section, the U.K. AML/CFT regime has not been applied to general insurance. In addition, based on discussions with the industry, insurance industry awareness of AML/CFT requirements is limited. Also, FSA oversight of relevant insurance firms for compliance with AML/CFT requirements has been less active than it is in the banking sector, reflecting, in part a perception that money laundering risks are low in the insurance sector. FSA indicated that ensuring compliance by the relevant insurance industry with AML/CFT requirements is being given a higher priority. While the possibility of bringing general insurance under the AML/CFT regime is being kept under review, there are no immediate plans to do so.
Criterion 104	
Description and Analysis	The JMLSG Guidance Notes do not appear to address directly the case where claims, commissions, and other monies are to be paid to persons (including partnerships, companies, etc.) other than the policyholder. However, the necessity to verify the identity of the proposed recipients of such monies can be inferred from the numerous examples that are discussed in the Guidance Notes. For example, 4.134, in discussing identification of the trustees in the case of life policies placed in trust, observes that where the applicant is also the beneficiary of the trust, the other trustees need not be identified. However, the remainder of the trusties would need to be identified in a situation where policy proceeds were being paid to a third party not identified in the trust deed. As noted in the introductory section, the U.K. AML/CFT regime has not been applied to general insurance. In Addition, based on discussions with the industry, insurance industry awareness of AML/CFT requirements is limited. Also, FSA oversight of relevant insurance firms for compliance with AML/CFT requirements has been less active than it is in the banking sector, reflecting, in part a perception that money laundering risks are low in the insurance sector. FSA indicated that ensuring compliance by the relevant insurance industry with AML/CFT requirements is being given a higher priority. While the possibility of bringing general insurance under the AML/CFT regime is being kept under review, there are no immediate plans to do so.
Ongoing monitoring of accounts and transactions **Detailed Assessment of Criterion 105** (Assessors are to describe and analyze Criterion 105)	
Criterion 105	
Description and Analysis	See Criterion 85, Description and Analysis, for procedures for identifying significant, unexpected and unexplained change in the behavior of account or policyholders. The JMLSG guidance notes do not appear to address specifically the particular risks from the practice of buying and selling second hand endowment policies, or the use of single premium unit-linked policies. Nor are insurance entities instructed to check any reinsurance or retrocession to ensure the monies are paid to bona fide re-insurance entities at rates commensurate with the risks undertaken. As noted in the introductory section, the U.K. AML/CFT regime has not been applied to general insurance. In Addition, based on discussions with the industry, insurance industry awareness of AML/CFT requirements is limited. Also, FSA oversight of relevant insurance firms for compliance with AML/CFT requirements has been less active than it is in the banking sector, reflecting, in part a perception that money laundering risks are low in the insurance sector. FSA indicated that ensuring compliance by the relevant insurance industry with AML/CFT requirements is being given a higher priority. While the possibility of bringing general insurance under the AML/CFT regime is being kept under review, there are no immediate plans to do so.
Recommendations	The JMLSG Guidance Notes should be updated to address specifically procedures for

and Comments	dealing with the AML/CFT risks from the practice of buying and selling second endowment policies, as well as the risks associated with use of single premium unit-linked policies. Similarly, the notes should be updated to include guidance that reinsurance or retrocession should be checked to ensure that monies are paid to bona fide re-insurance entities at rates commensurate with the risks undertaken.

Record keeping

Detailed Assessment of Criteria 106-107 (Assessors are to describe and analyze each of Criteria 106-107)

Criterion 106

Description and Analysis	Record keeping requirements are discussed under criterion 88 above. The record keeping requirements provided for in U.K. regulations, FSA Rules and the Guidance Notes are not specified in the same detail as provided for in criterion 106. However, the Guidance Notes state that records should be maintained in sufficient detail that any transactions effected via the firm on behalf of any individual customer can be reconstructed. Such detail would be equivalent to the details recommend in Criterion 106. As noted in the introductory section, the U.K. AML/CFT regime has not been applied to general insurance. In Addition, based on discussions with the industry, insurance industry awareness of AML/CFT requirements is limited. Also, FSA oversight of relevant insurance firms for compliance with AML/CFT requirements has been less active than it is in the banking sector, reflecting, in part a perception that money laundering risks are low in the insurance sector. FSA indicated that ensuring compliance by the relevant insurance industry with AML/CFT requirements is being given a higher priority. While the possibility of bringing general insurance under the AML/CFT regime is being kept under review, there are no immediate plans to do so.

Criterion 107

Description and Analysis	Criterion 107 addresses the ability of an insurance entity, as principle, to rely on an appointed representative of the insurance entity, if the representative is licensed under the insurance law in the insurance supervisor's jurisdiction. The elements of this criterion are addressed in various places in the Regulations, Rules and JMLSG Guidance notes. Business conducted by agents is addressed in sections 4.205-4.215. 4.205-4.207 deals with the case of a licensed entity dealing with a client that is also subject to the Regulations and bound by the FSA Sourcebook or is a U.K. regulated firm. In such the cases, the entity may rely on the agent, subject to verifying that the client is in fact a U.K. or EU regulated firm. Where the agent is not U.K. or EU regulated, 4.209 requires the entity to obtain written assurances that identification has been established in substantial accordance with procedures in the U.K. Section 4.210 deals with the case where the agent is in a country with practices that are recognized as being equivalent to the U.K. but is not regulated. Here the entity is required to take "reasonable measures" which can include following best practice in the industry, which is itself further discussed in 4.212. 4.214 states that, where the agent is in a non co-operating country or territory, or one which has material deficiencies, the business should not proceed unless the underlying beneficial owner of the funds have been identified to the satisfaction of the U.K. firm and in line with U.K. standards. As noted in the introductory section, the U.K. AML/CFT regime has not been applied to general insurance. In Addition, based on discussions with the industry, insurance industry awareness of AML/CFT requirements is limited. Also, FSA oversight of relevant insurance firms for compliance with AML/CFT requirements has been less active than it is in the banking sector, reflecting, in part a perception that money laundering risks are low in the insurance sector. FSA indicated that ensuring compliance by the relevant insurance industry with AML/CFT requirements is being given a higher priority. While the possibility of bringing general insurance under the AML/CFT regime is being kept under review, there are no immediate plans to do so.

Suspicious transaction reporting **Detailed Assessment of Criterion 108** (Assessors are to describe and analyze Criterion 108)	
Criterion 108	
Description and Analysis	Criterion 108 calls for the supervisory or other competent authority to provide GUIDANCE to identify suspicious transactions with respect to three specific categories of insurance transactions: early redemption, unusual employment of an intermediary, and unusual method of payments involving parties where AML/CFT measures are viewed to be inadequate. The Guidance Notes do not specifically address the particular circumstances of the identified insurance transactions. However, Appendix B of the Guidance Notes does use the case of cash purchase of a life policy and the case of cash purchase and early redemptions of a general insurance policy to illustrate specific types of money laundering vulnerabilities. (see case 11). Sections 5.7-11 of the Guidance Notes provides general guidance on procedures for identifying suspicious transactions. Section 5.9 notes that the firm will need to consider: Is the size of the transactions consistent with the normal activities of the customer? Is the transaction rational in the context of the customer's business or personal activities? Has the pattern of transactions conducted by the customer changed? Where the transaction is international in nature, does the customer have any obvious reason for conducting business with the other country involved? As noted in the introductory section, the U.K. AML/CFT regime has not been applied to general insurance. In Addition, based on discussions with the industry, insurance industry awareness of AML/CFT requirements is limited. Also, FSA oversight of relevant insurance firms for compliance with AML/CFT requirements has been less active than it is in the banking sector, reflecting, in part a perception that money laundering risks are low in the insurance sector. FSA indicated that ensuring compliance by the relevant insurance industry with AML/CFT requirements is being given a higher priority. While the possibility of bringing general insurance under the AML/CFT regime is being kept under review, there are no immediate plans to do so.
Recommendations and Comments	The guidance notes have relatively few references to insurance business. It would be useful to include more such references, both to orient relevant insurance firms in compliance with AML/CFT and to raise awareness of AML/CFT risks in the insurance sector.
Internal controls, Compliance and Audit **Detailed Assessment of Criteria 109-110** (Assessors are to describe and analyze each of Criteria 109-110)	
Criterion 109	
Description and Analysis	Criterion 109 calls for guidelines that recommend that insurance and reinsurance companies foster close working relationships between underwriters and claims investigators. The JMLSG Guidance Notes do not address this topic. See recommendations and comments on Criterion 108 above. Criterion 109 also calls for reporting systems to be in place to alert senior management and/or the board of directors if AML/CFT procedures are not properly followed. This requirement is fully addressed by the requirement to appoint a money laundering reporting officers with the duties specified in FSA rules and elaborated in the JMLSG notes. As noted in the introductory section, the U.K. AML/CFT regime has not been applied to general insurance. In Addition, based on discussions with the industry, insurance industry awareness of AML/CFT requirements is limited. Also, FSA oversight of relevant insurance firms for compliance with AML/CFT requirements has been less active than it is in the banking sector, reflecting, in part a perception that money laundering risks are low in the insurance sector. FSA indicated that ensuring compliance by the relevant insurance industry with AML/CFT requirements is being given a higher priority. While the possibility of bringing general insurance under the AML/CFT regime is being kept under review, there are

	no immediate plans to do so.
Criterion 110	
Description and Analysis	Criterion 110 states that the supervisor should have the authority to require that insurance entities have an ongoing audit function of a nature and scope appropriate to the nature and scale of the business. This includes ensuring compliance with all applicable policies and procedures and reviewing whether the insurer's policies, practices, and controls remain sufficient and appropriate for its business. FSA has such authority and the requirements of this criterion are satisfied. See the assessment of insurance core principle 5.8 in the separate assessment of the IAIS core principles assessment for the U.K.

Part C: Assessing the securities sector based on sector specific criteria

215. The international standards for securities regulation are set out in the "Objectives and Principles of Regulation" of the International Organization of Securities Commissions (IOSCO Core Principles) (issued in September 1998 and updated in February 2002). The IOSCO Core Principles document sets forth the objectives and principles upon which sound and effective securities regulation is based. Other IOSCO Public Documents and Resolutions also may provide further explanatory material relating to matters addressed by the IOSCO Principles. IOSCO Reports are cross-referenced to the IOSCO Principles in the February 2002 edition of the Principles. IOSCO Public Document No. 26, Report on Money Laundering, IOSCO Technical Committee, October 1992, is especially relevant. [29]

216. It is important to note that the IOSCO Core Principles were not created for the purpose of achieving an anti-money laundering regime. However, securities regulation complements the fight against money laundering, and the particular IOSCO Core Principles set forth below are relevant to assessing compliance with AML/CFT standards.

217. In assessing the securities sector for compliance with AML/CFT standards, the assessor should view Sections 2.2.1 and 2.2.2 (Part C) as integral components. Additionally, it is preferable that assessment of compliance with the criteria in Sections 2.2.1 and 2.2.4 (Part C) should be done either by or in close consultation with the assessor responsible for assessing a jurisdiction's compliance with the IOSCO Core Principles. The assessor responsible for assessing compliance with the IOSCO Core Principles will be intimately familiar with the criteria for which an IOSCO Core Principle will be deemed implemented.

218. There are no additional sector-specific criteria for sections I (General framework), III (Ongoing monitoring of accounts and transactions), and V (Suspicious transactions reporting). The additional specific criteria for the securities sector are as follows:

[29] The IOSCO Principles and IOSCO Public Documents and Resolutions are available on IOSCO's website at http://www.iosco.org/iosco.html.

Table 32. Detailed Assessment of Securities Sector based on Sector Specific Criteria

Customer identification **Detailed Assessment of Criterion 111** (Assessors are to describe and analyze Criterion 111)	
Criterion 111	
Description and Analysis	Regarding securities firms need to seek information identifying the circumstances and investment objectives relevant to the services to be provided, see the response to criterion 85 above. Section 4.9 of the JMLSG Guidance Notes states that: "the second requirement of knowing the customer is to ensure that sufficient information is obtained on the nature of the business that the customer expects to undertake, and any expected, or predictable, pattern of transactions. A risk based approach will be needed in respect of the extent of the additional information that might be required or validated for this purpose. This criterion is implemented in the manner discussed in the introductory section. As noted there, FSA follows a risk based approach to supervision. As implemented, the FSA approach to risk based supervision may tend to overlook money laundering risks in small firms because the scoring system used by FSA to evaluate risk to FSA objectives tends to give greater weight to larger firms than to smaller firms with similar vulnerabilities. The selectivity of this broad risk based approach poses a hazard that practices in smaller, low impact firms will not be sufficiently disciplined by the supervisory process. This possibility is most evident with respect to the large number of very small, low impact securities firms for which compliance checks are limited.
Recommendations and Comments	The U.K. AML/CFT regimes anticipates that financial service providers will be able to place some reliance on the procedures followed by other entities subject to FSA supervision. The very limited oversight by FSA of AML/CFT compliance by the large number of small, low impact firms is a weakness in this system. Procedures should by developed for more systematic, if randomized, verification of compliance with AML/CFT requirements by this group of firms.
Record keeping **Detailed Assessment of Criterion 112** (Assessors are to describe and analyze Criterion 112)	
Criterion 112	
Description and Analysis	With respect to record keeping, FSA SYSC 3.2.20 (the SOURCEBOOK on systems and controls) requires a firm to take reasonable care to make and keep adequate records (including accounting records) which are appropriate to the scale, nature and complexity of its business. See also the discussion of criterion 88 above and the assessment of IOSCO core principle 12.5 in the assessment of the IOSCO core principles. Regarding implementation, see criterion 111.
Recommendations and Comments	see criterion 111
Internal controls, Compliance and Audit **Detailed Assessment of Criterion 113** (Assessors are to describe and analyze Criterion 113)	
Criterion 113	
Description and Analysis	Regarding the adequacy of standards for internal controls, compliance and audit for securities companies, see assessment of IOSCO principle 23 in Assessment of IOSCO core principles. The specific requirements for AML/CFT controls, compliance and audit are addressed in various parts of the Regulations, Rules and JMLSG Guidance Notes but particularly in sections dealing with the role and duties of the MLRO. See Guidance Notes, section 3: Internal controls, policies and procedures. Regarding implementation, see criterion 111.

Recommendations and Comments	See criterion 111.
Integrity standards **Detailed Assessment of Criterion 114** (Assessors are to describe and analyze Criterion 114)	
Criterion 114	
Description and Analysis	Regarding integrity standards, see assessment of IOSCO principle 23 in the Assessment of IOSCO Core Principles. In addition, see the discussion under criteria 62 and 63 above of Integrity Standards.
Recommendations and Comments	
Enforcement powers and sanctions **Detailed Assessment of Criteria 115-117** (Assessors are to describe and analyze each of Criteria 115-117)	
Criterion 115	
Description and Analysis	Criterion 115 addresses the power of the supervisor to require the provision of information or to carry out inspections. The Financial Services Markets Act gives the FSA broad authority to inspect and/or require the production of any documents reasonably required by the FSA in the exercise of its functions; as such, records maintained by FSA-regulated persons pursuant to the requirements summarized above are available to the FSA.
Criterion 116	
Description and Analysis	With respect to the comprehensive investigative and enforcement powers of the supervisor see the assessment of IOSCO Core Principle 8.3 in the assessment of the IOSCO core principles.
Criterion 117	
Description and Analysis	With respect to supervisory powers to take effective action in cases of cross-border misconduct, see assessment of IOSCO core principle 8.4 in the assessment of the IOSCO core principles.
Co-operation between supervisors and other competent authorities **Detailed Assessment of Criteria 118-120** (Assessors are to describe and analyze each of Criteria 118-121)	
Criterion 118	
Description and Analysis	FSA has full authority to share both public and non-public information with domestic and foreign counterparts. see section 6 above
Criterion 119	
Description and Analysis	Regarding international cooperative mechanisms, including MOUs, see section 6 above.
Criterion 120	
Description and Analysis	Regarding the audit requirements for insurance companies see assessment of Insurance Core Principle criterion 5.8.

F. Description of the Controls and Monitoring of Cash and Cross Border Transactions

219. This section, based on FATF 22-23, is designed to collect information on any measures that may exist to control or monitor large cash transactions, and cross border movements of currency, monetary instruments or wire transfers. The section will not be used to assess compliance with AML/CFT criteria, but is included in the detailed assessment report to gain a broader understanding of the AML/CFT system. The questions include general financial conditions that influence the use of cash and any particular factors that have resulted in increase or decrease in the use of cash in transactions (e.g., existence of financial

transaction taxes, use of credit or debit cards; limitations on size denomination of bank notes; confidence in the banking system, etc).

Table 33. Description of the Controls and Monitoring of Cash and Cross Border Transactions
What has the jurisdiction done in response to the following FATF Recommendations?

FATF Recommendation 22:	
Description	The U.K. does not impose controls on the import and export of bank notes, and there are no reporting requirements for cross-border movements of currency or other negotiable instruments, or of high value commodities such as gold or diamonds, regardless of the amounts involved. Although consideration has been given to introducing such requirements, it has generally been concluded that the law enforcement benefits were likely to be minimal compared with the high costs of implementing the requirements. Similar to general currency transactions as discussed below, therefore, cross-border movements are controlled through intelligence-based systems. Separately, as discussed in detail above, HMCE has authority under the DTA to seize cash being imported or exported if there are reasonable grounds to suspect that the cash represents the proceeds or instrumentalities of drug trafficking, and such seized cash can be held for a period of up to two years or forfeited by means of a judicial order where the Court is satisfied that the origin or intended use of the funds is related to drug trafficking. The Proceeds of Crime Act expands these seizure powers to cover movements of suspect cash within the U.K. (rather than only at the border), and to allow seizure of property related to crimes other than drug trafficking.
FATF Recommendation 23:	
Description	The U.K. does not require the reporting of information on domestic or international currency transactions above a fixed amount, and does not maintain systems for collecting and processing such information. The authorities have considered introducing such automatic disclosures and systems from time to time, but generally have concluded that a suspicion-based system of reporting is more cost effective than automatic reporting, and also that intelligence-led systems of control are more effective in the U.K. context than generic systems to collect and process information for all transactions above a certain amount.
Interpretative Note to FATF Recommendation 22:	
Description	As noted under the discussion of FATF Recommendation 22 above, the U.K. authorities have given consideration to introducing requirements for cross-border transfers of cash, but have generally concluded that the law enforcement benefits of such a system are likely to be minimal compared with the high costs of implementing the requirements. They view as more optimal the approach in which cross-border movements are controlled through intelligence-based systems. HMCE collects general information to permit statistical macroeconomic analysis of the U.K.'s economy and for reporting to the Fund and BIS as appropriate. However, the U.K. Government does not normally keep statistics on shipments of items such as currency, negotiable instruments and precious metals.

G. Ratings of Compliance with FATF Recommendations, Summary of Effectiveness of AML/CFT efforts, Recommended Action Plan and Authorities' Response to the Assessment

Table 34. Ratings of Compliance with FATF Recommendations Requiring Specific Action

FATF Recommendation	Based on Criteria Rating	Rating
1 – Ratification and implementation of the Vienna Convention	1	COMPLIANT
2 – Secrecy laws consistent with the 40 Recommendations	43	LARGELY COMPLIANT
3 – Multilateral cooperation and mutual legal assistance in combating ML	34, 36, 38, 40	COMPLIANT
4 – ML a criminal offense (Vienna Convention) based on drug ML and other serious offenses.	2	COMPLIANT
5 – Knowing ML activity a criminal offense (Vienna Convention)	4	COMPLIANT
7 – Legal and administrative conditions for provisional measures, such as freezing, seizing, and confiscation (Vienna Convention)	7, 7.3, 8, 9, 10, 11	LARGELY COMPLIANT
8 – FATF Recommendations 10 to 29 applied to non-bank financial institutions; (e.g., foreign exchange houses)		See answers to 10 to 29
10 – Prohibition of anonymous accounts and implementation of customer identification policies	45, 46, 46.1	LARGELY COMPLIANT
11 – Obligation to take reasonable measures to obtain information about customer identity	46.1, 47	LARGELY COMPLIANT
12 – Comprehensive record keeping for five years of transactions, accounts, correspondence, and customer identification documents	52, 53, 54	LARGELY COMPLIANT
14 – Detection and analysis of unusual large or otherwise suspicious transactions	17.2, 49	LARGELY COMPLIANT
15 –If financial institutions suspect that funds stem from a criminal activity, they should be required to report promptly their suspicions to the FIU	55	LARGELY COMPLIANT
16 – Legal protection for financial institutions, their directors and staff if they report their suspicions in good faith to the FIU	56	COMPLIANT
17 – Directors, officers and employees, should not warn customers when information relating to them is reported to the FIU	57	COMPLIANT
18 – Compliance with instructions for suspicious transactions reporting	57	COMPLIANT
19 – Internal policies, procedures, controls, audit, and training programs	58, 58.1, 59, 60	LARGELY COMPLIANT
20 – AML rules and procedures applied to branches and subsidiaries located abroad	61	COMPLIANT
21 – Special attention given to transactions with higher risk countries	50, 50.1	LARGELY COMPLIANT
26 – Adequate AML programs in supervised banks, financial institutions or intermediaries; authority to cooperate with judicial and law enforcement	66	COMPLIANT
28 – Guidelines for suspicious transactions' detection	17.2, 50.1, 55.2	LARGELY COMPLIANT
29 – Preventing control of, or significant participation in financial institutions by criminals	62	LARGELY COMPLIANT

32 – International exchange of information relating to suspicious transactions, and to persons or corporations involved	22, 22.1, 34	COMPLIANT
33 – Bilateral or multilateral agreement on information exchange when legal standards are different should not affect willingness to provide mutual assistance	34.2, 35.1	COMPLIANT
34 – Bilateral and multilateral agreements and arrangements for widest possible range of mutual assistance	34, 34.1, 36, 37	COMPLIANT
37 – Existence of procedures for mutual assistance in criminal matters for production of records, search of persons and premises, seizure and obtaining of evidence for ML investigations and prosecution	27, 34, 34.1, 35.2	COMPLIANT
38 – Authority to take expeditious actions in response to foreign countries' requests to identify, freeze, seize and confiscate proceeds or other property	11, 15, 16, 34, 34.1, 35.2, 39	COMPLIANT
40 – ML an extraditable offense	34, 40	COMPLIANT
SR I – Take steps to ratify and implement relevant United Nations instruments	1, 34	COMPLIANT
SR II – Criminalize the FT and terrorist organizations	2.3, 3, 3.1	COMPLIANT
SR III – Freeze and confiscate terrorist assets	7, 7.3, 8, 13	LARGELY COMPLIANT
SR IV – Report suspicious transactions linked to terrorism	55	LARGELY COMPLIANT
SR V – provide assistance to other countries' FT investigations	34, 34.1, 37, 40, 41	COMPLIANT
SR VI – impose AML requirements on alternative remittance systems	45, 46, 46.1, 47, 49, 50, 50.1, 52, 53, 54, 55, 56, 57, 58, 58.1, 59, 60, 61, 62	rated where applicable NA
SR VII – Strengthen customer identification measures for wire transfers	48, 51	NON-COMPLIANT

Table 35. Summary of Effectiveness of AML/CFT Efforts for Each Heading

Heading	**Assessment of Effectiveness**
Criminal Justice Measures and International Cooperation	
I—Criminalization of ML and FT	U.K. law generally criminalizes money laundering on the basis of the Vienna and Palermo Conventions. Additional significant enhancements are provided for under the PCA 2002, which updates, unifies, and expands the applicable ML offenses, inter alia, by broadening the criminal intent requirement for certain crimes, removing the distinctions between drug and non-drug ML, and consolidating into one statute the dispersed provisions of U.K. law governing the criminalization of ML. The U.K. has criminalized FT on the basis of the 1999 UN International Convention for the Suppression of the Financing of Terrorism. Adequate and dissuasive sanctions are available for persons that commit ML or FT offences.

II—Confiscation of proceeds of crime or property used to finance terrorism	U.K. law provides broad authority for the competent authorities to confiscate property related to ML and FT, including laundered property or proceeds from, instrumentalities used in or instrumentalities intended for use in the commission of ML/FT offences. The PCA 2002 would enhance these provisions, inter alia, by expanding the circumstances in which restraint (freezing) orders can be issued; greatly expanding civil recovery powers; improving the procedures governing confiscation of the proceeds of crime; and creating a new ARA with functions focused on increasing criminal confiscation, implementing the PCA's new civil recovery powers, and taxing the proceeds of crime. *Heretofore, confiscation has not been a priority of the U.K. Crown Prosecution Services, which also lacks resources to handle confiscation matters.*
III—The FIU and processes for receiving, analyzing, and disseminating financial information and other intelligence at the domestic and international levels	NCIS functions as an effective FIU within the National Criminal Intelligence Service with functions related to all serious crimes. It has broad powers to gather, store and analyze information in order to provide and disseminate criminal intelligence. Its systems are modern and sophisticated. It cooperates effectively with national and overseas counterparts. Implementation of PCA 2002 will substantially enhance NCIS operating arrangements and authority.
IV—Law enforcement and prosecution authorities, powers and duties	U.K. law provides the various law enforcement agencies with a broad range of powers to conduct investigations of ML, FT and predicate offenses, including the power to compel production of financial records. U.K. law provides an adequate legal basis to use a wide range of investigative techniques, including controlled delivery and undercover operations. When the PCA 2002 enters into effect, certain more robust information gathering methods (customer information orders and account monitoring orders) would become available in all criminal investigations, rather than only FT and other terrorism investigations as is currently the case. *A range of law enforcement and prosecution agencies undertake the investigation and prosecution of ML and FT and the U.K. is committed to ensuring that its law enforcement, supervisory and judicial systems are properly resourced. When fully implemented the new legal tools available to the U.K. authorities will make it harder for money launderers to move their money and are essential components of an overall strategy to combat ML. However, a national ML strategy, drawing on the work of all relevant agencies, needs to be articulated. An important precursor to establishing a strategy and priorities is NCIS' work in preparing trend analyses and vulnerability reviews to guide policy makers. There are other areas of concern, including the fact that there is no single law enforcement entity that*

	covers all aspects of ML in the U.K.; there is no law enforcement entity that has as its mission the investigation of criminal acts and foreign counter-intelligence; the Crown Prosecution Service does not prosecute any matters other than narcotic ML; beyond the work done by NCIS on typologies, there does not appear to be any effort to identify on a national basis the U.K.'s vulnerabilities to ML and FT. The willingness of FSA to use its new criminal prosecution authority has not yet been established and is likely to be hampered by FSA total reliance on a risk based approach to determine which financial institutions to subject to on site examination.
V—International cooperation	The U.K. has laws and informal arrangements and procedures that allow comprehensive cooperation in AML/CFT matters. Most assistance is provided through informal processes rather than through the formal routes embodied in the criminal statutes and international treaties. There are also multilateral and bilateral arrangements for extradition, as well as statutory procedures for one-off extradition arrangements, the latter of which are reported to be cumbersome in practice. A bill to improve extradition procedures has been submitted to Parliament. *The U.K. has a comprehensive system in place for the provision of mutual legal assistance and the arrangements are coordinated by the U.K.CA. The U.K. has improved its response rate and turnaround times by devoting extra resources to this activity.* *The extensive efforts undertaken by HMT in supporting the FATF and the regional FATF-style bodies have been essential to their success in changing and enhancing the effectiveness with which the world addresses money laundering and now the financing of terrorism.*
Legal and Institutional Framework for All Financial Institutions	
I—General framework	With one noteworthy exception, confidentiality and secrecy laws or agreements do not in the U.K. inhibit implementation of the criteria called for by the methodology. The exception is due to legal requirements applicable to attorneys and accountants that may prevent financial institutions and MSBs from inquiring into (and preclude lawyers and accountants from divulging) the identity of the underlying clients when an attorney or accountant opens an account to hold client's funds. The operational significance of these secrecy provisions has not be established. The FSA is the designated agency for ensuring that the FATF 40 + 8 Recommendations are effectively implemented in almost all of the prudentially regulated

	financial sector. General insurance is not included in this regime, however. FSA supervision is generally effective, although compliance checking of small securities firms is limited. HMCE has recently been given responsibility for insuring that AML-CFT requirements are implanted by money service businesses. By design, HMCE applies a "light touch" supervisory regime to MSBs. In general, HMCE's oversight of MSBs is too recent to be evaluated under the criteria set forth in the Methodology.
II—Customer identification	Legal requirements for customer due diligence for financial firms and MSBs are contained in the 1993 Regulations and for certain FSA-supervised firms, in the FSA Money Laundering Sourcebook. Legal requirements are supplemented by detailed guidance provided in the non-mandatory industry-issued Guidance Notes. Taken together, these legal requirements and guidance provide a comprehensive standard that, on a day to day basis, is effectively enforced or (in the case of the Guidance Notes) encouraged by supervisors.
III—Ongoing monitoring of accounts and transactions	U.K. law imposes criminal liability on financial institutions and MSBs to report knowledge or suspicion of ML or FT. However, neither law nor regulation imposes an affirmative obligation to pay special attention to complex transactions, to give special attention to transactions with persons in jurisdictions that do not have adequate AML-CFT requirements, nor to give enhanced scrutiny to wire transfers. However, the guidance in the non-mandatory Guidance Notes calls for firms to monitor accounts and transactions in line with the standards set out in the Methodology. FSA monitoring of compliance in this area by regulated financial firms is effective.
IV—Record keeping	With minor exceptions the U.K. has comprehensive record keeping requirements in line with the standards called for in the methodology. Subject to the exceptions noted for general insurance and small securities firms, FSA monitoring of compliance in this area by regulated financial firms is effective.
V—Suspicious transactions reporting	Financial institutions and MSBs are required to report suspicions of ML or FT under the criminal laws and the 1993 Regulations, as well as under the Sourcebook (in the case of certain financial). When it comes into force PCA 2002 will strengthen and streamline the legal requirements for suspicious transaction reporting, inter alia, by expanding the applicable criminal intent requirement, requiring that all STRs of regulated entities be filed with NCIS (rather than with any "constable" as is currently the case), and providing for use of a uniform, system-wide STR form. Subject to the exceptions noted above, FSA implementation of the suspicious transactions reporting requirement is

	effective.
VI—Internal controls, compliance and audit	With a few exceptions, the U.K. requires internal controls and compliance functions applicable to AML that satisfy the standards specified in the Methodology. However, there are no express requirements concerning CFT internal controls and procedures. Although the definition of ML includes various FT predicate crimes, it is doubtful that the obligation to have AML systems and controls can be read as requiring CFT systems and controls where no ML is involved (e.g., where the source of funds used for FT is legitimate). There is as yet no comprehensive best practices or agreed upon approach concerning CFT controls, but the U.K. may be an appropriate jurisdiction to take a lead in this area. FSA supervision provides effective implementation of the requirements for internal systems and controls. subject to the qualifications noted with respect to general insurance and small securities firms.
VII—Integrity standards	The integrity standards established under U.K. law and regulation generally conform to the standards specified in the Methodology. FSA supervision achieves effective implementation of these standards among regulated firms. While fit and proper requirements are a prominent feature of U.K. regulation of financial institutions, U.K. laws and regulations do not explicitly bar criminals from holding or controlling a significant investment in financial institutions or MSBs, and there is no fit and proper or other integrity-based regime for MSBs.
VIII—Enforcement powers and sanctions	Violations of the Regulation's requirements to adopt appropriate AML procedures and controls for customer identification, record keeping, suspicious transactions reporting, employee awareness and training, and other aspects of ML prevention are punishable as a criminal offense. No criminal sanctions apply for violation of the regulatory requirements established in the Sourcebook. However, under its general enforcement authority FSA has a broad range of enforcement tools at its disposal to deal with breaches of those requirements. The 1993 regulations do not provide for the imposition of civil penalties for violations of AML-CFT systems and controls requirements. Other than criminal sanctions, HMCE has only limited civil sanctions available to it to enforce compliance by MSBs with AML-CFT requirements.
IX—Co-operation between supervisors and other competent authorities	FSA is generally adequately funded, staffed and provided with technical resources and specialized expertise to carry out its AML-CFT responsibilities. Additional resources would permit more thorough compliance checking. HMCE has adequate technical resources and specialized expertise but it is unclear if the planned self –financing scheme for supervision of MSBs will provide adequate funding to allow HMCE to carry out its responsibilities under the 2001 Regulations.

	Under FSMA, FSA has broad authority to cooperate and share information with other competent authorities. Gateways are provided. These provisions enable the FSA, on its own initiative or upon request, to exchange information relating to suspicious transactions with other domestic and foreign financial supervisors and law enforcement agencies. No court authorization is required for such disclosure of information by FSA. FSA is proactive in exercising its authority to co-operate and exchange information with other competent authorities. HMCE has similar authority although it is too early to evaluate its operational practices as they relate to MSB's.

Table 36. Recommended Action Plan to Improve the Legal and Institutional Framework and to Strengthen the Implementation of AML/CFT Measures in Banking, Insurance and Securities Sectors

Criminal Justice Measures and International Cooperation	**Recommended Action**
I—Criminalization of ML and FT	1. The U.K. should ratify as soon as possible the UN Convention Against Transnational Organized Crime 2000 (Palermo Convention). 2. The definition of ML under the 1993 Regulations (section 2 (3)) should be corrected to cross-reference current laws (including recent FT legislation) and delete obsolete cross-references.
II—Confiscation of proceeds of crime or property used to finance terrorism	The PCA 2002 provisions governing confiscation, seizure, assets recovery and civil recovery should be made effective as soon as possible, given the significant enhancements they make to the U.K. regime.
III—The FIU and processes for receiving, analyzing, and disseminating financial information and other intelligence at the domestic and international levels	1. The PCA should be made effective as soon as possible, given its substantial enhancements to the arrangements under which NCIS functions. 2. NCIS (or other appropriate government agency) should be given authority to impose civil fines on reporting parties – other than prudential regulated financial institutions – that fail to comply with their reporting obligations under the 1993 Regulations. 3. Consideration should be given to providing NCIS with the power to get supporting documents (rather than general information) from reporting parties that file STRs with it.
IV—Law enforcement and prosecution authorities, powers and duties	*1. As there is no law enforcement entity that has as its mission the investigation of criminal acts and foreign counter-intelligence, the U.K. should seriously consider the creation of a national law enforcement organization which has both these elements.* *2. Consideration should be given to passing*

	legislation that makes wiretap evidence admissible in judicial proceedings. *3.Special legislative considerations should be given to protecting national security information while balancing the defendants right to have access (in some form) to relevant evidence.* *4. NCIS or other competent authorities should undertake a U.K. trend analysis and vulnerability study of how and where money—especially cash—is laundered in the United Kingdom, in order to focus priorities and successfully use the new PCA 2002 and ARA powers.* *5. Prosecutors and judges should be trained on ML and asset confiscation so as to ensure adequate application of U.K. legislation.*
V—International cooperation	Legislation to enhance the statutory provisions on extradition should be adopted as soon as possible.
Legal and Institutional Framework for Financial Institutions	
I—General framework	1. Existing legal constraints should be relaxed on the ability of attorneys and accountants to identify their clients when acting on behalf of those clients. Financial institutions and MSBs should be cautioned against doing business with attorneys and accountants that are unable to provide information about the customers for whom they are opening accounts. 2. The self-financing scheme for HMCE supervision of MSBs should be kept under close review, to determine whether or not it can reasonably be expected to produce enough fees to enable HMCE to reasonably carry out its functions under the 2001 Regulations.
II—Customer identification	1. Financial institutions and MSBs should be required by law to include accurate and meaningful originator information on funds transfers and related messages that should remain with the transfer or message through the payment chain. 3. General insurance should be brought within the scope of the 1993 Regulations and FSA Rules with compliance checking of the insurance sector strengthened. 4. Small securities firms should be subject to systematic checks by FSA for compliance with AML-CFT due diligence and record keeping requirements, if only on a sampling basis. 4. Industry Guidance Notes should be prepared for MSBs. 5. Tighter limits should be placed on the circumstances in which firms may accept funds from applicants before satisfactory identity is obtained. In

	addition, the "financial exclusion" provision of the FSA Sourcebook should be drafted more narrowly so as to cover only financially disadvantaged persons. 6. Consideration could be given to assigning a supervisory authority to ensure compliance with the 1993 Regulations by covered entities that are not financial institutions or MSBs.
III—Ongoing monitoring of accounts and transactions	The 1993 Regulations and FSA Sourcebook should be revised (or other appropriate legal instrument issued) to impose an affirmative legal obligation for financial institutions and MSBs: a) to pay special attention to unusual transactions with no apparent economic or lawful purpose; b) to give special attention to business relations and transactions with persons in jurisdictions that do not have adequate systems in place to prevent or deter ML and FT; and c) to give enhanced scrutiny to wire transfers that do not contain complete originator information.
IV—Record keeping	1. Minimum information requirements should be made mandatory by amending the 1993 Regulations and the Sourcebook. 2. Financial institutions and MSBs should be required to keep records of the basis on which exceptions are granted to customer due diligence requirements.
V—Suspicious transactions reporting	1. Part 7 of the PCA 2002 will significantly strengthen the legal regime for suspicious transactions reporting and should be made effective as soon as possible. 2. Consideration should be given to amending the 1993 Regulations and the Sourcebook, or to introducing new regulations, to impose FT-related suspicious transactions reporting requirements.
VI—Internal controls, compliance and audit	1. Consideration should be given to requiring financial institutions and MSBs to adopt internal controls and procedures, and designate an appropriate compliance person, to prevent their institutions from being used for FT as such (rather than only for ML and FT-related predicate offenses). 2. Consideration should be given to expressly requiring that the AML/CFT programs of financial institutions and MSBs must include an audit function. 3. The 1993 Regulations should be revised to expressly require that the "appropriate person' required under the Regulations to handle the internal and external reporting requirements of the Regulations must be at management level. 4. MSBs should be required to put in place adequate screening procedures to ensure high standards when hiring employees.
VII—Integrity standards	1. The 1993 Regulations, Sourcebook or other

	appropriate legal provisions should be revised to explicitly prohibit criminals from holding or controlling a significant investment in financial institutions and MSBs. 2. The 2001 Regulations should also be revised to give HMCE powers to deny or cancel the registration of MSBs for integrity-related factors (e.g., previous convictions for ML, FT or similar serious crimes of the MSB, its controlling shareholders or managers).
VIII—Enforcement powers and sanctions	The 1993 Regulations should be revised to provide for civil penalties (administrative fines), in addition to the existing criminal penalties, for failure to observe the Regulations' requirements to adopt appropriate AML procedures and controls. This is particularly important with respect to strengthening HMCE's enforcement authority over MSB's.
IX—Co-operation between supervisors and other competent authorities	
Banking Sector based on Sector-Specific Criteria	
II—Customer identification	As noted above, Financial institutions and MSBs should be cautioned against doing business with attorneys and accountants that are unable to provide information about the customers for whom they are opening accounts.
III—On-going monitoring of accounts and transactions	
IV—Record keeping	
VI—Internal controls, compliance and audit	
VIII—Enforcement powers and sanctions	
IX—Co-operation between supervisors and other competent authorities	
Insurance Sector based on Sector-Specific Criteria	
II—Customer identification	1. General insurance should be brought under the 1993 Regulations and the FSA Money Laundering Rules. 2. FSA monitoring of the insurance sector for compliance with AML-CFT requirements should be intensified. 3. The JMLSG Guidance Notes should be updated to address the identification requirements where claims, commissions, and other monies are to be paid to persons (including partnerships, companies, etc.) other than the policyholder.
III—On-going monitoring of accounts and transactions	The JMLSG Guidance Notes should be updated to address specifically procedures for dealing with the AML/CFT risks from the practice of buying and selling second endowment policies, as well as the risks associated with use of single premium unit-linked policies. Similarly, the notes should be updated to include guidance that reinsurance or retrocessions should be checked to ensure that monies are paid to bona fide re-insurance entities at rates commensurate with the risks undertaken.

IV—Record keeping	
V—Suspicious transaction reporting	The guidance notes have relatively few references to insurance business. It would be useful to include more such references, both to orient relevant insurance firms in compliance with AML/CFT and to raise awareness of AML/CFT risks in the insurance sector.
VI—Internal controls, compliance and audit	
Securities Sector based on Sector-Specific Criteria	
II—Customer identification	Procedures should by developed for more systematic, if randomized, verification of compliance with AML/CFT requirements by this group of firms. The U.K. AML/CFT regimes anticipates that financial service providers will be able to rely on the on the due diligence procedures followed by other entities subject to FSA supervision. (see discussion of criterion 79). The very limited oversight by FSA of AML/CFT compliance by the large number of small, low impact firms undermines the reliability of this system with respect to customer identification practices by these firms.
IV—Record keeping	
VI—Internal controls, compliance and audit	
Vii—Integrity standards	
VIII—Enforcement powers and sanctions	
IX—Co-operation between supervisors and other competent authorities	

Authorities' response to the assessment

220. The U.K. authorities welcomed the assessment that the U.K. complies well with the FATF 40+8 Recommendations, with the exception of Special Recommendation VII concerning the inclusion of originator information on wire transfers. As the assessment acknowledges, the U.K. plans to legislate to implement this Recommendation when the FATF has issued an Interpretative Note clarifying some important details arising from this Recommendation.

221. The authorities noted that many of the suggestions in the FSAP for further improvements would be implemented when the Proceeds of Crime Act is brought fully into effect in the early part of 2003. The Assets Recovery Agency, which will commence operations on 24 February 2003, will focus on increasing criminal confiscation proceeds, implementing the new civil recovery powers, and improving training through the establishment of a new Centre of Excellence. A review of the arrangements for dealing with suspicious transaction reports was underway and the government intended to publish a national Money Laundering Strategy in 2003.

222. The authorities said that they would consider the rest of the FSAP recommendations, some of which would require new legislation, against their general policy of applying

AML/CFT controls on a risk basis, with the tightest controls and greatest resources focused on the areas with the greatest vulnerability. Proposals for new measures would be assessed using cost-benefit principles. The authorities are not convinced that some of the recommendations contained in the FSAP could be justified applying risk-based principles. However, they stressed that all aspects of the system are kept under review and changes will be made to it in the light of emerging evidence about vulnerability to money laundering and terrorist financing.

223. The authorities had the following specific comments on the recommendations:

- On *scope of the criminal offence of ML*, the definitions of money laundering under the 1993 Money Laundering Regulations will be updated when the Regulations are revised in June 2003, to implement the 2nd EU Money Laundering Directive. The U.K. authorities note that the current technical deficiencies in the definition have no practical effect on the ability to detect and prosecute money laundering.
- On *provisional measures and confiscation*, the referenced provisions will be made effective in the early months of 2003.
- On *general role of financial system in combating ML*, consideration will be given to the proposal here, but the U.K. authorities are not convinced, at present, that this would be proportionate to the money laundering risk in this sector.
- On *customer identification and record-keeping rules*, consideration will be given to all the suggestions. The basis will be whether they can be justified on cost-benefit principles given the extent of the vulnerability in these areas. Several of these proposals have been examined before and rejected because they have not been regarded as proportionate to the risk e.g. the risk of money laundering through general insurance business is generally acknowledged to be low. However, all these issues are kept under review.
- On *increased diligence of financial institutions,* the PCA 2002 provisions governing suspicious transaction reporting will be implemented on 24 February 2003. Consideration will be given to the suggestions on suspicious transaction reporting and monitoring of accounts and transactions, applying the risk-based criteria discussed above.
- On *implementation & role of regulatory and other administrative authorities*, the recommendations will be considered, applying the risk-based criteria discussed above.
- On *other forms of cooperation*, legislation is currently before Parliament to do this.
- On *wire transfers*, the U.K. will legislate to do this when the FATF Interpretative Note clarifying some details has been adopted by the FATF.
- On *law enforcement and prosecution*, the proposal for a national law enforcement organization raises issues that go well beyond the investigation of and collection of intelligence about money laundering. It would also require new legislation and fundamental changes in policing and intelligence collection. The assessors' comments are a valuable contribution to that wider discussion. With respect to wire-tapping legislation, there are good arguments for and against this suggestion which has been considered in the past and is kept under review. With respect to the proposed trend analysis and vulnerability study, NCIS is planning to conduct further analysis along those lines with contributions from partner agencies. On training of prosecutors and judges, such training programs are currently being arranged following the passage of the PCA 2002 and the new legislative provisions in these areas.