

**The FSA's Supervisory Enhancement Programme, in response to the Internal Audit  
Report on supervision of Northern Rock**

**High-Level Summary**

- 1.1 As we have already made clear in our evidence to the Treasury Select Committee, the failure of Northern Rock should first and foremost be attributed to the failure of its board and executive to create a durable funding model which could withstand the exceptional set of market circumstances that occurred in summer 2007. Nevertheless, the FSA acknowledges that its supervision of Northern Rock in the period leading up to July 2007 was not of sufficient intensity or appropriate rigour to challenge the company's board and executive on their risk management practices and their understanding of the risks posed by their business model.
- 1.2 The FSA's senior executive management committee (ExCo) therefore commissioned an Internal Audit review of lessons learned from the supervision of Northern Rock between January 2005 and July 2007. The report has been made first to the Audit Committee of the FSA Board and then to the Board itself. ExCo accepts the conclusions and resultant recommendations of the review and is today publishing the principal conclusions. The FSA Board agrees the steps now being taken by the Executive.
- 1.3 In parallel, the Tripartite Authorities have carried out a review of the market events between August and December 2007, which has resulted in proposals for enhancing the general framework for dealing with a failure in the banking sector, set out in the Tripartite Consultation Paper published in January.
- 1.4 The FSA will implement the improvements proposed in both reviews by including them in a Supervisory Enhancement Programme designed to strengthen its overall supervisory process. The programme will also incorporate the improvements already under way arising from our agenda of continuous improvement launched last year. The programme will be a key component of the current three-year plan (2007 – 2010) which, in terms of internal change, has as its primary objective the creation of an effective management, operational and cultural framework to deliver more principles-based regulation (described in more detail in the FSA paper published in April 2007). The Supervisory Enhancement Programme is due to be completed by December 2008.
- 1.5 This change programme should be seen in the context of the FSA's overall institutional philosophy. A successful regulator has to seek constantly to learn, change and improve. Financial markets are in a state of continual evolution and innovation. The concept that there is a fixed optimal approach to supervision is not credible. Rather, in our view the most effective regulatory system is one which has the capacity to respond flexibly to changing risks.
- 1.6 The FSA believes that the reviews of the events of last year and our general experience of operating ARROW 2 point to two principal conclusions for our supervisory activities. First, the FSA believes that its overall regulatory philosophy as a risk-based, outcome-focused regulator is supported and reinforced by this analysis. Second, although the report concluded that in terms of the number of issues identified, the supervision of Northern Rock was at the extreme end of the spectrum compared

with the other firms reviewed, there are clearly a number of management, operational and cultural improvements that should be made to the overall supervisory process.

## **Programme Summary**

### *Regulatory Philosophy*

- 2.1 Recognising the obligations set out in the Financial Services and Markets Act, our regulatory approach remains grounded in the principle that the primary responsibility for the management of a financial institution rests with its board and executive management. The supervisory framework will be designed to be proactive in seeking to ensure that the board and executive of firms discharge their responsibilities.
- 2.2 We will continue to use and improve our current ARROW 2 framework and operate a 'principles and outcome-based philosophy'.
- 2.3 We have finite funding and our allocation of resource must therefore be on a risk-based and proportionate basis. We will, however, ensure that all high-impact firms have an irreducible minimum level of staff to enable effective relationship management at all times.
- 2.4 Our supervisory framework is not designed to ensure that any given institution cannot fail. Rather, it remains a balance between seeking to mitigate risk, particularly to consumers and market stability, while fostering innovation and competition (which by definition involve risk).

### *Core enhancements to the FSA's supervision*

The principal themes of the programme are set out below.

### **Culture and People**

- 3.1 We will give greater priority to the task of supervising individual firms.
- 3.2 There will be increased emphasis on the direct involvement of FSA senior management in the supervisory process.
- 3.3 High-impact firms will be a key area of supervisory focus, regardless of probability of failure.
- 3.4 Our existing programme to improve staff quality and retention will be pursued rigorously. This programme encompasses further improvements to our programme for training supervisors, with a focus on ensuring that they will be proactive and will deliver good judgements on the judgements made by firms.
- 3.5 Supervisory staff numbers will be increased from the current levels. The previous strategy was one of reducing numbers to fund better-quality individuals, which has led to a reduction in supervising personnel of some 5% in the last two years. Across the whole organisation there will be a minimum staffing requirement for all high-

impact institutions, regardless of perceived risk, together with an annual zero budgeting process. The precise increase in headcount generated by this strategy will be determined during the programme, but is likely to be around 10%. As an indication, the number of supervisors employed at the end of January 2008 was 506. This supervisory enhancement programme will lead to an increase to around 570, which, along with the Small Firms strategy already announced, will take the total number of supervisors to 625 by March 2009. There will also be an increase, possibly of around 30, in the number of staff in the risk and business analysis functions. Thus the total likely headcount increase resulting from this programme is likely to be around 100 people.

## Organisation

- 4.1 A new group of supervision advisory specialists will be established. The group will, at a minimum, conduct a regular quality assurance review of the supervisory process of all high-impact firms. It will also provide general specialist assistance to supervisory teams.
- 4.2 The profile of prudential risk management and business analysis in the FSA will be enhanced. As announced recently, the existing Risk Review Department has been upgraded to divisional status and renamed Prudential Risk Division with the appointment of Colin Lawrence. The sector teams will also have their capacity increased.

## Process

- 5.1 The linkages between risk identification and supervisory action will be strengthened.
- 5.2 The balance of resource committed to conduct of business regulation relative to prudential supervision will be reassessed. In particular, the ARROW risk factors for all high-impact firms will be adjusted to increase focus on business model risk and financial stability. This will include deeper financial analysis and peer group comparison work.
- 5.3 The degree of senior management involvement in direct supervision and contact with firms and, in particular, with the senior management of firms will be increased.
- 5.4 Supervisors will increase their market contact and will seek enhanced input from external information sources.
- 5.5 Coordination with the Financial Stability Directorate of the Bank of England at working level will be improved.
- 5.6 The process will deliver the revised framework stemming from the tripartite reforms, in particular, the planned special regime of 'heightened supervision' for firms at particular risk.
- 5.7 Liaison with international regulators will be strengthened to improve crisis management for global groups.

5.8 There will in an increased focus on the competence of firms' senior management.

Technology

6.1 The intended enhancements to our technology platform supporting our supervisory and regulatory process will be accelerated.

Hector Sants  
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