

## Recommendations and actions

The review, in looking at the supervision of Northern Rock and the sample firms, found variations in supervisory practice, including examples of good practice. Overall the supervision of Northern Rock was at the extreme end of the spectrum of supervisory practices observed. The recommendations and actions go further than addressing the principal weaknesses found in the supervision of Northern Rock. They are designed to enhance the FSA's supervision of high impact firms generally.

Although, unless otherwise specified, the recommended actions are designed to apply to the supervision of all high impact firms, it is recognised that many are more generally applicable.

We make seven high level recommendations, and set out under each of these our recommended actions. No dates have been set for these. They will be implemented as part of a programme for which an overall end date and interim deliverable dates will be determined. The actions that we regard as high priority are shown in bold.

The seven high level recommendations are:

- FSA senior management to have increased engagement with high impact firms;
- FSA to increase the rigour of its day to day supervision;
- FSA to increase its focus on prudential supervision, including liquidity and stress testing;
- FSA to improve its use of information and intelligence in its supervision;
- FSA to improve the quality and resourcing of its financial and sectoral analysis;
- FSA to strengthen supervisory resources; and
- FSA senior management to increase the level of oversight of firms' supervision.

### 1. **FSA senior management to have increased engagement with high impact firms**

1.1 Directors responsible for supervising high impact firms should meet the Chief Executive and members of the executive team of each firm at least once a year, to discuss its key strategic issues. The session could be combined with the seeking of feedback from firms on the FSA's supervision (as set out in the relationship management 'Statement of Mutual Expectations' sent to firms in April 2006).

1.2 **Supervisors should perform an annual review of the business/strategic plans for each high impact firm. This should take into account the stress testing carried out by the firm, the assumed management actions, and the firm's view of the likeliest scenarios that could threaten its viability. Supervisors should assess the robustness of the firm's plans to maintain adequate financial (capital and liquidity) and other resources. This review should encompass a discussion with the firm, chaired at HoD level or above. Issues arising should feed into the supervisory programme.**

## 2. **FSA to increase the rigour of its day to day supervision**

- 2.1 A single Close and Continuous (C&C) approach should be defined and applied to all high impact firms. This should also be consistent across Business Units. It should include the annual review discussion of firms' business/strategic plans.
- The C&C approach should include regular meetings with key contacts at firms, although the frequency of meetings may vary between firms and some meetings/contacts may not be applicable for certain firms.
  - It should set out the minimum level of engagement to occur; this should only be reduced with the formal agreement of the Head of Department.
  - The purpose of C&C should be clearly defined and communicated to firms, together with a schedule setting out the programme.
  - If a pattern emerges of the FSA being first to identify issues in a firm, or if a change in the assessment of the control environment occurs, the C&C relationship should be reappraised.
- 2.2 Across peer high impact firms, similar supervisory issues should be captured in Risk Mitigation Programmes (RMPs). This is to maintain a consistent approach to supervision.
- 2.3 Issues not included in the RMP should be monitored and incorporated into an overall view of the firm's risk profile. This requires emerging issues to be entered onto Interim Risk Manager on an on-going basis.
- 2.4 **Interim Risk Manager (IRM) should be updated to reflect issues as they emerge. Principles for updating IRM should be established that are consistent across all supervisory divisions – both in terms of the type of information included and the frequency of update.**
- 2.5 In addition to the automated production of Watchlist entries from IRM, the presumption should be that firms identified as having outlying business models, whether through the work of the sub-sector resource or that of supervisors, should be added to the Watchlist.
- 2.6 Given that ARROW Panels are executive decision makers (not advisory), Panel recommendations should only be varied with the formal agreement of a director.
- 2.7 ARROW Panels should implement Strategy & Risk Division guidance to have a maximum 24 month supervisory period for high impact firms. Subsequent to the Panel, the period should only be varied with the formal agreement of a director.
- 2.8 Where weaknesses, or potential weaknesses, are identified in the competence or behaviour of firms' management, these concerns should be discussed by supervisors with the firm (or escalated to the board as appropriate).

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- 2.9 Any reluctance of firms to engage with particular FSA staff, or any lack of openness of the firm in the supervisory relationship, should be challenged.
- 2.10 Supervisors of high impact firms should meet the firms' external auditors at least once a year.

### 3. **FSA to increase its focus on prudential supervision, including liquidity and stress testing**

- 3.1 **For high impact firms, there should be an on-going supervisory assessment of all appropriate core ARROW risk areas, including capital. Capital and liquidity should have specific focus for high impact deposit-takers and investment firms and should not, in future, be de-prioritised below a certain level.**

**In practice, for capital and liquidity, this focus will include:**

- **applying the prevailing Handbook material;**
  - **checking regulatory returns and analysing changes in data over time;**
  - **considering the appropriateness of the data in the returns to the firm in question and, in light of this, considering what supplementary management information is needed from the firm on a regular basis;**
  - **ensuring that meetings with firms' senior management responsible for capital and liquidity, take place; and**
  - **ensuring that firms have appropriate risk management systems and controls in these areas.**
- 3.2 At the earliest opportunity, the FSA should confirm firms' effective compliance with existing Handbook liquidity risk material, qualitative and quantitative. In particular, the FSA should ensure that:
- in relation to the qualitative material, each firm is considering a range of scenarios of different severity, both firm-specific and market-wide, and has a plausible Contingency Funding Plan; and
  - in relation to banks subject to the Sterling Stock Regime (SSR), there is proper assessment of foreign currency aspects of a firm's liquidity and consideration of the appropriateness of the SSR.
- 3.3 In relation to liquidity, more detail should be provided to firms:
- to explain the linkage between the level of stress to which the quantitative framework is designed to test a firm's resilience, and the FSA's risk appetite; and

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- to explain the relationship between the proposed quantitative framework (in which firms would be required to hold liquidity sufficient to cover the test's implicit level of stress), and the qualitative material, particularly the requirement to have a contingency funding plan covering the preservation of a liquid position in extreme stresses.
- 3.4 The FSA should give more consideration to extreme but plausible scenarios on liquidity risk (and on other fundamental risks).
- 3.5 **The FSA should as a priority develop clear timetables for the implementation of changes to the qualitative and quantitative Handbook material on liquidity. Changes to the qualitative material are likely to build on existing material, and so should permit early implementation.**
- 3.6 The FSA should:
- re-confirm the approach to stress testing taken following its 2006 thematic review, including the decision not to add further Handbook rules or guidance; and
  - consider the case for amendment of the Handbook to make it easier to understand the body of material on stress testing and how its parts fit together.

Thereafter, it should communicate the results of this to firms (probably in the form of a follow-up Dear CEO letter), setting out what further work the FSA proposes in the area. If appropriate, the communication should make clear the FSA's intention to add further rules and guidance at a later point, in the event that firms' progress in reaching good practice levels is judged insufficient.

- 3.7 In the development of Handbook material generally:
- when changes (particularly deletions) are proposed, policy divisions should operate appropriate controls to ensure there is adequate investigation of the reasons why the existing material was previously included; and
  - the development cycle should include a timely post-implementation review of significant new material to test whether firms have put effective arrangements in place and to check the effectiveness of FSA arrangements to monitor firms' progress.
4. **FSA to improve its use of information and intelligence in its supervision**
- 4.1 **A strategy should be developed to ensure the priority risks identified in the Financial Risk Outlook are effectively 'operationalised':**
- **through firm and thematic work that addresses the risks; and**



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5.3 The Major Retail Groups Division director should consider whether there is a case for a divisional reorganisation to facilitate more effective peer comparison in firm supervision.

## 6. FSA to strengthen supervisory resources

6.1 **A bottom-up approach was used for the FSA's annual plan for 2008/09. This should be developed for future years and a 'zero-based budget' constructed for areas dealing with high impact firms. This should allow senior management to monitor the balance of resource planned against key supervisory activities/priorities for each firm, with subsequent regular MI to check the position.**

6.2 The role of the 'Reg E' manager and consequential impact on the role of the lead associate should be clarified. As part of this, some assessment should be carried out on whether the responsibilities and workloads are manageable both for the Reg E managers and lead associates reporting to them.

6.3 The presumption of tenure for a supervisory lead associate or manager, for a high impact firm, should be a minimum of two years and a maximum of four years.

6.4 Training for supervisors on the FSA's approach to firms' stress testing should be made available as soon as possible and undertaken by staff as a matter of priority. This should enable supervisors to engage effectively with firms to provide challenge on the robustness of their stress testing practices.

6.5 The FSA should ensure that any necessary training for supervisors in the area of liquidity risk has been made available as soon as possible and undertaken by staff as a matter of priority.

6.6 **The current training arrangements should be significantly enhanced to ensure that staff receive training appropriate for their roles, and that the roles they are assigned match their skills and experience and the training they have received and assimilated. Resource planning in divisions should take account of this.**

6.7 Corporate Learning should review the training offering that underpins the Regulatory Curriculum. We believe that, as a matter of priority:

- the training offered in three key areas (namely relevant Handbook rules and guidance, financial analysis and impact and influence) should be improved (in number as well as range of courses); and
- all training listed should be available (or a delivery date for courses under construction specified).

## **7. FSA senior management to increase the level of oversight of firms' supervision**

### **7.1 HoDs responsible for supervising high impact firms should formally review the supervision of each firm every six months.**

- **This review should act as a 'checkpoint' about the FSA's view of the firm, and take stock of the changes since the last formal ARROW risk assessment and last HoD review.**
- **It should cover both progress against the C&C schedule and MI relating to RMP actions.**
- **If the firm does not have an RMP, this review should assess whether that remains appropriate.**
- **It should be used as an opportunity to review the quality of MI received from the firm and to assess its continuing appropriateness, in particular as a complement to the standard regulatory returns.**
- **The review should also be used as a means of assessing manager performance and engagement.**

**As a result, formal ARROW risk assessments should become more of a stocktake, given more frequent challenge and escalation of issues as part of on-going supervision.**

### **7.2 Directors responsible for supervising high impact firms should have mechanisms in place, including MI, to enable them to monitor that the agreed supervisory strategy for each firm is being followed through into effective supervisory actions.**

### **7.3 Directors should have a process and forward plan to ensure that ARROW Panels have the appropriate breadth and balance of skills and experience.**

### **7.4 The lessons that can be learned from the Reg E change initiative should be applied in future restructuring programmes.**

### **7.5 The FSA should make greater use of tools, such as contingency planning and stress testing, for internal planning. This is to help it understand and deal with scenarios in a considered manner.**

### **7.6 To develop FSA thinking on whether and how contingency planning/stress-testing might be helpful, an assessment of the lessons learned from how the FSA has dealt with the current market crisis scenario should be performed.**

### **7.7 Directors should ensure that their divisions have agreed documented records management standards and that these are complied with.**

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- 7.8 Supervisors' objectives should be revised and their performance assessed to take account of the findings of this review and the implementation of its recommendations.