

**‘Shaping Tomorrow’
Financial Services Club:
the next five years - a view from the FSA**

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- **UK financial services sector**
- **The role of the FSA: the next five years**
- **Our outlook on key financial sector risks for the next year**
- **The outlook for the banking sector**
- **Closing thoughts**

UK financial services sector



- **The financial services sector plays a major part in the UK economy. It:**
 - contributes over 5% of GDP and employs over one million people
 - is home to some of Europe's largest markets – i.e. banking, insurance, fund management
 - is home to the largest foreign exchange market and second largest securities market in the world
- **Regulation of the financial services sector**
 - undertaken by the Financial Services Authority
 - from early 2005 the FSA will regulate some 25,000 firms and 180,000 individuals in the market
 - the FSA employs 2,400 staff, mostly in London
 - funded by levies on regulated firms with no funding from Government

Role of the FSA: the first five years

- **What has the FSA focussed on since its creation?**
 - **brought together previous regimes**
 - **establishing new domestic regulatory policies**
 - **responding to international policy initiatives**
 - **therefore a taxing consultation programme**
ie. change

Role of the FSA: objectives and aims



- **Four statutory objectives: no change**
 - **Maintaining confidence in the UK financial system**
 - **Promoting public understanding of the financial system**
 - **Securing the right degree of protection for consumers**
 - **Helping to reduce financial crime**

Role of the FSA: objectives and aims



- **Aim to achieve the objectives by:**
 - **promoting efficient, orderly and fair markets**
 - **helping retail customers achieve a fair deal**
 - **making the FSA easier to do business with**

Role of the FSA: our principles



- **A concern to make the markets work effectively, as the best means of providing benefits to both customers and providers of financial services**
- **A determination, where we have discretion, to take regulatory action only where there is a market failure and intervention is likely to be cost-effective**
- **A risk-based approach, which accepts that some financial failures neither can nor should be avoided**

Role of the FSA: the next five years



- **What will we do going forward?**
 - **emphasis on implementation not on new domestic policy**
 - **main policy drivers will therefore be European**
 - **continue to work to ensure proportionate regulation**
 - **embed new operating structure**

Role of the FSA: the next five years



How will we do it?

- **work with industry to minimise regulatory burden on firms eg.:**
 - **‘costs of regulation’ project**
 - **Handbook improvements**
- **balanced with meeting consumer focussed objectives**
- **Focus upon our three aims**

Helping retail customers achieve a fair deal



- **Financial capability**

- Increasing consumer understanding and awareness to deliver more capable and confident consumers

- **Clear and simple information**

- We want consumers to have access to simple, understandable information to help them make financial decisions

- **Treating customers fairly**

- We expect that those who produce and advise on retail financial services and products act responsibly and treat their customers fairly

- **Risk-based supervision**

- It is essential that our regulation is effective and proportionate.

Promoting efficient, orderly and fair markets (that are internationally attractive and stable)



- **Effective and proportionate supervision:**
 - ensuring a strong correlation between risk and resource
 - delivering on thematic initiatives: *conflicts of interest; business continuity; stress-testing; corporate governance and senior accountability, hedge funds etc.*
- **Effective and coherent policy formulation:**
 - MiFID
 - Basel
 - Integrated Prudential sourcebook
 - ICAS, IAS, Solvency II
- **Effective and tailored relationship management**

Improving our business capability and effectiveness



- **Implementing our new people strategy**
- **Implementing mortgage and general insurance regimes**
- **Enhancing our risk-based approach and operating process (ARROW)**
- **Better understanding the costs and benefits of our regime**
- **Focus upon meeting service standards and increasing operating efficiency**
- **Improve use of IT (eg. electronic reporting)**

Financial Risk Outlook

Long-term themes

- **Increasing individual responsibility**
- **Low inflation**
- **Ageing population**
- **The influence of the European union**

2005 scenarios

Central scenario

- Global growth slows modestly in 2005
- UK interest rates near peak
- but imbalances (twin deficits, consumer debt) unresolved

Financial market volatility

- oil prices volatile and higher, possibly aggravated by terrorism and supply shocks
- rapid decline in US dollar
- volatility in other markets (eg bonds)

Falling house prices

- housing market downturn in UK (also possible in US)
- consumer spending and then growth slows
- lower interest rates

Fiscal / interest rate pressures

- US twin deficits and UK fiscal pressures feed inflation
- interest rates higher than in central scenario
- growth is slower

Impact of 2005 scenarios (illustrative)



Central scenario

- concerns over financial position of life insurance firms continue to recede
- UK interest rates increase only marginally – so there should be no immediate debt service problems for most consumers
- consumer borrowing does not slow
- inflation remains subdued: consequently nominal investment returns will remain low. Consumers and firms will continue to ‘search for yield’, which implies taking on more risk
- the marketing environment for investment products will remain difficult
- global economic imbalances will remain unresolved, so firms will need to ensure their risk management continues to take account of disorderly adjustment scenarios

Impact of 2005 scenarios (illustrative)



Financial market volatility

- institutions' risk management capabilities will be tested
- greater financial stability risk from hedge funds
- consumer confidence in investments could be further damaged

Falling house prices

- retail business volumes likely to fall, with earnings impact for firms
- retail credit losses could increase as a result of lower employment
- how will consumer behaviour react to lower house prices?

Fiscal and interest rate pressures

- higher interest rates will cause stresses for heavily indebted consumers
- slower growth and higher long-term interest rates may damage corporate credit quality

Priority risks

- **Continuing vulnerability caused by low consumer understanding**
- **Savings gap and occupational pensions**
- **Changes in pattern of distribution**
- **Search for yield may mean credit or other risk controls are relaxed**
- **Increased operational/reputational risk from more complex structured products**
- **Potential for disorderly market adjustment**
- **Risks arising from the volume of EU and other international regulatory initiatives**
- **Terrorism**

Regulatory Risk: the “Perfect Storm”



Regulatory Risk: the “Perfect Storm”



- **MiFID: retail and wholesale business affected**
- **CRD / Basel 2**
- **IAS, solvency II and ICAS**
- **And coming up....**
 - Payment Services Directive
 - Credit for Consumers Directive
 - Unfair Commercial Practices Directive
 - Directives threaten the survival of the Banking Code – though FSA supports it

Risk management challenges

- **Crucial need for good stress testing/ risk management frameworks eg.:**
 - US twin deficit
 - EU growth issues
 - China
 - Oil price
 - UK housing market
 - Commercial property
- **Wrong time in the cycle to relax credit standards**
- **Need for effective BCP**

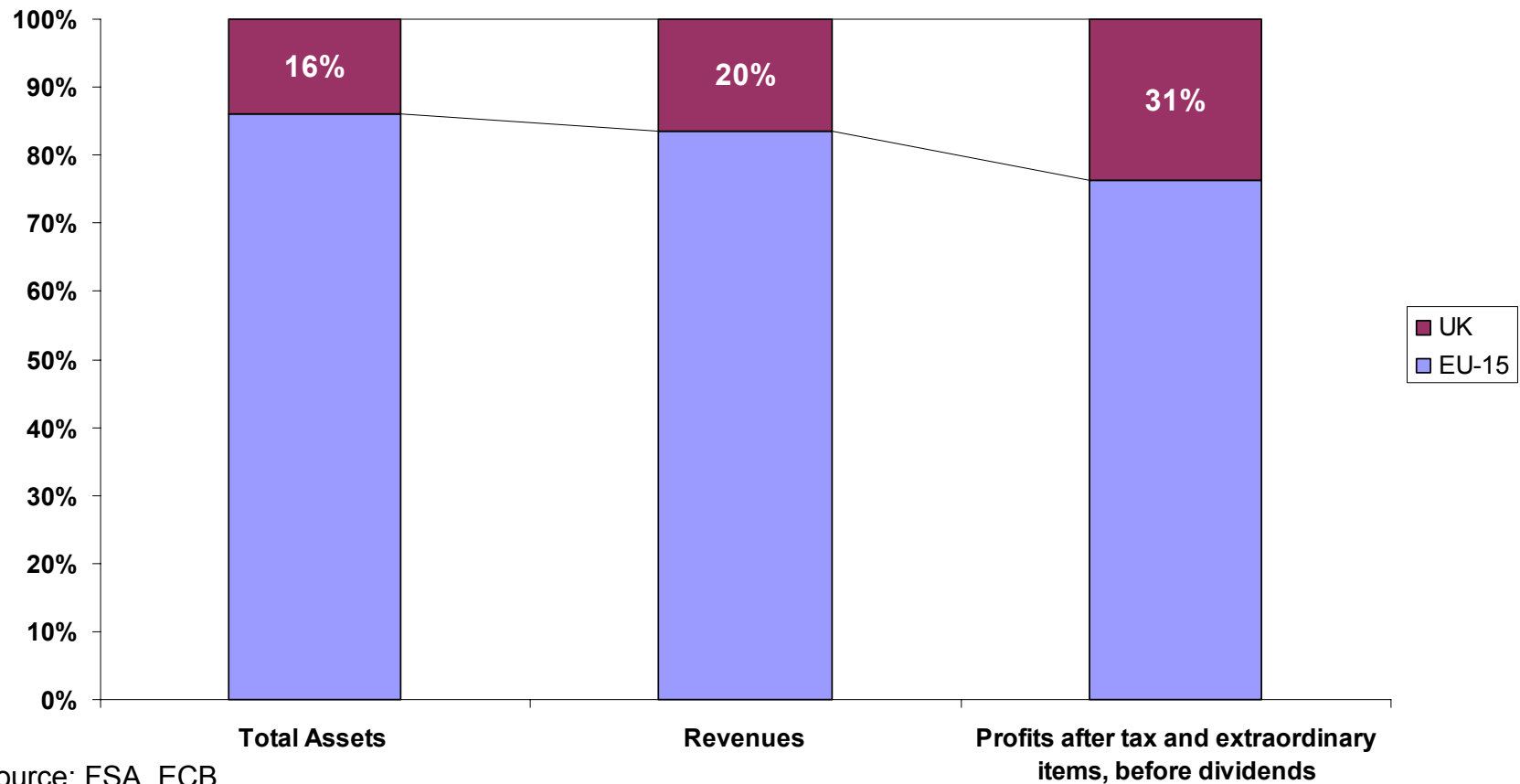
Banking sector

“Where” is the banking sector?

- **Strong financial performance**
- **Well-capitalised, assets quality good**
- **But (as ever) there are risks:**
 - Interest rate cycle in US and Europe
 - Squeeze on margins
 - Personal sector; house price outlook
 - Commercial property

Where is the banking sector? *A major force in Europe*

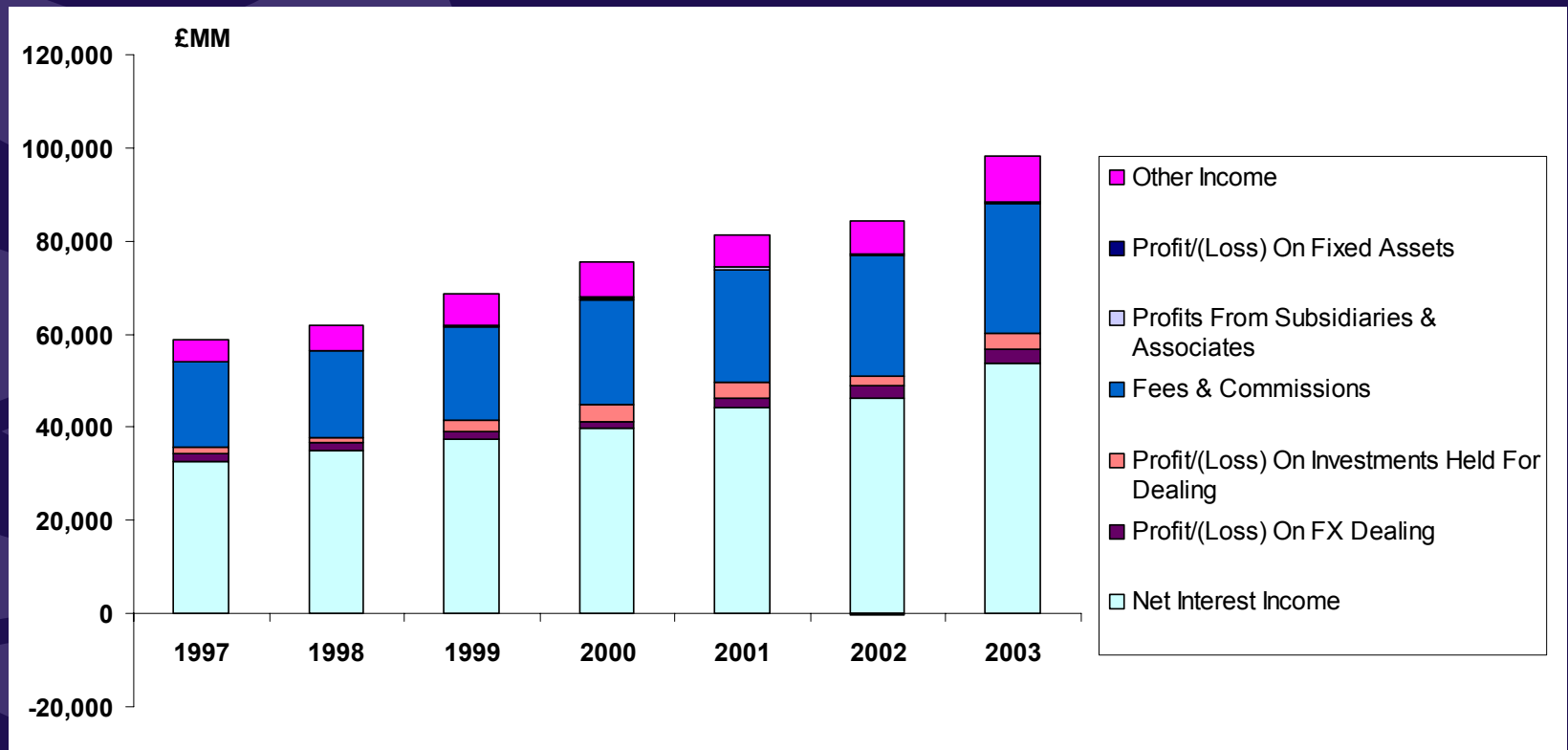
UK Banks contribution to European Banking Sector, 2003



Source: FSA, ECB

Where is the banking sector? *Strong financial performance*

UK Banks Revenues, 1997-2003

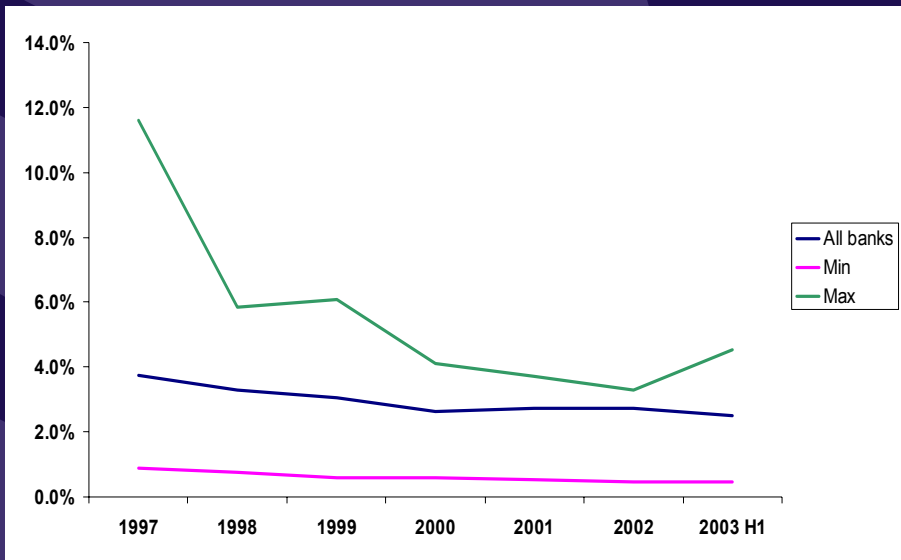


Where is the banking sector?

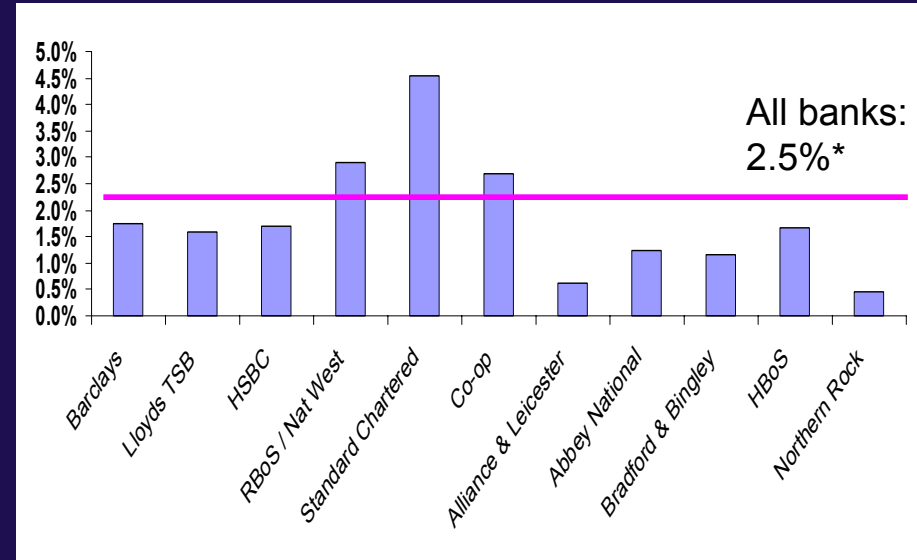
Asset quality remains good



NPL ratio, evolution 1997-2003



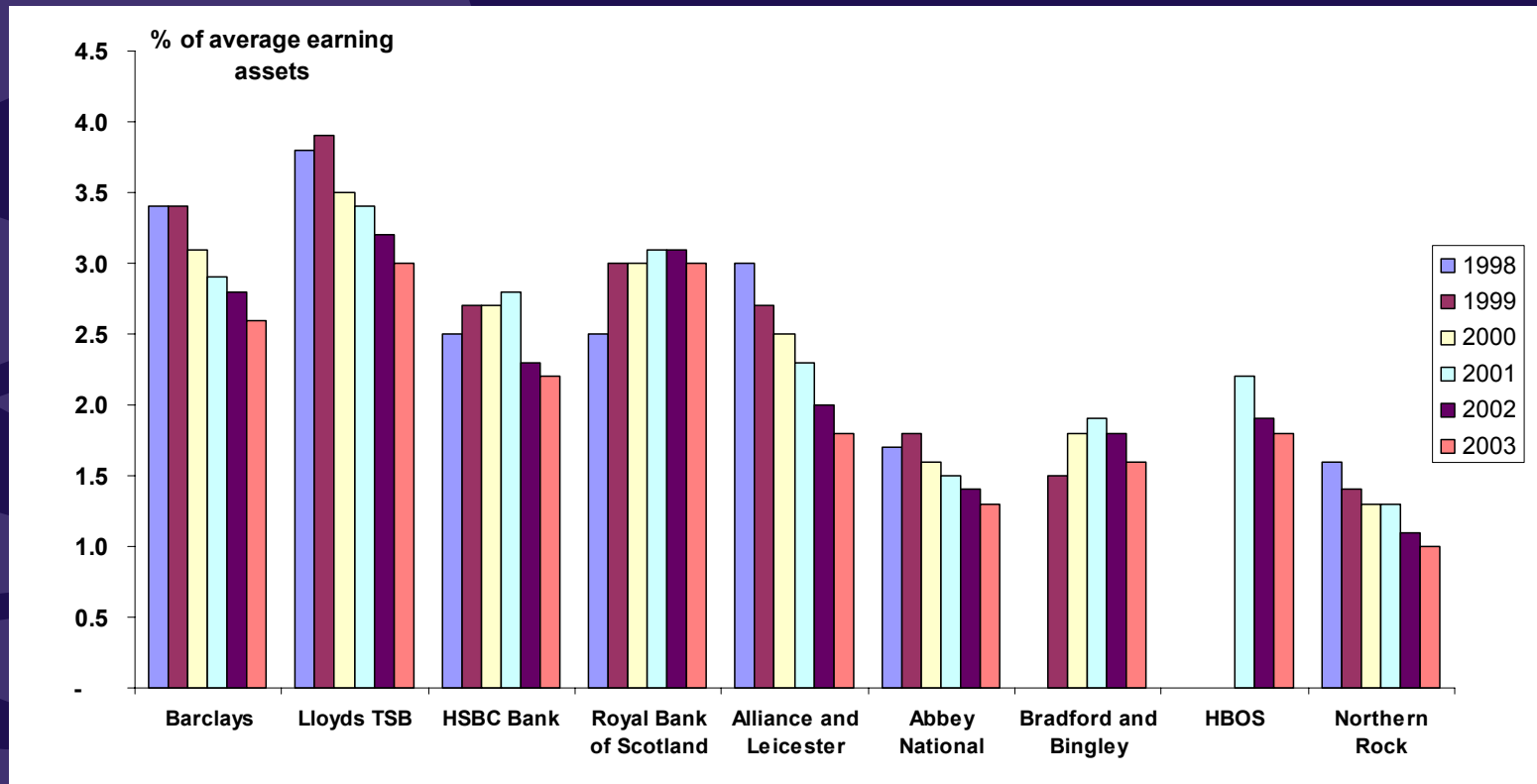
NPL ratio, peer comparison (H1 2003)



* Euro area: 3.3%
Source: FSA

Where is the banking sector? *Squeeze in Net Interest Margins*

Net Interest Margin as a % of average earning assets, 1997-2003



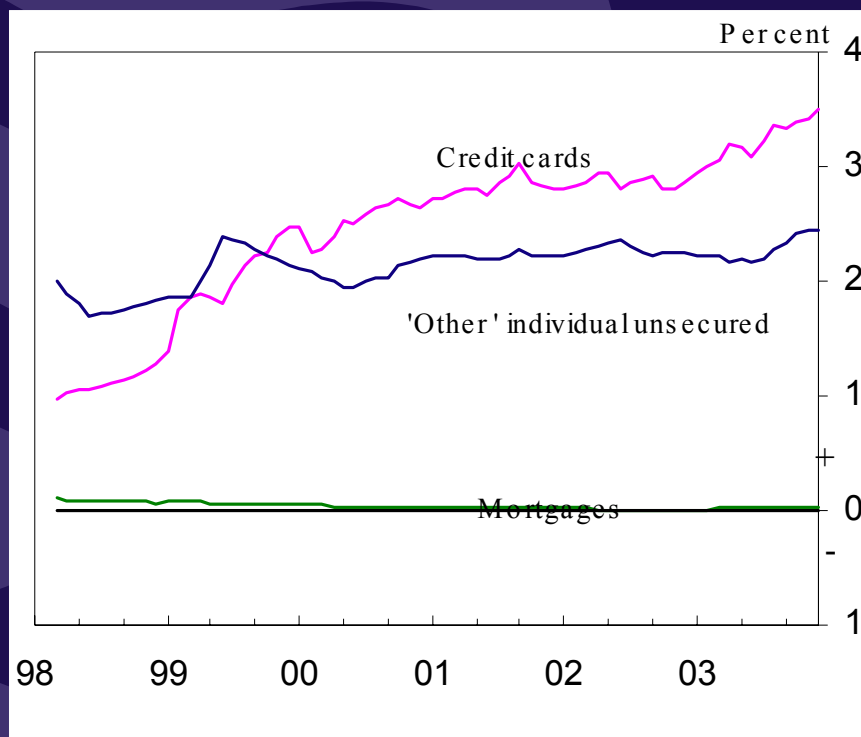
Source: BBA, Major Banking Groups statistics

Where is the banking sector?

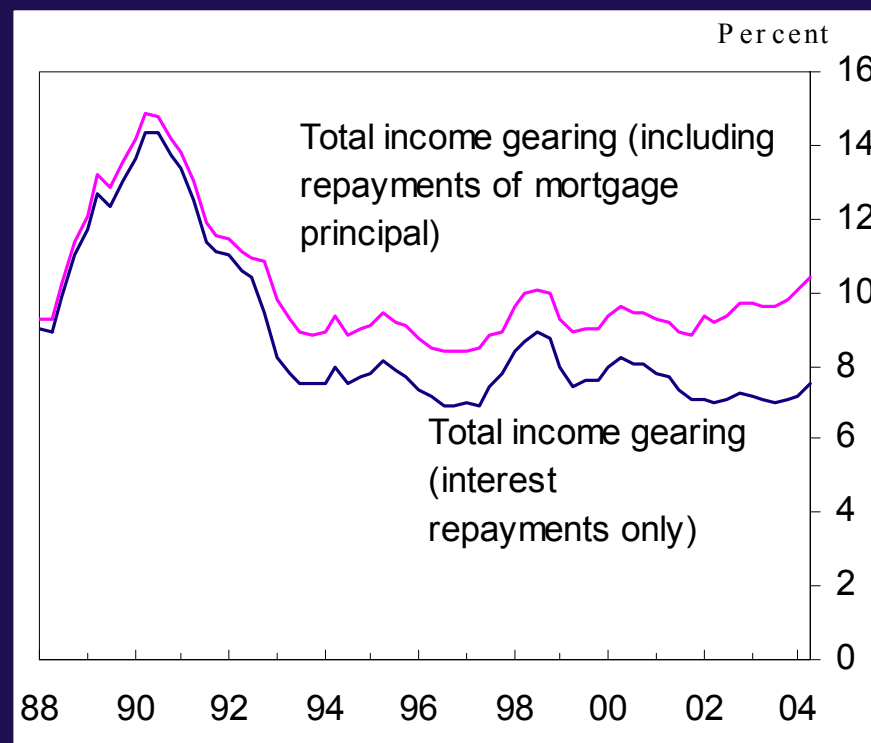
Increasing personal sector credit risk



UK-banks rolling twelve month write-off rates on domestic loans



Household sector income gearing



- **Where will growth come from?**
 - Could volume (and quality) of new business come under pressure next year?
- **Limited success in cost cutting**
 - & constraints given barriers to domestic mergers
- **International M & A risks for UK banks**
 - Both as bidders...
 - ... and as targets

Strategic challenges (cont'd)



- **Credit quality**
 - Corporate credit sector appears healthy, with spreads at a historic low...
 - ... but not a good time to lower standards
- **Making money out of branch network – cross selling without regulatory problems**
- **Need to be wary of top-line dominance and / or complacency at this point in the banking cycle**

Financial crime



- **Increasing fraud risk**
- **Senior management engagement on information security**
- **Staff fraud**
 - Coercion / Infiltration
- **Identity theft – growing exponentially**
- **Hacker attacks**

Business Continuity Planning



- **Terrorist threat remains high**
- **Resilience & recovery benchmarking exercise over the next year**
 - How resilient is the infrastructure?
 - What are the weak points?
 - Feature within ARROW visits

Closing thoughts (1)

- **Our current focus on consumer objectives will continue**
- **Prudential objectives will remain at the centre of our work, but may appear lower key at present given the economic backdrop**
- **We will continue to pursue our objectives to tackle financial crime**
- **The EU will be increasingly significant to policy development**
- **Globalisation will be a continuing theme with wide ranging impact**

Closing thoughts (2)

- **Our agenda will be driven by the objectives of:**
 - **being pro-active in our response to priority risks**
 - **ensuring that we are proportionate in our intervention**
 - **operating with appropriate economy and efficiency**