THE INTERIM PRUDENTIAL SOURCEBOOK FOR BUILDING SOCIETIES INSTRUMENT 2001

Preface

1. The Financial Services Authority makes the rules and gives the guidance in this instrument on 21 June 2001.

2. Sections 138, 149 and 156 of the Financial Services and Markets Act 2000 (the "Act") are specified for the purpose of section 153(2).

3. This instrument shall come into force at the beginning of the day on which section 19 of the Act (the general prohibition) comes into force.

4. This instrument is to be interpreted in accordance with, and applies subject to, the General Provisions contained in the General Provisions Instrument 2001.

5. This instrument may be cited as the Interim Prudential Sourcebook for Building Societies Instrument 2001.

6. This instrument, excluding the provisions in this preface, may be cited as the Interim Prudential Sourcebook for Building Societies , or IPRU (BSOC).

By order of the Board

21 June 2001

ANNEX

IPRU (BSOC)

Interim Prudential sourcebook: Building Societies

FSA

Financial Services Authority

Final Rules – Building Societies
Volume 1 of 2

Part of:

The Interim Prudential Sourcebook for Building Societies

June 2001

IPSB FOR BUILDING SOCIETIES

CONTENTS LIST

Interim Prudential Sourcebook for Building Societies

X. Introductory Chapter

X.1 Introduction

X.1.1 G The rules in this sourcebook are made under section 138 of the Financial Services and Markets Act 2000 (“the Act”) and that section and sections 149 and 156 are specified for the purposes of section 153. The guidance in volume 2 of this sourcebook is given under section 157(1)(b) of the Act.

X.2 Application

X.2.1 R The Interim Prudential Sourcebook for building societies applies to all firms with permission from the Financial Services Authority to accept deposits which are also building societies as defined in the Building Societies Act 1986 and, in this sourcebook, “society” and “societies” are construed accordingly.

X.3 Content of this sourcebook

X.3.1 G This sourcebook is divided into two volumes. Volume 1 contains eleven prudential chapters which set out the Financial Services Authority’s prudential standards for societies. Three of the prudential chapters incorporate material drawn from the Interim Prudential Sourcebook for banks and guidance on the presentational style of the bank material can be found in section 4 of chapter GN of that sourcebook. Volume 2 contains five chapters of constitutional guidance: the Financial Services Authority (the “FSA”) inherits from the Building Societies Commission (“the Commission”) a range of functions under the Building Societies Act 1986 (“the 1986 Act”) related to the constitutional aspects of building societies and these chapters give guidance on how the FSA will exercise certain of these functions. The constitutional chapters replace Guidance Notes previously issued by the Commission.

X.4 The Purpose of the Interim Prudential Sourcebook for Building Societies

X.4.1 G The Interim Prudential Sourcebook for building societies sets out the FSA's detailed prudential standards and related notification requirements applying to societies authorised under the Act and covers the constitutional matters referred to above. Other prudential standards applying to societies are set out in the Act and elsewhere in the Handbook: see, for example, the Threshold Conditions (COND), the Principles for Businesses (PRIN) and Senior Management Arrangements, Systems and Controls (SYSC). Other notification requirements are set out in chapter 15 of the Supervision Manual (SUP).

X.4.2 G This sourcebook, together with the separate prudential sourcebook applying to banks, also implements EC directives setting out prudential standards as they apply to credit institutions.

X.4.3 G This sourcebook applies to societies on an interim basis pending the preparation and implementation of a single Prudential Sourcebook applying to all firms regulated by the FSA – termed the Integrated Prudential Sourcebook. In developing the interim sourcebook, the FSA has drawn on the standards which formerly applied to societies authorised under the 1986 Act set out in the Statement of Principles and Prudential Notes issued by the Commission. These standards took the form of the Commission's interpretation of the criteria of prudent management in section 45 of the 1986 Act (which are repealed under the Act). The FSA has expressed some of the content of the former criteria of prudent management as rules in this Interim Prudential Sourcebook, but the majority of the previous material has now been recast as guidance under the Act. A significant amount of material previously published by the Commission has not been carried forward into the Interim Prudential Sourcebook, particularly descriptive, historical and explanatory material. This has been removed because the FSA considers that it is not appropriate material for prudential rules and guidance under the Act, not because the material is in any way incorrect or irrelevant to societies' business. The rules and evidential provisions are distributed throughout the prudential chapters of this sourcebook: rules can be found in paragraphs X.2.1, X.8.2, 1.2.1, 1.2.2, 4.2.1, 4.2.5, 4.2.6, 5.2.1, 5.2.7, 5.2.9, 6.2.1, 6.2.2, 6.2.3, 7.6.2, 7.6.3, 7.7.1, 7.7.3, 8.2.1, 9.2.1, 9.2.7 and 9.2.8. Evidential provisions can be found in paragraphs 5.2.4, 9.2.3 and 9.2.5.

X.4.4 G The approach outlined in X.4.3 has been adopted, after consultation, as appropriate for material drawn from the previous standards of the Commission that will apply on an interim basis only. It is the FSA's intention in developing its final prudential standards (in the Integrated Prudential Sourcebook) to make further use of its rule-making powers to express its detailed prudential standards.

X.4.5 G This sourcebook also sets out both rules and guidance on the information related to prudential standards which societies should notify to the FSA. The FSA needs to be provided with certain information by societies if it is to monitor compliance with its requirements. The rules and guidance in this sourcebook supplement, for societies, the FSA's general notification requirements set out in the Supervision Manual (see SUP 15). In addition to the rules, the following paragraphs contain guidance on matters about which the FSA expects to be notified: 1.5.2, 1.6.4(1), 1.11.1, 1A4.2, 2.9.1, 4.5.8, 7.6.4 and 7.6.5.

X.4.6 G In addition to the rules and guidance applying to societies under the Act, directors and certain staff of all firms are subject to obligations referred to as the Statements of Principle for Approved Persons. The FSA has issued a Code of Practice to help determine whether an Approved Person's conduct has complied with a Statement of Principle. The Statements and the Code of Practice are set out in APER. A society's failure to meet the prudential standards set out in this sourcebook may also be relevant to the FSA's assessment of whether a particular Approved Person has complied with a Statement of Principle.

X.5 Principal Purpose of a building society and funding and lending limits

X.5.1 G Building societies are bound by sections of the 1986 Act which place limitations on certain aspects of their business (particularly sections 5, 6 and 7). The following paragraphs provide guidance on compliance with those sections and the FSA's powers in relation thereto, replacing guidance previously included in the Commission's Statement of Principles.

X.5.2 G A building society may only be, and continue to be, incorporated under the 1986 Act if its principal office is in the United Kingdom and if it complies with the purpose or principal purpose (section 5(1) of the 1986 Act) of all building societies, namely:

> *"... that of making loans which are secured on residential property and are funded substantially by its members ..."*

This criterion lies at the heart of what it is to be a building society and sets down its defining characteristics. A failure, or projected failure, to comply with the criterion may therefore cast doubt on the society's longer-term commitment to remain as a building society.

X.5.3 G The lending (section 6) and funding (section 7) limits, commonly known as the "nature limits", are quantitative criteria which help to determine an individual society's compliance with the purpose or principal purpose.

X.5.4 G Compliance with the statutory purpose is not, however, limited to compliance with limits on the composition of the society's assets and liabilities. Societies are involved in activities or provide services which do not of themselves create significant balance sheet assets or liabilities. Such business may still have an impact on a society's compliance with the statutory purpose because of the actual or projected proportion of the society's business made up of those activities.

X.5.5 G In assessing whether a society is complying with the statutory purpose, the FSA will adopt a broadly-based judgement taking all relevant factors, both quantitative and qualitative, into account. As part of that overall assessment, there are two main quantitative indicators. First, the actual and projected proportion of the society's gross income that is, or is intended to be, derived from activities or services that have little or no connection with the making of loans secured on residential property (income from car insurance would, for example be considered unconnected business but income from mortgage and property related insurance and valuation services would, for example, be considered connected with core lending business). Second, it would take into account the actual and projected proportion of the society's resources (for example, financial assets, capital, senior management and staff) that are, or are intended to be, applied to those other activities or services.

X.5.6 G The FSA expects societies to draw up their corporate and other business plans so as to provide reasonable assurance that they will comply with the statutory purpose and the nature limits. The FSA inherits the Commission's enforcement powers (in sections 36, 36A and 37 of the 1986 Act) in relation to breach of statutory purpose or nature limits.

X.6 The continuing 1986 Act

X.6.1 G Before N2, the main piece of legislation governing building societies and their activities has been the Building Societies Act 1986, as amended, in particular by the Building Societies Act 1997. The 1986 Act fulfilled a number of roles. It established the Commission as the prudential supervisor for societies and gave the Commission certain prudential powers of control, but it also, for example, set out the principal features of a building society and made provision for societies' internal constitutional arrangements and procedures for mergers and transfers of business. Although nearly all of those sections of the 1986 Act which related to prudential supervision have been repealed by or under the Act, a substantial part of the 1986 Act remains in force. For example, all references to the Commission have been removed and any remaining powers of control pass to the FSA (the Commission's powers to make secondary legislation under the remainder of the 1986 Act pass to the Treasury). The constitutional parts of the 1986 Act, however, remain, e.g. principal purpose and nature limits, the obligation to prepare annual accounts, provisions on societies' rules and general governance, membership, meeting and voting arrangements and procedures for mergers and transfers.

X.7 Frequently Used terms

X.7.1 G The following terms are used frequently in the sourcebook and have the meaning described here:

PN	a Prudential Note issued by the Building Societies Commission
section 9A	section 9A of the Building Societies Act 1986, as amended
the Accounts Regulations	the Building Societies (Accounts & Related Provisions) Regulations 1998 (SI 1998/504) as amended
the Act	the Financial Services and Markets Act 2000
the BCD	Directive 2000/12/EC of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions (the "Banking Consolidation Directive"). This directive consolidated most of the EC directives relating to credit institutions into one text. The directives so consolidated include the Own Funds Directive (89/299/EEC), the Solvency Ratio Directive (89/647/EEC), the Large Exposures Directive (92/121/EEC), the 1st and 2nd Banking Co-ordination Directives (respectively 77/780/EEC and 89/646/EEC) and the 2nd Consolidated Supervision Directive (92/30/EEC).
the central office	the department of the FSA carrying out the registration functions transferred from the central office of the Registry of Friendly Societies
the Commission	the Building Societies Commission
the FSA	the Financial Services Authority
the 1986 Act	the Building Societies Act 1986, as amended in particular by the Building Societies Act 1997 and by and under the Financial Services and Markets Act 2000
the 1997 Act	the Building Societies Act 1997

X.8 Schedule of Transitional Provisions

X.8.1 G A number of rules in this Sourcebook require societies to provide copies of policy statements covering various aspects of their business and their corporate plan to the

FSA. These rules replace similar prudential requirements previously imposed by the Commission.

X.8.2 R A society which, before the date of the coming into force of this rule, had provided to the Commission a copy of its current policy statement on each of financial risk management, liquidity, and lending and a copy of its current corporate plan is taken to be in compliance, at that date, with any obligation to submit to the FSA such document contained in, respectively, rules 4.2.5, 5.2.7, 6.2.2, and 9.27.

X.8.3 G X.4.5 refers to particular paragraphs in this Sourcebook which contain guidance on matters about which the FSA expects to be notified or in respect of which it expects to receive certain documents. These matters were previously required to be communicated to the Commission and in some cases (where the communication related to a past event, a proposed change in a society's approach or a situation which is ongoing) notification or documents may already have been given to the Commission before the date on which the guidance set out in this Sourcebook comes into effect. The relevant guidance for these purposes is set out in paragraphs 1.5.2, 1.6.4(1), 1.11.1, 1A.4.2, 2.9.1, 4.5.8, 7.6.4 and 7.6.5. Any society which, before that date, had notified the Commission, or provided documents to the Commission, about a matter referred to in any of those paragraphs, in compliance with the Commission's guidance, is taken to be in compliance, at that date, with the relevant paragraph in this Sourcebook in so far as it relates to the matter in respect of which notification or documents had been received by the Commission.

X 8.4 G In addition , GEN contains some technical transitional provisions that apply throughout the Handbook and which are designed to ensure a smooth transition at commencement (that is ,when section 19 of the Act (the general prohibition) comes in to force) . The Supervision manual (SUP) contains transitional provisions which carry forward written concessions relating to pre-commencement provisions.

Interim Prudential Sourcebook for Building Societies

1 SOLVENCY

CONTENTS

Interim Prudential Sourcebook for Building Societies

1 Solvency

1.1 Introduction

1.1.1 G This chapter replaces PN 1998/1 issued by the Commission. It includes rules and guidance for societies on the Threshold Condition in Schedule 6 paragraph 4(1) of the Act (the resources of a firm must, in the opinion of the FSA , be adequate in relation to the regulated activities it seeks to carry on) – see also COND 2.4 - and on Principle 4 ("a firm must maintain adequate financial resources "). It describes the purpose of capital in a deposit-taking institution and the particular risks faced by building societies. It describes how societies should calculate their solvency ratio for capital adequacy purposes, what funds are eligible for inclusion in own funds and the FSA's methodology for setting Threshold Ratios. It should be read in conjunction with Chapter 2.

1.1.2 G This chapter further explains that the FSA will set each society a Threshold Ratio based on the FSA's assessment of a society's risk profile. Societies are expected to meet their Threshold Ratio at all times on both a consolidated and society only basis. The setting of a Threshold Ratio by the FSA does not absolve the society's board from maintaining such higher capital ratio as it considers prudent for the maintenance and management of the society's business and its future plans.

1.1.3 G Finally this chapter explains how the capital adequacy requirement should be calculated and sets out the FSA's methodology for setting threshold ratios.

1.2 Rules

1.2.1 R A society must maintain adequate capital resources commensurate with the nature and scale of its business and the risks inherent in its business. Where a society has subsidiary undertakings it must also maintain capital resources commensurate with the scale and nature of the activities of the whole group.

1.2.2 R A society must maintain own funds of at least £1m.

1.3 The Purpose of Capital

1.3.1 G The capital of a body corporate is the amount by which the value of its assets exceed its non-capital liabilities. A deposit taking institution needs sufficient capital:

(1) to maintain itself as a viable going concern, able to overcome either expected or unexpected difficulties (including both squeezes on margins and losses on assets), to exploit opportunities and to sustain its infrastructure;

(2) to secure, in conjunction with liquidity, its ability to repay deposits (and in a building society, shares) whenever that may be required; and

(3) to maintain public confidence that the institution will be able to repay such deposits (and shares) in full.

1.4 EU Directives

1.4.1 G The EU has harmonised capital adequacy requirements for credit institutions in the EU by the following principal directives:

(1) Council Directive of 17 April 1989 on the Own Funds of Credit Institutions (89/299/EEC);

(2) Council Directive of 18 December 1989 on a Solvency Ratio for Credit Institutions (89/647/EEC).

1.4.2 G In March 2000, these directives, along with the Large Exposures Directive, the 1st and 2nd Banking Co-ordination Directives and the 2nd Consolidated Supervision Directive, were consolidated into a single Directive, known as the Banking Consolidation Directive (2000/12/EC). Elsewhere in this sourcebook, references will be to the consolidated directive ("BCD").

1.4.3 G A further directive, 93/6/EEC on the capital adequacy of investment firms and credit institutions (the "CAD", not included in the BCD), sets out the capital requirements for credit institutions which have trading books and foreign exchange exposures. Building societies which are on the "Trading Book" approach to Treasury management may engage in those activities (see section 1.18).

1.4.4 G The BCD requires national authorities to ensure that all credit institutions maintain sufficient capital resources in relation to their business to ensure a minimum solvency ratio of 8%. The BCD specifies the types of capital resources whose inclusion is permitted in the calculation of the solvency ratio: those resources are known, collectively, as "own funds". It also sets out the calculation of the solvency ratio as follows:

$$\text{solvency ratio} = \frac{100 \times \Sigma \text{ own funds}}{\Sigma(\text{risk weighted assets} + \text{off balance sheet items})} \geq 8\%$$

i.e. the solvency ratio equals own funds divided by the sum of risk weighted assets and off balance sheet items, expressed as a percentage and should be 8% or more.

1.4.5 G The BCD specifies the minimum risk weights which should be applied to assets in the balance sheet and the "credit conversion factors" to be applied to off balance sheet items, in order to calculate the denominator of the solvency ratio.

1.5 Threshold Ratios

1.5.1 G Each society has been informed of the Threshold Ratio it is expected to maintain. This has been set by the FSA taking account of the nature and inherent risks of that society's business in areas which are not covered or not sufficiently covered by application of risk weighting. The Threshold Ratio should be maintained on both a society only basis and on a group basis reflecting the fact that the subsidiaries are separate legal entities and that the society cannot rely on having access to their capital at all times. In certain circumstances solo consolidation may be agreed; this is further explained in section 1.11. Paragraph 1.5.3 explains the FSA's approach to setting threshold ratios for societies. In every case the FSA has provided against a society inadvertently breaching the EC 8% minimum. The setting of a Threshold Ratio by the FSA does not absolve boards of societies from the responsibility of maintaining such higher ratios as they consider appropriate for their business and future plans.

1.5.2 G There is no prescribed amount by which the FSA expects a society's capital to exceed that required to meet the threshold but it is the responsibility of the society to plan so it has sufficient capital at all times to avoid breaching its Threshold Ratio. The Board should therefore set and monitor a capital margin above both the society only and the group threshold ratios which management will be expected to observe at all times; societies' systems should be able to demonstrate that this is the case. The FSA should be advised of the margin set and any changes thereto. Subject to the foregoing, the FSA does not object to societies reducing solvency ratios, for example, by repaying excess capital to their members, but it will want to be satisfied that any such reduction is planned and capable of being reversed without undue adverse affect should changes in the economic position of the society or in its risk profile so dictate. Any society that falls below its margin and/or is in danger of breaching its Threshold Ratio should advise the FSA immediately, stating how it proposes to remedy the situation. The projected solvency ratio should feature in all operational and strategic plans and any proposal for a new business venture should take into account any impact on the society's solvency ratio.

1.5.3 G A society's threshold ratio reflects the FSA's assessment of the society's risk profile. The seven factors which go into establishing the threshold ratio are board, management, systems, asset quality (insofar as not adequately covered by minimum risk weights and including MIG arrangements), treasury management (including hedging, funding and liquidity), planning (including the planning and control of new initiatives) and operating performance (including consistency in financial results and vulnerability to external shocks, for example, through geographic concentration). A blank appraisal form currently used to assess societies' risk profile can be found in Annex 1J.

1.5.4 G There are a number of points which have an important bearing on the appraisal process:

(1) the seven broad factors, and the various criteria underlying those factors, do not carry equal weight amongst themselves or uniformly across societies. The system recognises that some factors and criteria are more important to some societies than others, consequently the threshold ratio is not based on an arithmetical average of criteria and factors but these are weighted by the FSA to the extent appropriate to each society;

(2) the assessment system recognises that there are other criteria, which may be relevant only to particular societies, and these are also taken into account where they exist;

(3) whilst some criteria focus on societies' competence in a particular area, others evaluate the risk of particular activities which are not reflected in the asset weighting formula but which exist even in the most competently managed operation;

(4) societies are assessed in the context of both their past performance and of their current and planned business activities. The process recognises that some societies' business requires less sophisticated systems and less board and managerial expertise than others;

(5) where societies merge, the merged institution will be the subject of a full new appraisal. The FSA recognises that the threshold ratio which is set on the basis of this appraisal might affect the merger terms and the FSA will be prepared to give an advance indicative ratio, if so requested by the societies involved.

1.5.5 G In setting the ratios the FSA has been careful to review each society's ratio against those of the rest of the building society sector to ensure that societies' ratios are consistent with one another. Both societies and the economic environment in which they operate are constantly evolving and the FSA reviews societies' ratios both individually and across the sector on a regular basis, but it is the FSA's expectation that threshold ratios will be reasonably stable with infrequent changes.

1.6 Own Funds

1.6.1 G The BCD specifies which capital resources can count towards own funds and the extent to which they may do so. Its purpose is to ensure that credit institutions operating under supervisory regimes in different EU member states do not count towards own funds any items not falling within the BCD's list nor include any items to a greater extent than the BCD permits. But not all the items contained in the list are relevant to societies: moreover the BCD gives national authorities discretion whether or not to allow the use of the various constituents of capital listed.

1.6.2 G For building societies, own funds comprise reserves, all other capital resources listed in Annex 1A and minority interests in accordance with section 1.7.

1.6.3 G The BCD distinguishes between those components of own funds, such as reserves and PIBS, which may be included without limit and those to which a limit applies (see also chapter 2). These two categories closely correspond to the categories of core, or Tier 1 capital and supplementary, or Tier 2 capital used in the Basel Accord, and the same terminology is therefore used for convenience in this chapter although it does not feature in the BCD itself.

1.6.4 G Whenever a calculation of own funds is to be made other than at the balance sheet date, the amount of reserves included should be after deduction of any overall losses in the current year:

(1) where a society does not seek to take credit in its solvency ratio calculation for profits earned in the current year, but simply reports on the basis of its previous year-end reserves, then as a minimum the society should have passed a board resolution, after the close of the second financial quarter, to the effect that the directors have satisfied themselves that no reduction in reserves has been sustained during the first six months of the financial year and a copy of this resolution should be forwarded to the FSA. Should the FSA be concerned about a society's ability to meet its capital requirements the society may be required to

obtain a certificate or opinion from its external auditors that no reduction in reserves has been sustained;

(2) interim current year profits may be included with reserves, i.e. in Tier 1, but only if they have been verified by the society's external auditors and a report from the auditors that the interim profits have been verified should be provided.

Where a society includes general provisions in its solvency ratio calculation other than at balance sheet date then as a minimum it should have passed a board resolution, after the close of the second financial quarter, to the effect that the directors have satisfied themselves that the general provisions meet the requirements set out in Annex 1A3.1.

1.6.5 G What constitutes verification by external auditors is summarised in Annex 1E. Societies may include interim profits on a quarterly basis, but are not required to do so: some societies whose capital is plentiful may prefer to choose the simpler minimum procedure outlined in paragraph 1.6.4(1). Moreover, the FSA recognises that it will not be practicable for societies or their auditors to complete the verification procedures prior to the deadline for submission of the quarterly returns. For the first, second and third financial quarters societies may include interim profits in their returns, if they so wish, on the understanding that the society will submit the required reports and, where necessary, board resolutions within two months of the quarter end. For the fourth quarter the FSA will rely on the forthcoming audited accounts and accordingly the full year's profits should be included in own funds under Tier 1. The figure shown for reserves in the return for the first quarter should agree with that shown in the annual accounts.

1.7 Minority Interests

1.7.1 G The BCD provides for the inclusion of minority interests when they are credit (negative) items in the capital of a subsidiary undertaking in the calculation of consolidated own funds of a society and these subsidiaries. The FSA believes that building societies should not regard minority shareholdings as having all the properties of their own capital because minority interests cannot absorb the losses of the building society or any other member of its group and they would not necessarily be available to the building society if the society or subsidiary undertaking were to be wound up.

1.7.2 G Accordingly, minority interests should only be included for the purpose of calculating consolidated own funds, and then only if:

(1) the total amount of minority interests aggregated with Tier 1 or Tier 2 capital does not exceed 10% of the society's own funds in that category;

(2) it is clear that the society has effective practical control over the subsidiary undertaking and can pass a special resolution;

(3) the society owns at least 75% of the equity capital of the subsidiary undertaking.

In determining which elements of minority interests should be integrated into Tier 1 own funds societies should have regard to the characteristics of the subsidiary undertaking's capital. Only those items which are analogous to a society's Tier 1 own funds should be included in Tier 1. The remainder should be assigned to the appropriate category of Tier 2 funds. In this section, references to subsidiaries are to entities which are subsidiaries of the society.

1.8 Deductions

1.8.1 G Societies should make certain deductions from own funds and observe certain restrictions on the inclusion of Tier 2 items. The deductions comprise:

(1) intangible fixed assets, including goodwill;

(2) all holdings of capital instruments of other credit or financial institutions (see Annex 1D for definitions);

(3) all holdings of capital instruments of regulated broker-dealers (subject to CAD or an analogous regime);

(4) (a) the amount of the capital deficit of any subsidiary undertaking which has such a deficit (only required for society only calculations). The entire deficit should be excluded even if the subsidiary is only partially owned;

(b) the proportion attributable to outside minority interests in the capital deficit of any subsidiary undertaking which has such a deficit (required for consolidated calculations).

1.8.2 G Societies may be expected to make a deduction from own funds to reflect the existence of a contingent liability which, if called, would create an asset that societies would be required to deduct from own funds.

N B: See section 1.13 for deductions in respect of insurance companies, section 1.14 for MIG captives, section 1.16 for holdings in other institutions, and for possible deductions arising out of securitisation, section 1.15.

1.9 Limits on Tier 2 Capital

1.9.1 G The maximum amount of term subordinated debt which should be counted as own funds within Tier 2 is 50% of Tier 1 capital after deduction of intangible fixed assets. Total Tier 2 capital should not exceed 100% of Tier 1 capital after deduction of intangible fixed assets. Funds eligible for inclusion in Tier 2 capital are defined in Annex 1A.

1.10 Solvency Ratio

1.10.1 G The solvency ratio of any society is determined by the formula set out in paragraph 1.4.4. Societies should calculate their own ratios using the definition of own funds contained in this Chapter and in Annex 1A and the risk weights and credit conversion factors in

Annexes 1B and 1C. The relevant risk weight (a percentage) is applied to the balance sheet value of an asset, or in the case of off balance sheet items, to the nominal value multiplied by the appropriate credit conversion factor. Asset values and values attributed to off balance sheet items should also be determined on a basis consistent with the Accounts Regulations and should be net of any specific provisions. Where a society has subsidiary undertakings, the solvency ratio should be calculated on a consolidated basis. Consolidation should be on the same basis as applies to the society's statutory accounts (i.e. the Accounts Regulations). Where subsidiary undertakings, either singly or in aggregate, have either:

(1) total gross assets equal to or greater than 1% of the society's assets; or

(2) income which is equal to or greater than 1% of the society's total income; or

(3) profits or losses which are equal to or greater than 1% of the society's profits;

the society should also calculate its solvency ratio on a society only basis and both calculations should meet the society's solvency ratio threshold (see Annex 1H for definitions of terms used in (1), (2) and (3)). Societies should report their solvency ratios quarterly in the QFS1 return.

1.10.2 G The percentage weights given in the BCD are minima: the directive explicitly recognises that national authorities may set higher weightings as they see fit. The FSA has decided to do so for securities issued by Zone A or Zone B countries. These are weighted at 10% or 20%, according to residual maturity, as a proxy for interest-rate risk, rather than at 0% as the BCD permits.

1.10.3 G The FSA uses the "mark-to-market" approach for the measurement of off balance sheet risks associated with interest-rate and foreign exchange contracts, and societies are expected to report on this basis. Treatment of off-balance sheet items is shown in Annex 1C.

1.11 Solo Consolidation

1.11.1 G The FSA recognises that for structural reasons societies have historically conducted certain core business through subsidiaries which they might otherwise have preferred to conduct themselves. In such cases the FSA may agree or expect societies to consolidate such subsidiary undertakings when calculating their society only solvency ratio. However, in so doing the FSA may expect the society to deduct a percentage of the subsidiary undertaking's capital from the society's own funds when making the society only solvency ratio calculation. This deduction will reflect the FSA's view of any enhanced risk in opting to conduct the business through a subsidiary rather than the society itself. At the minimum there is a risk that the environment which made the subsidiary route profitable may change leaving the society with a cost to unwind the structure. The FSA will discuss with societies where solo consolidation is considered appropriate or necessary, but see section 1.12. Where solo consolidation occurs societies should confirm annually in writing to the FSA that the solo consolidated subsidiaries continue to meet the criteria under which solo consolidation is agreed and that there has been no change in the type of business conducted by the subsidiary undertaking. Confirmation should be received within two months of the society's year end.

1.12 Mortgage Subsidiaries

1.12.1 G The principle of solo consolidation can be applied not only to capital adequacy but also to large exposures (see Chapter 7 Large Exposures) and although these are two distinct issues the grounds for confusion are much reduced if it is possible and prudent to adopt a common approach in respect of specific subsidiaries or categories of subsidiaries. Provided they comply with certain criteria, mortgage subsidiaries are a suitable category for solo consolidation in respect of both large exposures and capital adequacy. To enable the FSA to make valid comparisons across the building society sector it is important that all mortgage subsidiaries which meet the criteria are treated in a similar manner; however, under the BCD the FSA is required to give its approval to applications from each society individually. All societies which have mortgage subsidiaries which:

(1) are under the effective day to day control of the society’s executives;

(2) are wholly owned by the society;

(3) are not subject to the capital requirements of another regulator;

(4) have no restrictions on winding up and upstreaming capital at any time;

and either:

(5) have no third party creditors at all (this is not intended to include small administrative creditors such as the electricity bill); or

(6) are constituted so that the society can substitute itself for the mortgage subsidiary and perform its obligations to third party creditors;

should apply to the FSA to solo consolidate these subsidiaries confirming that they meet the above mentioned criteria.

1.13 Exclusions from Consolidation

1.13.1 G Subject to a limited degree of discretion allowed to the supervisory authorities, the BCD requires building societies to consolidate subsidiary undertakings which are financial or credit institutions (defined in Annex 1D) for the purposes of calculating their solvency ratio. However unless:

(1) the inclusion of a particular non financial institution or non-credit institution subsidiary undertaking would result in a higher solvency ratio than if it were to be excluded; or

(2) the FSA specifically requires the subsidiary undertaking to be excluded;

societies should include all their subsidiary undertakings when calculating their solvency ratio. Exclusion is likely where the FSA believes that a subsidiary's inclusion in the consolidation would be misleading or inappropriate. Life insurance and general insurance companies fall into this category and societies should calculate their solvency ratio after reversing the impact of the investment in, or consolidation of, these subsidiary undertakings. In the society only ratio calculation, the carrying value of the investment should be removed from the weighted asset total, and an equal deduction made from the society's own funds. In the consolidated ratio calculation, the weighted assets of the insurance subsidiary should be removed from the consolidated weighted assets, and the reserves of the subsidiary consolidated into group own funds should be reversed out, including any benefit of the embedded value taken through the group's reserves. The only profits of the subsidiary that may count as group own funds are those that have been distributed to the parent society i.e. as dividends.

1.14 Mortgage Indemnity Insurance Captives

1.14.1 G Societies which own a MIG Captive should include the captive when calculating their consolidated solvency ratio (for rules and guidance on mortgage indemnity insurance, see chapter 8). For the society only solvency ratio the FSA has adopted a composite treatment which recognises both that the capital invested in the captive bears a heavier risk of loss than the generality of investments in subsidiaries, and that the captive bears only the society's own lending risk, albeit in concentrated form, and is not using its capital to "gear up" and assume new external liabilities. Out of the total capital committed to the captive, whether fully paid or not, 25% (or, if greater, the actual capital requirement imposed by the local insurance supervisor) should be deducted from the society's own funds, in the society only calculation. The remainder should be risk-weighted at 100% as if an ordinary investment in a subsidiary.

1.15 Securitisation

1.15.1 G In considering how to treat societies' securitisation transactions, the three key points are:

(1) whether, and to what extent, to include securitised assets, which have been financed on a limited recourse basis, in the calculation of the society's (or society group's) solvency ratio (subject to their relevant risk weightings);

(2) whether, and to what extent, to require the deduction from societies' own funds of quasi-capital exposures to securitisation transactions; and

(3) how to reflect the largely unquantifiable risks that are left with a society after securitisation.

1.15.2 G In order to achieve consistency and simplicity, the FSA deals with these as follows:

(1) securitisation transactions by, or involving, building societies will be analysed in the same way as similar transactions by, or involving, banks. The FSA will apply the principles and guidance contained in chapter SE of the IPSB for banks, which is set out, with additional guidance for building societies, as chapter 10 of this sourcebook. This will determine whether securitised assets are to be risk weighted and included in the solvency ratio calculation, and whether (and to what extent) quasi-capital exposures, such as first loss provisions or holdings of deeply subordinated notes, are to be deducted from own funds.

(2) all other risks arising from securitisation will, collectively, be considered in the context of the process of appraisal that leads to the setting or reviewing of an individual society's threshold solvency ratio. Depending on the scale and nature of a society's securitisation activity, this could lead, other things being equal, to an increase in that threshold ratio.

1.15.3 G Some of the risks that securitisation leaves with a society are inherent in most, if not all, existing securitisation structures and are thus unavoidable. Particular examples are the risk from servicing and liability under warranties. But in other respects, particularly in relation to "moral hazard", there is much greater scope for conscious acceptance or avoidance of risk through the selection and adaptation of particular structures.

1.15.4 G While a society may endeavour to avoid the accumulation of such risks, to the extent that risk is accepted and/or is unavoidable, an assessment of the various residual risks will be made by the FSA as part of the appraisal for setting or reviewing the society's threshold solvency ratio. This assessment will reflect the scale and nature of a society's current and planned securitisation programme. It will also cover how the society has addressed the residual risks in the structure(s) it proposes to use. Where, for example, securitisation activity is small-scale relative to the society's asset base, a "clean break" with borrowers has been achieved, the society has good errors and omissions insurance to cover servicing risk, and substantial audit of the pool of assets to be transferred has been carried out, the effect on the solvency threshold ratio is likely to be minimal and there may indeed be no actual change. While recognising that assessment through the solvency threshold appraisal process is less transparent for societies, the FSA considers that much is gained by simplicity and the avoidance of a proliferation of risk weightings or other formulae intended to capture individual, largely unquantifiable, risks.

1.16 Deductions in Respect of Holdings in Other Institutions

1.16.1 G Articles 51.1 and 51.2 of the BCD prohibit a credit institution from having a "qualifying holding" in excess of 15% of its own funds in an undertaking or 60% in several undertakings which are neither credit institutions, financial institutions, nor undertakings which carry on "ancillary banking services".

1.16.2 G A qualifying holding is defined as "a direct or indirect holding in an undertaking which represents 10% or more of the capital or of the voting rights, or which makes it possible to exercise a significant influence over the management of the undertaking in which the holding subsists".

1.16.3 G The Directive gives member states the option not to apply the restrictions to life and general insurance companies and not to apply them in other cases provided they require a deduction from the credit institution's own funds of 100% of the amount in excess of the 15% or 60% limits.

1.16.4 G The FSA has decided not to apply the limits to participation in insurance companies but see section 1.13 for capital treatment in respect of holdings in insurance companies. The FSA has also decided not to apply the limits in other cases but to recommend a 100% deduction from own funds of the amount of the holding in excess of 15%.

1.17 Capital Cost and Pricing

1.17.1 G When acquiring assets societies should consider what effect the profit or cost derived from those assets will have on their solvency ratios. The higher the weighting which an asset carries the greater the capital cost and societies will need to decide whether they can, or should, pass on such cost or accept a lower rate of return.

1.18. Capital Adequacy Directive (CAD)

1.18.1 G Societies on the "Trading" approach to financial risk management (described in chapter 4, Financial Risk Management), under which they can trade securities and maintain unhedged foreign exchange positions within defined limits, should calculate the capital requirements for their trading book and foreign exchange positions separately in accordance with the FSA's guidance to banks (as set out in the IPSB for banks). In moving to the "Trading" approach societies will need to satisfy the FSA that they have the systems to calculate and report their capital position in accordance with the FSA's guidance.

ANNEX 1A

CALCULATION OF "OWN FUNDS"

G

1A.1 Tier 1 Capital

1A.1.1 Reserves as disclosed in the latest year end balance sheet;

plus

cumulative interim profits for the year to date which have been verified by the society's external auditors (see Annex 1E); or

less

cumulative losses (if any) for the year to date.

1A.1.2 Deferred shares which meet the requirements of chapter 2, currently PIBS, and deferred shares which were issued prior to the Building Societies (Deferred Shares) Order 1991 (SI 1991/701) and which met the statutory requirements then in force.

1A.1.3 Tier 1 minority interests in a subsidiary undertaking which meets the requirements of section 1.7.

1A.1.4 Deduct intangible assets from the sum of 1A.1.1, 1A.1.2 and 1A.1.3 to calculate Tier 1 capital.

1A.2 Tier 2 Capital

1A.2.1 Term subordinated debt and undated subordinated debt, which meet the requirements of chapter 2; together with general provisions for bad debt and revaluation reserves.

1A.2.2 Tier 2 minority interests in a subsidiary undertaking which meets the requirements of section 1.7.

1A.3 General Provisions for Bad Debt

1A.3.1 General provisions should be made to cover possible losses, existing at the balance sheet or other reporting date, which have not been specifically identified. As such, they are freely available to the society to be utilised against any actual losses subsequently identified or arising and so conform with Article 35.1(a) of the BCD. But the BCD does not permit the inclusion in "own funds" of a provision which covers identified deterioration in particular assets, whether individual or group. Thus societies should not include the latter type of provision in own funds. Societies may only include general provisions in their solvency ratio calculation to an amount less than or equal to that shown in the society's last audited accounts or the amount provided when interim profits were last verified by the external auditors.

1A.4 Revaluation Reserves

1A.4.1 Societies may include revaluation reserves arising out of the differences between book values and the current market value of property fixed assets but only if:

(1) the society applies the revaluation method to all of its property fixed assets, or all of its property fixed assets in a designated class and not selectively;

(2) the values result from regular professional valuations of each property. If not annually, there should be:

(a) a rolling programme such that no professional valuation of a property is more than five years old;

(b) in the intervening year(s) in which a property is not professionally valued, an interpolation of value by the Board which takes into account any decline in property values disclosed by valuations of other properties in that year;

(c) where a society owns less than five properties, none of which are valued during the financial year, the valuation should be determined by the Board on the basis of their knowledge of appropriate property values in the area.

1A.4.2 If a society divides its fixed property assets into classes for the purposes of the valuation then it should advise the FSA of the basis of the division and the valuation policy in respect of each class.

1A.4.3 Any increase in revaluation reserve should be supported by a professional valuation.

1A.4.4 For the purposes of this calculation the revaluation reserve will be the amount standing to the credit of any revaluation reserve in the balance sheet or the amount of any such reserve in the accounting records of the society, for the time being, whichever is the lesser amount.

1A.5 Limits on capital

1A.5.5 Term Subordinated Debt which meets the guidance in chapter 2 may not exceed 50% of Tier 1 constituents minus intangible assets.

1A.5.6 Tier 2 capital resources in aggregate may not be included to an extent greater than 100% of Tier 1 constituents minus intangible assets.

1A.5.7 The total amount of minority interests which may be aggregated with Tier 1 or Tier 2 capital may not exceed 10% of the society's own funds in that category.

1A.6 Own funds

1A.6.1 Gross own funds comprise Tier 1 capital plus Tier 2 capital. From this should be deducted:

(1) all holdings of capital instruments of other credit or financial institutions, or in regulated broker-dealers (subject to CAD or an analogous regime);

(2) the amount of capital deficit of any subsidiary undertaking which has such a deficit (for society only calculations);

(3) the proportion attributable to outside minority interests in the capital deficit of any subsidiary undertaking which has such a deficit (for consolidated calculations);

(4) any deductions in respect of insurance companies (section 1.13), MIG Captives (section 1.14), holdings in other undertakings (section 1.16) and securitisation (paragraph 1.15.2);

to arrive at "own funds".

1A.6.2 Article 34.2(3) of the BCD allows "funds for general banking risks" to be counted as Tier 1 capital. Such funds are not general provisions for bad debt but are akin to banks' "hidden reserves" and are therefore not applicable to building societies.

RISK ASSET WEIGHTS

G

1B.1 General

1B.1.1 Risk weights should be applied net of any specific provision. Items subject to deduction from Own Funds should be zero weighted. Assets held by a subsidiary undertaking are weighted on the same basis as if held by the parent society.

1B.2 Assets to be weighted at 0%

1B.2.1 The following assets should be weighted at 0%:

(1) Bank notes or coinage of any territory or country;

(2) Deposits with:

(a) any Zone A Central Bank (see Annex 1G for Zone A countries);
(b) the National Savings Bank;
(c) any Zone B Central Bank denominated in local currency and funded by liabilities in the same currency (see Annex 1G for Zone B countries);

(3) Certificates of Tax Deposit issued by the Treasury;

(4) National Savings Bonds;

(5) Loans granted at the society's administered rate and supported by the explicit guarantee of a Zone A central government or central bank.

1B.3 Assets to be weighted at 10%

1B.3.1The following assets should be weighted at 10%:

(1) Deposits with any gilt edged market maker or participant in the UK gilt market supervised by a regulatory authority in the EEA provided they are collateralised by assets which, if held directly, would have a weighting of not more than 20%.

(2) Stock lending rights arising from the lending of securities issued in the UK by HM Government.

(3) Fixed-rate securities with a residual maturity of one year or less or floating rate securities:

  (a) issued or guaranteed by a Zone A Central government (including Ginnie Maes);

  (b) issued or guaranteed by a Zone B Central government denominated in the local currency and funded by liabilities in the same currency;

  (c) issued or guaranteed by the European Atomic Energy Community, European Coal and Steel Community or European Economic Community.

(4) Loans either with a maturity of one year or less and granted on a fixed rate basis, or with any maturity and granted at a rate which is periodically reset at least annually against a market rate, and in either case supported by the explicit guarantee of a Zone A central government or central bank.

1B.4 Assets to be weighted at 20%

1B.4.1 The following assets should be weighted at 20%:

(1) Fixed rate securities, with a residual maturity over 1 year:

(a) issued or guaranteed by a Zone A Central government (including Ginnie Maes); or

(b) issued or guaranteed by the European Atomic Energy Community, European Coal and Steel Community or European Economic Community.

(2) Deposits with or securities issued, guaranteed, or (in the case of bills of exchange) accepted by, any Zone A credit institution (see Annex 1G).

(3) Deposits with, or securities issued, or (in the case of bills of exchange) accepted by any Zone B credit institution (see Annex 1G), with a maturity of one year or less.

(4) Securities issued by, or loans to, any relevant authority (see Annex 1F for definition) or loans to the Department of Finance and Personnel (Northern Ireland).

(5) Securities issued by, or loans to, Fannie Maes and Freddie Macs.

(6) Securities issued or guaranteed by multilateral development banks (International Bank for Reconstruction and Development, International Finance Corporation, Inter-American Development Bank, Asian Development Bank, African Development Bank, Caribbean Development Bank, European Investment Bank, European Bank for Reconstruction and Development, Nordic Investment Bank, Council of Europe Resettlement Fund, European Investment Fund and Inter-American Investment Corporation).

(7) Cash items in the process of collection.

(8) Loans with a maturity greater than one year that are either granted on a fixed rate basis, or at a market rate which is periodically reset less frequently than annually and, in either case, supported by the explicit guarantee of a Zone A central government or central bank.

(9) Loans supported by an unconditional guarantee issued by a Zone A credit institution.

(10) Loans, with a maturity of one year or less, supported by an unconditional guarantee issued by a Zone B credit institution.

(11) Loans supported by the unconditional guarantee of a relevant authority (see Annex 1F).

1B.5 Assets to be weighted at 50%

1B.5.1 The following assets should be weighted at 50%:

(1) Mortgage-backed securities (MBS) issued by special purpose mortgage finance vehicles where the following conditions are met:

(a) they are fully secured at all times on a pool of first mortgages on residential property, no part of which is used for non residential purposes, or on loans to Registered Social Landlords which are registered with the Housing Corporation or Scottish Homes or the National Assembly of Wales or the Northern Ireland Department of Social Development, fully secured by a mortgage on a residential property that is:

(i) already let, or

(ii) under development and will be let on condition that the development attracts Social Housing Grant (SHG) and/or other public subsidy on equivalent terms and the loans are fully secured by a charge (but not necessarily a first priority charge) on a residential property owned by Registered Social Landlords which is rented;

(b) the notes embody an express promise to repay the noteholder;

(c) the issue documentation contains provisions which would ultimately enable noteholders to initiate legal proceedings directly against the issuer of the MBS. As an example such provisions would allow noteholders to proceed against the issuer where the trustee, having become bound to take steps and/or to proceed against the issuer, fails to do so within a reasonable time and such failure is continuing;

(d) the documentation contains provisions which would ultimately enable noteholders to acquire the legal title to the security (i.e. the mortgagee's interest in it) and to realise the security in the event of a default by the mortgagor;

(e) the mortgage loans should not be in default at the time at which they are transferred to the vehicle;

(f) the vehicle's activities are restricted by its articles of association to mortgage business. The vehicle may also hold assets qualifying for a risk weighting of less than 50%;

(g) the notes do not absorb more than their pro rata share of losses in the event of arrears or default (see chapter 10 for treatment of junior or B notes).

(2) Loans to individuals fully and completely secured by a first priority charge on residential property that is (or is to be) occupied by the borrower or is rented.

(3) Loans to Registered Social Landlords, registered with the Housing Corporation, or Scottish Homes or the National Assembly of Wales or the Northern Ireland Department of Social Development, fully secured by a mortgage on residential property that is:

(a) already let; or

(b) under development and will be let, on condition that the development attracts Social Housing Grant (SHG) and/or other public subsidy on equivalent terms, of an amount equal to, or greater than, 50% of the approved total scheme cost, the security for which is subordinated to the loan, where the funding body has legally committed itself to the full payment of the subsidy.

(4) Loans to public universities, fully secured by a mortgage on a residential property that is:

(a) already let; or

(b) under development and will be let, on condition that the lender is in possession of a certificate, issued by a quantity surveyor or architect appointed by the society, showing that work to the value of 20% of the projected finished end value of the project (excluding cost of land) has been completed, prior to any draw down under the loan; and

(c) can readily be sold or let on the non student market.

N.B. For the purposes of paragraphs 1B.5.1(3) and (4), once a property has been let it is not necessary to increase the weighting to 100% during a subsequent temporary void.

1B.6 Assets to be weighted at 100%

1B.6.1 All other assets should be weighted at 100% including:

(1) Deposits with, or securities issued or (in the case of bills of exchange) accepted by any Zone B credit institution authorised by the competent authorities of a member state of the European Community, with a maturity greater than one year.

(2) Commercial Paper issued or guaranteed by companies of the types to which Directive 78/660/EEC on the annual accounts of certain types of company (as amended by subsequent acts of accession) applies (that is, public or private companies limited by shares or by guarantee).

(3) Securities issued by the European Telecommunications Satellite Organisation, International Monetary Fund, and European Company for the Financing of Railway Rolling Stock.

(4) Other mortgages and MBS.

(5) Unsecured loans and leasing receivables

(6) Development and residential property:
land acquired
development projects
rented housing
equity interest in shared ownership schemes

(7) Investments in connected undertakings which are not subsidiary undertakings (except where treated as a deduction from own funds or netted on consolidation)

(8) Premises, plant, equipment and other fixed assets

(9) Prepayments, accrued income, sundry debtors etc (except where the asset represents a claim on a counterparty which normally attracts a weighting below 100%, e.g. UK central government (0%), local authorities or credit institutions (20%), in which case it should be weighted accordingly).

1B.7 Repos and Reverse Repos

1B.7.1 Gilt edged securities subject to a repo transaction should be treated as remaining on the balance sheet of the seller throughout the repo period. The weightings for UK Government securities at 10% or 20% (according to residual maturity) apply. A reverse repo should be treated as a collateralised loan and should be weighted on the basis of the collateral (i.e. the gilt) securing the loan at 10% or 20% according to residual maturity for the duration of the transaction.

1B.8 Gilt Strips

1B.8.1 The weighting for gilt strips does not differ from that of traditional holdings in gilt-edged securities (10% or 20% according to residual maturity), but societies should bear in mind that considerable activity in the more sophisticated repos and strips markets will be taken into account and weighed against the expertise available when assessing their threshold solvency ratio.

1B.9 Stock Lending

1B.9.1Securities held in a liquid asset portfolio and loaned to the market will already be weighted for capital adequacy purposes in accordance with this Annex. A possible additional risk posed by the lending of the security will depend upon whether the transaction is collateralised. The lending of gilt edged securities, for example, should not attract any additional weighting for counterparty risk because it is fully collateralised under the terms of a stock lending agreement.

1B.9.2 However, stock lending which is not fully collateralised, such as that conducted through the Cedel and Euroclear stock lending programmes, needs to take account of the counterparty risk. As Cedel and Euroclear are both Zone A banks, an additional capital weighting of 20% should be applied.

ANNEX 1C

TREATMENT OF OFF-BALANCE SHEET ITEMS

G

1C Classification of Off-Balance Sheet Items (other than items related to interest rates and foreign exchange)

	Degree of Risk	Credit Conversion Factor
1C.1	Full Risk	100%

- Guarantees having the character of credit substitutes,
- Acceptances,
- Endorsements on bills not bearing the name of another credit institution,
- Transactions with recourse,
- Irrevocable standby letters of credit having the character of credit substitutes,
- Asset sale and repurchase agreements (repos),
- Assets purchased under outright forward purchase agreements,
- Forward forward deposits,
- The unpaid portion of partly-paid shares and securities.

1C.2	Medium Risk	50%

- Documentary credits issued and confirmed (see also medium/low risk),

- Warranties and indemnities (including tender, performance, customs and tax bonds) and guarantees not having the character of credit substitutes,
- Irrevocable standby letters of credit not having the character of credit substitutes,
- Undrawn credit facilities (agreements to lend, purchase securities, provide guarantees or acceptance facilities) with an original maturity of more than one year,
- Note issuance facilities (NIFs) and revolving underwriting facilities (RUFs).

1C.3 Medium/low Risk 20%

- Documentary credits in which underlying shipment acts as collateral and other self-liquidating transactions.

1C.4 Low Risk 0%

- Undrawn credit facilities (agreements to lend, purchase securities, provide guarantees or acceptance facilities) with an original maturity of up to and including one year, or which may be cancelled unconditionally at anytime without notice (including facilities related to cheque guarantee cards, automated teller machine cards, credit cards and mortgage offer letters which are expressly stated to be subject to immediate cancellation).

Each item described in 1C.1 to 1C.4 should be multiplied by the appropriate credit conversion factor and then weighted by the risk weight applicable to the category of the counterparty for an on-balance sheet transaction.

The portion of unpaid capital subscribed to the European Investment Fund should be weighted at 20%.

1C.5 The treatment of off-balance sheet items using the "mark to market" approach.

Societies may, of course, only enter into such contracts permitted by the 1986 Act, guidance in respect of which can be found in chapter 4.

1C.5.1Method

1C.5.2 Step (a): by attaching current market values to contracts (mark to market) the current replacement cost of all contracts with positive values is obtained. (Societies should consult their external auditors if they require guidance on how to ascertain market values).

1C.5.3 Step (b): to obtain a figure for potential future credit exposure, the notional principal amounts or values underlying a society's aggregate book are multiplied by the following percentages:

Residual maturity	Interest rate contracts	Contracts concerning foreign exchange rates and gold	Contracts concerning equities	Contracts concerning precious metals except gold	Contracts concerning commodities other than precious metals
One year or less	0.0%	1%	6%	7%	10%
Over one year, less than five years	0.5%	5%	8%	7%	12%
Over five years	1.5%	7.5%	10%	8%	15%

1C.5.4 Contracts which do not fall within one of the five categories indicated in this table shall be treated as contracts concerning commodities other than precious metals.

1C.5.5 For contracts with multiple exchanges of principal, the percentages have to be multiplied by the number of remaining payments still to be made according to the contract.

1C.5.6 For contracts that are structured to settle outstanding exposure following specified payment dates and where the terms are reset such that the market value of the contract is zero on these dates, the residual maturity would be equal to the time until the next reset date. In the case of interest-rate contracts that meet these criteria and have a remaining maturity of over one year, the percentage shall be no lower than 0.5%.

1C.5.7 In the case of single-currency "floating/floating interest rate swaps" only the current replacement cost will be calculated (i.e. no future credit exposure).

1C.5.8 Step (c): the sum of current replacement cost and potential future credit exposure for each contract is multiplied by the risk weighting allocated to the relevant counterparties for on-balance sheet transactions, (except that the 100% weightings shall be replaced by 50% weightings) to give the risk-weighted amount relating to that contract which is to be included in the solvency ratio calculation.

1C.5.9 Societies should ensure that the notional amount to be taken into account is an appropriate yardstick for the risk inherent in the contract. Where, for instance, the contract provides for a multiplication of cashflows, the notional amount should be adjusted in order to take into account the effects of the multiplication on the risk structures of that contract.

1C.5.10 Interest-rate and foreign-exchange contracts traded on recognised exchanges where they are subject to daily margin requirements and foreign exchange contracts with an original maturity of 14 calendar days or less are excluded.

1C.6 Netting

1C.6.1 Societies may treat as reducing risk and therefore as permitting weighting on a net, rather than gross basis:

(1) bilateral contracts for novation between the society and its counterparty under which mutual claims and obligations are automatically amalgamated in such a way that this novation fixes one single net amount each time novation applies and thus creates a legally binding, single new contract extinguishing former contracts (in the case of foreign exchange transactions a separate single net amount should be fixed for each currency and value date);

(2) other bilateral netting agreements between the society and its counterparty;

but only under the following conditions;

(a) the society should have a contractual netting agreement with its counterparty which creates a single legal obligation, covering all included transactions, such that, in the event of a counterparty's failure to perform owing to default, bankruptcy, liquidation or any other similar circumstance, the society would have a claim to receive or an obligation to pay only the net sum of the positive and negative mark-to-market values of included individual transactions;

(b) the society should have made available to the FSA written and reasoned legal opinions to the effect that, in the event of a legal challenge, the relevant courts and administrative authorities would, in the cases described under (a), find that the society's claims and obligations would be limited to the net sum, as described in (a), under;

- the law of the jurisdiction in which the counterparty is incorporated and, if a foreign branch of an undertaking is involved, also under the law of the jurisdiction in which the branch is located;

- the law that governs the individual transactions included;

- the law that governs any contract or agreement necessary to effect the contractual netting.

(c) the society should have provided assurances to the FSA that it has set in place procedures for ensuring that the legal validity of its contractual netting is kept under review in the light of possible changes in the relevant laws;

(d) the society should have provided assurances to the FSA that it has adequate systems to monitor netting. Any society not on the comprehensive or trading approach should produce confirmation from its external auditors that its systems are adequate.

1C.6.2 No contract containing a provision which permits a non-defaulting counterparty to make limited payments only, or no payments at all to the defaulter, even if the defaulter is a net creditor (a 'walkaway' clause) should be recognised as risk reducing.

1C.6.3 The FSA will recognise as risk-reducing contractual-netting agreements covering foreign-exchange contracts with an original maturity of 14 calendar days or less, written options (where these are permitted by section 9A) or similar off-balance-sheet items to which this Annex does not apply because they bear only a negligible or no credit risk. If, depending on the positive or negative market value of these contracts, their inclusion in another netting agreement can result in an increase or decrease of the capital requirements, societies should use a consistent treatment.

1C.6.4 No contractual netting will be recognised as reducing risk until the FSA has confirmed that conditions (b), (c) and (d) above have been met and that it is satisfied that contractual netting is legally valid under the law of each of the relevant jurisdictions.

1C.6.5 Effects of Netting

(1) Contracts for novation

(a) The single net amounts fixed by contracts for novation, rather than the gross amounts involved, may be weighted. Thus in:

Step (a) the current replacement cost, and in

Step (b) the notional principal amounts or underlying values

may be obtained taking account of the contract for novation.

(2) Other Netting Agreements

(a) In step (a) the current replacement cost for the contracts included in a netting agreement may be obtained by taking account of the actual hypothetical net replacement cost which results from the agreement; in the case where netting leads to a net obligation for the credit institution calculating the net replacement cost, the current replacement cost is calculated as "0";

In step (b) the figure for potential future credit exposure for all contracts included in a netting agreement may be reduced according to the following equation:

$$PCE_{red} = 0.4 * PCE_{gross} + 0.6 * NGR * PCE_{gross}$$

Where:

PCE_{red} = the reduced figure for potential future credit exposure for all contracts with a given counterparty included in a legally valid bilateral netting agreement,

PCE_{gross} = the sum of the figures for potential future credit exposure for all contracts with a given counterparty which are included in a legally valid bilateral netting agreement and are calculated by multiplying their notional principal amounts by the percentages set out in the table in 1C.5.3,

NGR = "net-to-gross ratio": this should be done as a separate calculation: the quotient of the net replacement cost for all contracts included in a legally valid bilateral netting agreement with a given counterparty (numerator) and the gross replacement cost for all contracts included in a legally valid bilateral netting agreement with that counterparty (denominator).

For the calculation of the potential future credit exposure according to the above formula perfectly matching contracts included in the netting agreement may be taken into account as a single contract with a notional principal equivalent to the net receipts. Perfectly matching contracts are forward foreign exchange contracts or similar contracts in which notional principal is equivalent to cash flows if the cash flows fall due on the same value date and fully or partly in the same currency.

1C.7 Types of Off-Balance Sheet Items to which the treatment in section 1C.5 above is to be applied.

1C.7.1Interest-rate contracts

- Single-currency interest-rate swaps;
- Basis swaps;
- Forward-rate agreements;
- Interest-rate futures;
- Interest-rate options purchased;
- Other contracts of a similar nature.*

1C.7.2Foreign-exchange contracts and contracts concerning gold

- Cross-currency interest-rate swaps;

- Forward foreign-exchange contracts;
- Currency futures;
- Currency options purchased;
- Other contracts of a similar nature*
- Contracts concerning gold of a similar nature to the above items*

Contracts of a nature similar to those in points above other than those marked * concerning other reference items or indices concerning:

- equities,
- precious metals except gold,
- commodities other than precious metals,
- other contracts of a similar nature.

1C.7.3 Where off balance sheet items carry explicit guarantees, they shall be weighted, to the extent of the guarantee as if they had been incurred on behalf of the guarantor rather than the counterparty. Where off balance sheet items are secured by collateral listed in Annex 1B.2.1(1), 1B.3.1(2) or 1B.4.1(3), they shall be weighted, to the extent of the collateral at the weight appropriate to the collateral by which they are secured.

1C.7.4 Societies may apply a 50% weighting to off balance sheet items which are sureties or guarantees having the character of credit substitutes and which are fully guaranteed by mortgages which would themselves attract a 50% weighting provided the guarantor has direct right to such collateral.

ANNEX 1D

HOLDINGS OF CAPITAL INSTRUMENTS OF OTHER CREDIT AND FINANCIAL INSTITUTIONS TO BE EXCLUDED FROM "OWN FUNDS" CALCULATIONS
G

1D.1 Definitions

1D.1.1Capital Instruments Includes without limitation any constituent of own funds (as set out in Article 34 of the BCD) or the equivalent in a financial institution

1D.1.2Credit Institution An undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account

1D.1.3Financial Institution An undertaking other than a credit institution the principal activity of which is to acquire holdings or to carry on one or more of the following activities:

(1) lending

(2) financial leasing

(3) money transmission services

(4) issuing and administering means of payment (e.g. credit cards, travellers cheques and bankers drafts)

(5) guarantees and commitments

(6) trading for own account or for account of customers in

   (a) money market instruments (cheques, bills, CDs etc)

   (b) foreign exchange

   (c) financial futures and options

   (d) exchange and interest rate instruments

   (e) transferable securities

(7) participation in securities issues and the provision of services related to such issues

(8) advice to undertakings on capital structure, industrial strategy and related questions and advice and services relating to mergers and the purchase of undertakings

(9) money broking

(10) portfolio management and advice

(11) safekeeping and administration of securities

ANNEX 1E

INTERIM PROFITS: VERIFICATION PROCEDURES

G

1E.1 Verification of Interim Profits by External Auditors

1E.1.1 The FSA interprets "verified" to mean obtaining a reasonable degree of comfort on the accuracy of the reported interim results. For this purpose, the analytical review procedures commonly used by auditors in the normal course of their work can be helpful and a combination of some of them will provide adequate assurance that reported interim profits are of sufficient quality for inclusion in the capital base, provided that the society has complied in all material respects with the valuation principles of the Accounts Regulations.

1E.1.2 The particular procedures which the FSA considers appropriate for this purpose are listed below. A full scope audit is not required, but in situations where the scope of work carried out differs materially from that set out in this chapter, the FSA will expect to be informed by the auditor in his report.

1E.1.3 Verification by auditors should in normal circumstances entail at least the following:

(1) satisfying themselves that the figures forming the basis of the interim profits have been properly extracted from the underlying accounting records and that the reliability of any major change to the systems, upon which the accounting records are dependent, has been considered;

(2) reviewing the accounting policies used in calculating the interim profits so as to obtain comfort that they are consistent with those normally adopted by the society in drawing up its annual financial statements and are in accordance with the principles set out in the Accounts Regulations;

(3) performing analytical procedures on the result to date, including comparisons of actual performance to date with budget and with the results of prior period(s);

(4) discussing with management the overall performance and financial position of the society;

(5) obtaining adequate comfort that the implications of current and prospective litigation, all known claims and commitments, and changes in business activities been properly taken into account in arriving at the interim profits;

(6) following up problem areas of which the auditors are already aware in the course of auditing the society's financial statements;

(7) enquiring into the adequacy of provisions for bad and doubtful debt.

1E.1.4 The external auditors should submit an opinion to the society on whether the interim results are fairly stated. The text of the report is set out below:

"Dear Sirs
In accordance with your letter of instruction dated [ ] we have reviewed [name of society's] current year interim profits for the period [ ] as reported on Form QFS1, a copy of which is attached for identification. Our review, which did not constitute an audit, has been carried out having regard to the FSA's Interim Prudential Sourcebook for building societies Chapter 1.

On the basis of the results of our review, nothing came to our attention to indicate that:

(1) the interim profits as reported on QFS1 have not been calculated on the basis of the accounting policies adopted by the society in preparing its latest statutory accounts for the year to [ ];

(2) those accounting policies differ in any material respects from those required by the Accounts Regulations [except for ....];

(3) the interim profits amounting to £[ ] as so reported are not fairly stated."

ANNEX 1F

DEFINITION OF RELEVANT AUTHORITY

G

1F.1 "Relevant authority" means any of the following:

(1) a local authority;

(2) any authority all the members of which are appointed or elected by one or more local authorities;

(3) any authority the majority of the members of which are appointed or elected by one or more local authorities in the United Kingdom, being an authority which by virtue of any enactment has power to issue a precept to a local authority in England and Wales, or a requisition to a local authority in Scotland, or to the expenses of which, by virtue of any enactment, a local authority in the United Kingdom is or can be required to contribute;

(4) the Receiver for a combined police authority (within the meaning of the Police Act 1964);

(5) a Passenger Transport Executive within the meaning of section 9(1) of the Transport Act 1968;

6) a residuary body within the meaning of section 105(1) of the Local Government Act 1985.

ANNEX 1G

DEFINITIONS OF ZONE A AND ZONE B COUNTRIES
G

1G.1 ZONE A:

1G.1.1 Member States of the European Community and all other countries which are full members of the Organisation for Economic Co-operation and Development (OECD) and those countries which have concluded special lending arrangements with the International Monetary Fund (IMF) associated with the Fund's General Arrangements to Borrow (GAB). Any country which reschedules its external sovereign debt is however, precluded from Zone A for a period of 5 years. Zone A countries currently comprise Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany (including pre-unification claims on East Germany), Greece, Hungary, Iceland, Ireland, Italy, Japan, South Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Saudi Arabia, Spain, Sweden, Switzerland, Turkey, United Kingdom and USA.

Note: The Channel Islands, Gibraltar, Bermuda and the Isle of Man should be regarded as Zone A countries for the purposes of calculating a society's solvency ratio.

1G.2 ZONE B:

1G.2.1 All other countries.

Note: A United Kingdom branch of a credit institution which has its head office in a Zone B country is regarded as a Zone B institution even though its United Kingdom branch is authorised by the FSA.

ANNEX 1H

SOCIETY ONLY SOLVENCY RATIO CALCULATIONS DEFINITIONS G

1H.1 "Gross assets" - being the sum of ASSETS according to Balance Sheet Format 2 in Schedule 4 of the Companies Act 1985 (or any alternative accounting regulations under which a subsidiary undertaking may be required to prepare its financial statements), which is equivalent to the total of ASSETS according to the Format of Society Balance Sheet under Schedule 2 Part I of the Accounts Regulations.

1H.2 "Income" - being the sum of turnover, other operating income, income from shares in group undertakings income from participating interests, income from other fixed asset investments and other interest receivable and similar income according to Profit and Loss Account Format 1 in Schedule 4 of the Companies Act 1985 (or any alternative accounting regulations under which a subsidiary undertaking may be required to prepare its financial statements), which is equivalent to the sum of interest receivable, income from investments, fees and commissions receivable, net profit on financial operations and other operating income according to the Format of Society Income and Expenditure Account under Schedule 1 Part I of the Accounts Regulations.

1H.3 "Profit" or "Loss" - being the profit or loss for the financial year according to Profit and Loss Account Formats 1 and 2 in Schedule 4 of the Companies Act 1985 (or any alternative accounting regulations under which a subsidiary undertaking may be required to prepare its financial statements), which is equivalent to profit or loss for the financial year according to the Format of Society Income and Expenditure Account under Schedule 1 Part I of the Accounts Regulations.

ANNEX 1J

G
CONFIDENTIAL

Society Threshold Appraisal Sheet

Date of Appraisal:

Society :

Total Assets :

Associate :

Manager :

Deposit Limit :

Liquidity Limit :

Treasury Approach :

External Auditors :

Summary grades	This assessment	Last Consistency Review	Any Subsequent Change & Date
Board Competence			
Management Competence			
Systems			
Asset Quality			
Treasury			
Planning/Diversification			
Operational Risk Profile			

Summary

Grading and Threshold	Threshold Ratio Recommended at this Review	Position at Last Consistency Review	Any Subsequent Change & Date
Overall grade			
Threshold ratio			
Own funds required			
Surplus/(deficit) Own Funds available against required			
Surplus/(deficit) as % of Own Funds available			

A.	BOARD COMPETENCE	COMMENTS	GRADE
1.	Range of Skills		
2.	Range of ages and succession planning		
3.	Effectiveness of Chairman		
4.	Effectiveness of Non Executives		
5.	Summary		

B.	MANAGEMENT COMPETENCE	COMMENTS	GRADE
1.	Range and depth of skills		
2.	Succession planning, reliance on key person		
3.	Effectiveness of Chief Executive		
4.	Existence of "four eyes" management responsibility		
5.	Management and corporate culture, dominance of Chief Executive		
6.	Delegation and Control, quality of 2nd Tier Management		
7.	Quality of communications with FSA staff and responsiveness to FSA concerns		
8.	Summary		

C. SYSTEMS	COMMENTS	GRADE
1. Adequacy of business control systems and their documentation, Delegation of authority, Risk Management, Operational Controls.		
2. Quality of Policy documents: Liquidity, Treasury, Funding, Lending, etc.		
3. Independence, quality and effectiveness of internal and external audit and compliance function.		
4. Adequacy of IT systems, existence of a tested contingency plan		
(i) Ability to maintain and amend software		
(ii) Ability to absorb future upgrades and development costs		
(iii) Computer literacy of Board, Senior Management, and Internal Audit		
5. Quality of management information		
6. Summary		

D.	ASSET QUALITY	COMMENTS	GRADE
1.	Philosophic approach to risk/ reward in lending		
2.	Controls on lending and arrears management and approach to provisioning		
3.	Actual levels of mortgage arrears		
4.	Extent of large exposures		
5.	Mortgage Indemnity cover		
6.	Summary		

E.	TREASURY	COMMENTS	GRADE
1.	Volatility of retail funds/reliance on special products, exposure to large shareholdings.		
2.	Level of wholesale funding relative to industry, reliance on short-term deposits		
3.	Approach to hedging and level of position risk accepted		
4.	Adequacy of Treasury management skills, inc. information output and internal skills		
5.	"Quality" of liquidity/observance of minimum 7 day and adjusted net liquidity limits, availability of undrawn committed facilities.		
6.	Adequate Senior Management oversight of Treasury		
7.	Summary		

F. PLANNING/DIVERSIFICATION	COMMENTS	GRADE
1. Quality of corporate planning		
2. Quality of planning, execution and control of new initiatives (including proper consultation with FSA)		
3. Approach and extent of diversification, impact of diversification mix on overall business.		
4. Level of commitment of management resource to new ventures or subsidiary operations		
5. Availability at NXD level, of specialist expertise to query/challenge management plans/proposals for subsidiaries or new ventures		
6. Significant commitment to new ventures - not easily reversed if unsuccessful		
7. Potential for risks incurred by, or systems failures within subsidiaries (or other diversifications) to cause financial or reputational problems for the parent society.		
8. Reliability of forecasting		
9. Summary		

G.	OPERATIONAL RISK PROFILE	COMMENTS	GRADE
1.	Geographic concentration		
2.	Vulnerability on account of small size		
3.	Stability of profit track record		
4.	Ability to cover management expenses, in the face of narrowing interest margins, loss of fee income or reduction of profit from other causes.		
5.	Adequacy and quality of capital, reliance on Tier 2 and 3, cost of servicing capital, headroom for future issues, timing of repayment or amortisation of Tier 2 and Tier 3 Capital and impact on business.		
6.	Risk from service activities not covered in asset risk weighting		
7.	Summary		

Interim Prudential Sourcebook for Building Societies

2 ISSUED CAPITAL

CONTENTS

2 Issued Capital

2.1 Introduction

2.1.1 G This chapter replaces PN 1998/2 issued by the Commission. It contains guidance for societies on issued capital to amplify the Threshold Condition set out in Schedule 6, paragraph 4(1) of the Act (the resources of a firm must, in the opinion of the FSA, be adequate in relation to the regulated activities it seeks to carry on) – see also COND 2.4 - and Principle 4 ("a firm must maintain adequate financial resources"). It should be read in conjunction with Chapter 1.

2.1.2 G This chapter is relevant only to those societies that have issued, or propose to issue, capital instruments to supplement their reserves. It explains the terms and conditions on which capital should be issued if it is to count as own funds. It advises prior consultation with the FSA before issuing capital and describes the documentation which societies should submit to the FSA before including the issue as own funds. Capital which was issued prior to N2, and which does not conform with the guidance in this chapter, will continue to count as own funds provided that at the time it was issued it complied with the statutory instruments or Prudential Note in force at that time.

2.2 Types of Issued Capital

2.2.1 G The FSA will recognise PIBS, Undated Subordinated Debt, and Term Subordinated Debt as own funds qualifying for inclusion in the calculation for capital adequacy, provided they conform with the guidance in this chapter.

2.2.2 G The FSA will not recognise as own funds any capital where the issue terms include clauses which would inhibit mergers or transfers in circumstances where the FSA gives a direction under section 42 B (1), (3), or (4) of the 1986 Act.

2.2.3 G The BCD distinguishes between several classes of capital and sets limits on the proportion of the lower classes of capital which may be held in relation to the highest class (the classes are referred to as Tier 1, Tier 2, and Upper Tier 2 capital). Provided they conform to the guidance in this chapter, PIBS count as Tier 1, Undated Subordinated Debt counts as Upper Tier 2 and Term Subordinated Debt counts as Tier 2.

2.3 Rules of the Society

2.3.1 G The rules of the society should, in the event of conflict, take precedence over any separate terms in respect of issued capital. Provisions in such terms of issue purporting to override the society's rules are inconsistent with this, as are provisions purporting to restrict the society's freedom to amend its rules. Societies should also note that for issued capital to count as own funds there should be no provision in the issuing society's rules permitting the write down of shares, other than deferred shares as defined in the Building Societies (Deferred Shares) Order 1991 (SI 1991/701).

2.4 Interest Terms

2.4.1 G The terms of the capital issue may provide for variation of either the rate of interest, or the interest margin over a bench mark market rate during the life of the instrument. But the extent of such variation should be such that it will not create a presumption, at the time of issue, that the society will in practice elect (with the agreement of the FSA) to repay the debt where the terms of issue give the society that option. Accordingly no term should provide for variation in either the interest rate or the margin which is:

(1) greater than 0.5% p.a. in the first ten years of the issue; or

(2) greater than 1% p.a. over the whole life of the issue;

whether in a single step, or a series of steps. Any new bench mark should be of a broadly similar type to the previous one and no change in bench mark should take place within five years of the previous one. Capital may be issued on the basis that the interest rate is capped and/or floored at a specified rate.

2.4.2 G These limits are not intended to set a "market norm" for such variation as that is for societies to negotiate. They can be seen as the maximum level of increase that can be provided for without creating expectations, through the exercise of a repayment option, that the capital will be repaid before maturity or, in the case of permanent instruments, repaid at a certain date.

2.5 Amount Eligible as Own Funds

2.5.1 G Only fully paid up funds, together with premia if any, should be counted as own funds, although deductions for reasonable fees or commission incurred in arranging the issue may be disregarded for this purpose.

2.6 Permanent Interest Bearing Shares

2.6.1 G PIBS are a sub-set of deferred shares which comply both with the Building Societies (Deferred Shares) Order 1991 (SI 1991/701) and the BCD. PIBS are usually listed on the Stock Exchange. To be eligible for inclusion in the calculation for capital adequacy, the PIBS issue should meet the conditions in paragraphs 2.6.2 to 2.6.9.

Permanence

2.6.2 G PIBS are perpetual instruments. Repayment may normally only occur on the winding up of a society, and no other events of default entitling the holders of PIBS to repayment are possible. However, PIBS may be issued on terms which permit the issuing society, in accordance with a board resolution, to repay PIBS but only subject to the prior consent of the FSA (SI 1991/701 Article 3 and Schedule). The decision to repay PIBS should be genuinely at the instance of the society's board. Such consent would only be given if the FSA were satisfied that the remaining capital would be adequate for the society's present and foreseeable future needs. It is unlikely to be given within five years of the issue date.

Subordination

2.6.3 G On winding up PIBS should rank after all types of ordinary (i.e. non-deferred) shares and all other liabilities including subordinated debt.

Waiver of Interest - Non-cumulative

2.6.4 G In order for PIBS to be effective as a protection against running losses, the issue terms should provide that interest payments due on PIBS at a particular date may be reduced or cancelled by the board of the issuing society if the society is, or after the payment would be, in breach of capital adequacy requirements. The issue terms should also provide that no interest is payable on PIBS if the society has cancelled, or failed to pay, interest or dividend upon other shares of any class (other than deferred shares) or deposits with the society. Interest on PIBS so cancelled is non-cumulative. A term of issue may allow a society to issue further PIBS as fully paid by application of reserves to the extent that interest is foregone.

Conversions/Takeovers/Mergers

2.6.5 G The issue terms should provide that, if a society transfers its business to a commercial company, the PIBS will be transformed into undated subordinated debt of the successor company, ranking behind any undated subordinated debt previously issued by the society. The issue terms should provide that the issue should continue to rank as PIBS in the successor society after an amalgamation or transfer of engagements.

Notice to Subscribers

2.6.6 G At the time of issue the attention of subscribers should be drawn to the deferred nature of PIBS and to their exclusion from the deposit sub-scheme of the Financial Services Compensation Scheme and this information should also be shown prominently on any documents of title (SI 1991/701 Article 3 (2)).

Limits

2.6.7 G Not only does the issuing of PIBS directly reduce the endowment effect of reserves but, by increasing the potential to issue Tier 2 capital, it provides scope for reducing the endowment effect still further. The FSA would not expect a society to issue PIBS in excess of 50% of its reserves.

Secondary Market: Stockbrokers

2.6.8 G A stockbroking subsidiary of a society may accept orders for the purchase and sale of the society's PIBS but, to ensure that the society's capital in the form of PIBS is not reduced except with FSA consent, neither the society nor any subsidiary undertaking may trade, buying and reselling on its own account, as opposed to executing client orders.

Retail Issues

2.6.9 G Societies issuing PIBS as retail instruments directly to the public will be expected to take the utmost care that retail investors are made fully aware of the risks of investing in PIBS as opposed to investing in societies' normal investment share accounts. Issues of PIBS, whether retail or not, should be restricted to minimum denominations of not less than £1000.

2.7 Undated Subordinated Debt

2.7.1 G To be eligible for inclusion in the calculation for capital adequacy, any issue of Undated Subordinated Debt should meet the conditions in paragraphs 2.7.2 to 2.7.7.

Permanence

2.7.2 G Undated Subordinated Debt should be permanent. Repayment may normally only occur on the winding up of a society and no other events of default entitling the holders of such debt to repayment are possible. However, undated debt may be issued on terms which permit the society, in accordance with a board resolution, to repay undated debt, subject to the prior consent of the FSA. The decision to repay the debt should be genuinely at the instance of the society's board. Such consent would only be given if the FSA were satisfied that the remaining capital would be adequate for the society's present, and future foreseeable needs. It is unlikely to be given within the first five years of issue.

Subordination

2.7.3 G In the event of winding up, Undated Subordinated Debt should, together with deferred shares, rank so as to support the solvency of the society. That is to say, the terms of the issue should provide that the claims of a holder of Undated Subordinated Debt, in the winding up of the borrower, shall be limited to such amount as would have been payable if, immediately prior to the commencement of a winding up, the holder held deferred shares of equivalent value instead of subordinated debt. Upon winding up, the holders of Undated Subordinated Debt should rank after all creditors and holders of non-deferred shares, including creditors in respect of term subordinated debt but their claims should, nevertheless, rank ahead of any existing PIBS or other deferred shares in issue by that society.

Interest Deferral

2.7.4 G Interest payments on Undated Subordinated Debt should rank after those on all other deposits, including other types of Subordinated Debt, and all non-deferred shares. The terms of issue should prohibit the payment, or crediting, of interest on Undated Subordinated Debt unless all amounts payable on non-deferred shares, or deposits with the society, in respect of any earlier or concurrent period, have been paid.

2.7.5 G The interest payment due on Undated Subordinated Debt at a particular date may be deferred by the board if, after the payment, the society would otherwise be in breach of capital adequacy requirements. However, such interest need only be deferred, not cancelled, i.e. it may be cumulative. Societies may make a scrip issue of Undated Subordinated Debt in satisfaction of the interest payments.

2.7.6 G The terms of issue should allow for the extreme situation by prohibiting the society from paying interest on Undated Subordinated Debt if the society is insolvent, or would be insolvent, after making the payment.

Conversions/Takeovers/ Mergers

2.7.7 G The issue terms should provide that the loss absorption characteristics of Undated Subordinated Debt will continue as a feature of the corresponding liability of the successor company in the case of transfer of business to a company or the successor society in the case of a merger. In order to preserve, as far as possible, the relative rankings of PIBS-holders and holders of Undated Subordinated Debt through the conversion process, issues of PIBS should become a form of Undated Subordinated Debt on conversion, ranking behind any Undated Subordinated Debt previously issued by the society. This avoids the situation in which, upon conversion, PIBS could have become, say, 10 year term subordinated debt of the successor company and be repaid ahead of undated subordinated debt already in issue by the society. This stipulation was first introduced on 15 April 1994 and may not feature in earlier issues of PIBS.

2.8 Term Subordinated debt

2.8.1 G To be eligible for inclusion in the calculation for capital adequacy, any issue of Term Subordinated Debt should meet the conditions in paragraphs 2.8.2 to 2.8.11.

Subordination

2.8.2 G On winding up, Term Subordinated Debt should rank after all types of ordinary (i.e. non-deferred) shares, and interest due thereon, and other liabilities excluding PIBS and Undated Subordinated Debt.

Maturity

2.8.3 G The original maturity should be not less than five years and one day. Where the debt is drawn down in tranches the minimum term should be calculated from the date of the last draw down.

Amount Eligible as Own Funds

2.8.4 G With a discounted issue it is the amount actually received, not the amount due to be repaid at the end of the term, which counts as own funds.

2.8.5 G Subordinated loan capital in its final four years to maturity should not count in full as part of own funds but should be amortised on a straight line basis by 20% p.a. The debt should be included in the capital base according to the following schedule:

Years to maturity	**Amount included in own funds**
More than 4	100%
Less than and including 4 but more than 3	80%
Less than and including 3 but more than 2	60%
Less than and including 2 but more than 1	40%
Less than and including 1	20%

2.8.6 G If repayment is by instalments then either:

(1) the debt is divided into its constituent instalments and during the five years preceding the repayment of any instalment of debt, its contribution to own funds is written down on a straight line basis; or

(2) where the debt repayment schedule is of equal annual, semi annual, or quarterly instalments over the last three to five years of the debt term, the amounts which may be counted as own funds during the last five years of its term are calculated

by multiplying the principal debt outstanding by the residual term outstanding, and dividing the result by five.

Early Repayment

2.8.7 G There should be no provision allowing early repayment of the debt other than in the event of approval being granted by the FSA. Only a society or its successor may request this approval for repayment.

2.8.8 G Early repayment should not be capable of being triggered by performance conditions, cross-default clauses, negative pledges, or by mergers, or transfers - in circumstances where the FSA gives a direction under section 42 B (1), (3) or (4) of the 1986 Act.

2.8.9 G However, the loan terms may require the borrower to consult the lender(s) and/or trustee about partial transfers of engagements, or transfer of business where the lender(s) or trustee is not satisfied that the successor company will keep its authorisation under the Act.

2.8.10 G The terms may also provide for certain events of default which would allow the lender or his trustee to require early repayment of the loan but only in a winding up/dissolution of a society or in a winding up of its successor. The permitted events of default should be restricted to:

(1) the commencement of the winding up of the society or its successor;

(2) the commencement of the dissolution of a society where it is dissolved otherwise than by virtue of any one or more of sections 93(5), 94(10) or 97(9) and 97(10) of the 1986 Act;

(3) the cancellation of a society's registration under the 1986 Act otherwise than under section 103 (1)(a) of the 1986 Act.

2.8.11 G The FSA would consider any request for early repayment in the light of the projected capital position of the society if repayment were allowed. Approval would only be given where the FSA was satisfied that the society's capital would remain adequate after repayment for the society's existing and proposed business.

2.9 Notification to the FSA

2.9.1 G It is the responsibility of the society's board to satisfy itself that the terms of issue (which include the relevant sections of the society's rules) meet the guidance in this chapter and the 1986 Act: this would normally be on the basis of specialist legal advice. Before including any issued capital in a society's calculation of its solvency ratio for capital adequacy purposes the FSA expects to receive from the society:

(1) evidence, usually in the form of a certified board minute, that the board has considered the specialist legal advice provided to the society, and that the board is satisfied that the society has the power to make the issue and that the issue will meet the guidance in this chapter;

(2) a copy of the legal opinion provided to the society which should cover at least the following points:

  (a) that the society has the power to make the issue (having made the necessary amendments to rules, etc.);

  (b) that any terms not contained within the society's rules are consistent with the rules;

  (c) that the terms of the issue (including the terms within the society's rules) comply with the guidance set out in this chapter.

Interim Prudential Source Book for Building Societies

3 BOARDS AND MANAGEMENT

CONTENTS

Interim Prudential Sourcebook for Building Societies

3 Boards and Management

3.1 Introduction

3.1.1 G This chapter replaces PN 1998/3 (Boards and Management) and PN 1992/2 (New Business Developments and New Initiatives) published by the Commission. It provides additional guidance for building societies supplemental to other FSA rules and guidance in this area, especially the FSA Statements of Principle for Approved Persons and the Code of Practice (see APER) and the rules and guidance on senior management arrangements (see SYSC).

3.1.2 G It also provides additional guidance on the provisions of Part VII (Management of Building Societies) of the 1986 Act.

3.1.3 G Building societies have a particular constitutional form not shared by the generality of deposit-taking firms regulated by the FSA. They are mutual institutions run for the benefit of their members (i.e. their borrowers and savers). This mutual structure means that a society cannot be owned or controlled by an outside institution or major shareholders. Society boards and management have a special responsibility to protect the interests of their customers through the highest standards of corporate governance.

3.2 Corporate Governance

3.2.1 G As for all firms, the FSA regards the board and senior management as the focus for the accountability of the society for the conduct of its business. Accordingly, the FSA will take into account its assessment of the standards of governance, and board and management competence (relative to the nature, scale and complexity of the society's business), in setting the society's threshold solvency ratio.

3.2.2 G Although societies are not publicly quoted, they should have regard to the Combined Code, developed by the Committee on Corporate Governance for listed companies, when establishing and reviewing their own corporate governance arrangements. A sample Code of Governance is attached as Annex 3A, which is a version of the Combined

Code, adapted for the particular circumstances of building societies. Societies are encouraged to adopt this code to apply principles of good governance practice within their business.

3.3 Fit and Proper

3.3.1 G As set out in SUP, all directors of building societies, including non-executives, will be Approved Persons and thus are expected to meet the “fit and proper” criteria and comply with the Principles for Approved Persons and the Code of Practice.

3.3.2 G Under section 60 of the 1986 Act, directors of building societies are elected by the members , and subsection (4) makes clear that , subject to certain conditions , any natural person is eligible to be elected a director .(Subsection (4A) however provides that a person subject to a prohibition order under section 56(2) of the Act is not eligible.) Members have the right under a society’s rules to nominate candidates and the FSA has no power to intervene in elections for board directors. Where members nominate a candidate, in the FSA’s view it is not open to the board to refuse to accept a candidate’s nomination on the grounds that, in the board’s view, he (or she) is not fit and proper (except , of course , in the limited circumstances of a prohibition order being in force in relation to that person). However, the board should, prior to the election, take such steps as are practicably open to it to establish whether there are any matters concerning the candidate’s fitness and propriety of which the members should be aware in advance of the election. If there are such matters, the board should bring them to the attention of the members. The FSA will not vet candidates for election.

3.3.3 G On election, all directors, whether recommended by the board or nominated by members, have the same status. The FSA would, in the exercise of its responsibilities under the Act concerning the regulation of Approved Persons, apply the requirements for approval equally to all directors upon election (i.e. before the elected individuals can take up controlled functions).

3.4 Other requirements and guidance

3.4.1 G Part VII of the 1986 Act contains requirements relating to the management of building societies. This section contains further guidance on this Part of the 1986 Act and sets out some factors the FSA will take into account in assessing the adequacy of a society's board and management arrangements for the purposes of setting its threshold solvency ratio.

3.4.2 G Section 58(2) of the 1986 Act requires each building society to have a chairman and this person plays a key role in the strategic direction of the society. The chairman should not have any executive post in the society. This assists in the separation of strategic direction from the day to day running of the business and helps the chairman take an independent view of management performance. It also protects against undue concentration of power.

3.4.3 G Given the mutual status of building societies, a clear majority of directors on a society's board should be non-executive. The appropriate ratio of non-executives to executives will vary with the scale, nature and complexity of the society's business. The board should have an appropriate range of skills and experience to control and direct the society's activities effectively. The composition of the board should be reviewed at regular intervals.

3.4.4 G It will rarely be appropriate or desirable for a chief executive or other executive director to remain as a non-executive board member after his or her retirement.

3.4.5 G The composition of a board should change progressively over time in a planned manner. As societies increasingly innovate in their mainstream business and use wider powers, so they should recognise the need to enhance their overall board and management resources and expertise accordingly. Non-executive directors should not be given the expectation that they will remain on the board, automatically standing for re-election every 3 years, until the retirement age in the society's rules. They should serve for fixed terms, both initially and for any subsequent term.

3.4.6 G Each society is required by section 59(1) of the 1986 Act to have a chief executive. The chief executive plays a key role in the running of the society and has specific responsibilities in SYSC. He or she should be a member of the board.

3.4.7 G Smaller societies may not need as many executives on the board as larger societies, but every society should have at least one executive director on the board.

3.4.8 G Where executives are appointed under formal service contracts, the board should consider carefully the terms of such contracts. It should have regard not only to the need to attract or retain executives but also to the need to preserve the board's freedom, considering the potential associated costs, to make a change if circumstances so require. A board should consider in particular the period of notice the society must give and the potential liability to the society if it wishes to terminate the contract otherwise than on grounds of misconduct. The objective should be for notice or contract periods to be one year or less.

3.4.9 G Societies are required under the Accounts Regulations to give particulars of the service contracts of directors and chief executives in their annual Report and Accounts. Where there are no such service contracts in existence, societies should say so.

3.4.10 G Each society is required by section 59(2) of the 1986 Act to have a secretary. The secretary plays a key role within the society, with the responsibility of a company secretary to ensure that board procedures are followed and regularly reviewed and to provide guidance on the board's responsibilities and how they should be discharged.

3.4.11 G In assessing the adequacy of society's corporate governance arrangements, the FSA will consider whether the society has established committees of the board appropriate to the scale and nature of its business. Such committees should include at least an audit committee (see Chapter 9 Systems) and may also include an asset and liability committee (ALCO) and a remuneration committee.

3.4.12 G Paragraphs 15.3.7 to 15.3.10 of SUP give guidance on how the FSA will assess compliance with Principle 11 ("A firm must deal with its regulators in an open and co-operative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice"). They indicate that firms should notify the FSA of any "proposed restructuring, reorganisation or business expansion which could have a significant impact on the firm's risk profile or resources". A society entering a new area of activity should ensure that it has appropriate board and management skills properly to manage and control that activity. It is for boards to satisfy themselves on the commercial aspects of any such new venture and to be satisfied that such a venture will not put the society at undue risk, that capital remains adequate and that adequate systems of control have been established.

3.5 Dealings with Directors

3.5.1 G Dealings with directors (and other officers) of societies are subject to restrictions contained in Part VII of the 1986 Act. These include limitations on specified financial transactions, requirements for directors to disclose their interests in any existing or proposed contracts, and the requirement for permitted dealings to be reported. The requirements are concerned with issues of particular sensitivity to a society and its members. In view of this, and the risk of damage to a society's reputation, the board should satisfy itself that there are written procedures and controls in place to ensure compliance with statutory requirements for dealings with directors.

Loans to Directors

3.5.2 G Section 65 of the 1986 Act places restrictions on the loans societies can make to directors or connected persons (as defined in the 1986 Act). Given this, it would be inappropriate for a society simply to follow its usual loan procedures when a loan application is made by a director or a person connected with a director. The responsibility for approving such loans should not rest with staff members, even if the loan could otherwise be decided within staff mandates. A board should ensure that the society has written procedures for dealing with loan applications from directors or persons connected with them and that all directors are familiar with such procedures. They should include consideration by the board or a board committee before approval and should require a review of the proposed terms of a loan, including legal advice, if necessary, to ensure that the loan is allowed by the 1986 Act. Such transactions should take place at arm's length. There should be written procedures to identify applications for director-connected loans.

3.6 Reporting Requirements

3.6.1 G The Accounts Regulations set out specific legal and regulatory requirements about the form and content of the annual report and accounts, summary financial statements, etc., that societies and their directors must produce. A board should present to the members an assessment of the society's position which is balanced (that is, setbacks should be reported as well as successes) and understandable.

3.6.2 G A key principle behind the requirements in the Accounts Regulations is that the members of a society should be given additional disclosure in the annual report and accounts about the interests in the society of directors, the chief executive (on the matter of service contracts) and other officers (on the matter of options to subscribe for share or debentures). The reporting requirements in the Accounts Regulations accordingly include individual directors' remuneration, particulars of service contracts for the directors and chief executive, additional retirement benefits to current and past directors and interests in shares or debentures of connected undertakings. In the interests of transparency, societies should say in their annual report whether they adhere to the sample code of governance in Annex 3A and, if not, in what respects.

ANNEX 3A

Sample Code of Governance

3A.1 G This sample Code of Governance is an adapted version of the Combined Code, which is considered suitable for building societies.

The board

3A.2 G The board should have procedures to ensure that due consideration is given before the appointment of any director or manager to whether the candidate is fit and proper.

3A.3 G The chairman of a building society should not have any executive post in the society.

3A.4 G All directors should bring an independent judgement to bear on issues of strategy, performance, resources (including key appointments) and standards of conduct.

3A.5 G A board should review its composition at appropriate intervals or when considering a major new activity.

3A.6 G A clear majority of directors on a society board should be non-executive.

3A.7 G A society should have at least one executive director on the board.

3A.8 G A non-executive director should serve for specified initial and subsequent terms (if any). Towards the end of each term the board should review whether to recommend re-election.

3A.9 G The chief executive should be a member of the board.

Executive Directors and Other Executives

3A.10 G The terms of an executive's service contract should reflect a reasonable balance between attracting or retaining executives of the requisite calibre and preserving the board's freedom to make a change. The objective should be for notice or contract periods to be one year or less.

Board Procedures

3A.11 G A board should establish a remuneration committee, consisting only of non-executive directors, to develop a general policy, and to make recommendations, on the pay of executive directors.

3A.12 G A board should establish an audit committee of non-executive directors consisting of at least three members.

3A.13 G It is a board's responsibility to ensure that an objective and professional relationship is maintained with the external auditors.

3A.14 G A board should ensure that the society has specific written procedures for the consideration of loan applications by directors or persons connected with them and that all directors are familiar with these procedures.

3A.15 G If a director or any person connected with a director participates in an existing share option scheme, that director should not be allowed to vote on, or to use any discussion to promote, any transaction (such as sale of a subsidiary undertaking) under which that director or connected person would benefit financially.

3A.16 G A board should have a procedure that enables individual directors to obtain independent professional advice at the society's expense for the furtherance of their duties.

3A.17 G Each director should have access to the advice and services of the secretary and any separately appointed compliance officer(s).

Reporting

3A.18 G A board should present a balanced and understandable assessment of the society's position to the members.

3A.19 G Directors should explain their responsibility for preparing the accounts next to a statement by the external auditors about their reporting responsibilities.

3A.20 G Directors should (if it be the case) report that the society is a going concern, with supporting assumptions or qualifications as necessary.

Interim Prudential Sourcebook for Building Societies

4 FINANCIAL RISK MANAGEMENT

CONTENTS

4.1 Introduction

4.1.1 G This chapter replaces PN 1998/4, issued by the Commission, and contains rules and guidance for societies on financial risk management, a key part of compliance with Principle 3 ("a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems").

4.1.2 G This chapter describes the key financial risks to which societies are exposed, explains the statutory restrictions on funding, market making, trading and use of derivative instruments, sets out the framework within which the FSA will supervise the treasury activities of societies, including details of the five "approach" categories (Administered, Matched, Extended, Comprehensive and Trading) applied, and emphasises the respective responsibilities of boards and management for monitoring and controlling financial risks. (Unless otherwise explicitly stated, references in this chapter to "societies" are to society groups, consolidated to include all subsidiary undertakings.)

4.2. Rules

4.2.1 R A society must have an adequate system for managing and containing financial risks to the net worth of its business, and risks to its net income, whether arising from fluctuations in interest or exchange rates or from other factors.

4.2.2 G Societies should have systems and procedures for identifying, monitoring and controlling all material maturity mismatch, interest rate, foreign exchange and similar (e.g. index related) risks, and for reporting exposures to senior management and the board on a regular, and timely, basis. Societies should also have interest margin management systems in place to estimate the expected profitability of new mortgage and savings products, and to project forward the cumulative effect of mortgage incentives and loyalty schemes.

4.2.3 G Societies should have credit limits in place for all counterparties both for placing liquidity and for transacting derivative contracts (further guidance also in Chapter 5 (Liquidity)).

4.2.4 G Societies' boards should ensure that there are adequate internal controls in place covering all treasury activities, including appropriate segregation of duties between initiation of a transaction and confirmation/settlement/ accounting for it, such controls to be the subject of regular review by internal auditors with the requisite skills and experience.

4.2.5 R A society must maintain, and submit to the FSA, a board-approved policy statement on financial risk management.

4.2.6 R A society making any significant change to its policy statement on financial risk management must provide the FSA with a copy of the amended statement as soon as possible after it has been adopted.

4.2.7 G Boards have ultimate responsibility for understanding and controlling the degree of risk, by type, which is being taken by their societies. They should approve the general business strategies, including the treasury section of the society's corporate plan, and the risk management policies that control the extent of risk which is taken, and should give clear guidance on the level of risk considered to be acceptable – such strategies and guidance to be reviewed regularly by the board.

4.2.8 G The policy statement establishes guidelines for the society's senior managers on the control of financial risks, including: operational risk; structural risk; funding risk; and counterparty credit (including settlement) risk. Such documents should be consistent with the type of business undertaken by the society and compliant with sections 7 and 9A of the 1986 Act.

4.2.9 G Policy statements should set out the strategic framework for treasury operations, recording the rationale for that framework i.e. why and how treasury activities are expected to support the society's core business, and the "approach" category being followed, derived, where possible, from the results of a financial risk audit. They should clearly state the conditions under which authority is delegated to a board sub-committee, or to management. The documents should establish the operating limits and high level controls that will maintain exposures within levels consistent with the policy, and the procedures/controls on the introduction of new products or activities. Copies of the policy statements should be made available to, and read by, all personnel involved in treasury operations.

4.3 Financial risks

Funding risks

4.3.1 G Building societies' current core business, financing long-term residential mortgages with short-term personal savings, necessarily involves a high degree of maturity transformation, and this constitutes the major financial risk that all societies need to manage.

4.3.2 G Wholesale deposit funding, available from a range of sources, provides a useful supplement to the stocks, and inflows, of personal savings. Wholesale markets typically provide funding at longer and/or more definite maturity, often at advantageous rates, but may concentrate the refinancing risks societies face.

4.3.3 G The particular constitution of building societies means that the scale of deposit funding has a significant impact on the position of investor members. The public perceives building society share accounts to be as secure as (or even more secure than) bank deposits. However, unlike depositors with banks, share account investors are contributories, not creditors, so they rank after deposit funders, including suppliers of wholesale funding. A society which gears itself up significantly with wholesale funds thereby dilutes the security of its share account investors, whilst at the same time increasing its refinancing and liquidity risks.

4.3.4 G Guidance on the management of short-term cashflow mismatches, and the liquidity requirements which flow from such positions, is given in Chapter 5 (Liquidity). Risks arising from the interest basis/structure or currency of the funding are covered later in this chapter.

Structural risks

4.3.5 G Most societies are susceptible to interest rate exposure arising not only as a result of changes (or potential changes) in the general level of interest rates or the relationship between short term and long term rates, but also from divergence of rates for different balance sheet elements ("basis" risk), for example, the risk that it may not be possible to increase administered mortgage rates in line with increases in money market (LIBOR) rates, resulting in a margin squeeze where funding is LIBOR-based. In this chapter, risks which arise from the different interest rate or currency characteristics of assets and liabilities, and from transactions based on other financial reference rates or indices, are referred to as "structural" risks.

Operational risks

4.3.6 G The extension of building society activities into new forms of funding, liquidity and off balance sheet instruments has dramatically increased the operational risks involved. The documentation, accounting treatment and settlement procedures for such instruments can be highly complex, with significant costs and penalties arising from operational mistakes. Societies involved in these areas of activity need rigorous management procedures and control systems to ensure that robust legal documentation is used, that compliance with market practice is achieved, and that deal recording and settlement systems are effective (with appropriate contingency arrangements in place).

Key risk categories

4.3.7 G The key financial risks which, in order to comply with Rule 4.2.1, societies should manage and control are:

(1) Maturity mismatch, including the risks:

(a) that the society may be unable to refinance term wholesale borrowings on a rollover date due to general market conditions (which may or may not be related to the position of the society itself);

(b) associated with the bunching of roll-over dates for wholesale funding or maturities of term retail funding;

(c) from concentration on a limited number of funding providers, giving rise to increased dependence particularly on roll-over days; and

(d) arising from the prepayment (early redemption) profile of mortgages, and those inherent in the early withdrawal characteristics of retail savings products (i.e. behavioural v. contractual maturity risks);

(2) Interest rate risk to a society's earnings (most significantly, to its interest margin) and to its economic value (the present value of future cashflows) arising from:

(a) repricing mismatches, e.g. where, in a rising interest rate environment, liabilities reprice earlier than the assets which they are funding, or, in a falling rate environment, assets reprice earlier than the liabilities funding them (in both cases leaving the society with a reduction in future income); repricing risk is inherent in fixed rate instruments, the market value of which will change with interest rate movements (e.g. Gilts), and unhedged fixed rate retail products (e.g. unhedged fixed rate mortgages funded by variable rate liabilities would yield less margin should the cost of the liabilities increase due to changes in market rates);

(b) yield curve risk, where unanticipated changes to the shape or slope of the yield curve will cause assets and liabilities to reprice relative to each other - possibly exposing positions which were hedged against a parallel shift in rates only;

(c) interest basis mismatches, arising from the imperfect correlation of rates on instruments with similar repricing characteristics, e.g. between LIBOR rates and mortgage rates (both of which are variable but are subject to different market forces), or between LIBOR and reference Gilt rates, or between 3 and 12 month LIBOR rates etc. Risk can also arise where the underlying market rate is the same for matching assets and liabilities, but the margin paid relative to the offer rate diverges from the margin received relative to the bid rate;

(d) balance sheet composition, where an increase in the proportion of assets and liabilities repricing at fixed or variable wholesale market rates implies a reduced administered rate element in the balance sheet - which will nevertheless have to bear (at least in the short term) the full brunt of any rate changes required in order for a society to widen its margins, if necessary for business or profitability reasons (e.g. in the event of a significant credit deterioration leading to rising provision levels);

(e) optionality (i.e. explicit/contracted option contracts, such as “caps”, “collars” and “floors”, which confer the right, but not the obligation, to fix an interest rate for an agreed amount and for an agreed period. and embedded/implied options included within products, such as early withdrawal or redemption entitlements), magnifying the effect of other interest rate risks: in particular, societies may be subject to implied optionality in respect of retail savings rates (for which a minimum rate payable - a “floor” - above 0% may need to be assumed), and from prepayment of mortgages/pre-withdrawal of deposits (where the customer may effectively have an “option” which may not be adequately “hedged” by way of early redemption charges); and

(f) product pricing, arising particularly where products are not immediately profitable and where longer term payback is dependent upon the achievement of specific cost and/or pricing assumptions.

(3) Currency risk, arising from the effects of changing exchange rates on unmatched assets and liabilities denominated in different currencies; and

(4) Index related risk, arising from the effects of movements in an index of financial assets (e.g. the FTSE 100), or similar reference rate, on unmatched assets or liabilities paying or receiving a return based on that index/rate.

4.3.8 G Societies’ financial risk management policies should also cover:

(1) Settlement risk: the risk of losses arising from failure to settle transactions accurately, or on a timely basis;

(2) Counterparty risk: associated with settlement risk, where a counterparty cannot or will not complete a transaction;

(3) Investment risk: associated with the financial consequences of capital projects including diversification investments; and

(4) Operational risk: including failure of internal controls or procedures, and the risk arising from errors in legal documentation.

4.4 Statutory restrictions

Funding limit

4.4.1 G Section 7 of the 1986 Act provides that at least 50% of the funds (excluding those qualifying as own funds) of a building society (or, if appropriate, of the society's group) must be raised in the form of shares held by individual members of the society (excluding share accounts held by individuals as bare trustees for corporate bodies).

Structural risk management restrictions

4.4.2 G Section 9A prohibits a society or its subsidiary undertakings (subject to certain defined exemptions) from:

(1) acting as a market maker in securities, commodities, or currencies;

(2) trading in commodities or currencies; or

(3) entering into any transactions involving derivative investments.

4.4.3 G Section 9A contains definitions of the above terms, and societies are directed particularly to section 9A(9) for the purposes of compliance monitoring.

4.4.4 G Section 9A also includes a "purpose" test for entering into derivatives contracts and a "safe harbour" clause for society counterparties stating that any transaction in contravention of the section 9A prohibitions is not, however, thereby invalid and may be enforced against the society.

4.4.5 G The exemptions in section 9A fall into two broad categories:

(1) those which allow a society or subsidiary undertaking to provide certain retail services to its customers, including:

(a) acting as market maker in currency or securities transactions of less than £100,000;

(b) trading in currencies (but not commodities) up to a value of £100,000 per transaction;

(c) entering into "contracts for differences" in respect of customers who wish to hedge exposures arising from their own loans or deposits with, the society group; or

(d) acting as market maker or entering into "derivative investments" in its capacity as manager of a collective investment scheme; and

(2) those which allow a society or subsidiary undertaking to use "derivative investments" in order to limit the extent to which it, or a connected undertaking, will be affected by changes in interest rates, exchange rates, any index of retail prices, any index of residential property prices, any index of the prices of securities , or the creditworthiness of any borrower(s).

4.4.6 G The Treasury may, by negative resolution order, amend the £100,000 transaction limit and may add factors to, or remove factors from, the list in 4.4.5(2) above. The Treasury may, by affirmative resolution order, make more significant amendments to section 9A.

4.4.7 G Boards should have procedures and controls to ensure that use of section 9A exemptions by their society (and subsidiary undertakings, if any) is within the law. The exemptions permitting transactions of up to £100,000 (as market-maker in currency or securities transactions, or trading currencies) may not be abused by artificially breaking up larger transactions into a number of smaller amounts falling within the £100,000 ceiling (section 9A(8) is the relevant anti-avoidance provision). Compliance with the 1986 Act may be assisted by specifying the purposes and circumstances in which hedging transactions may be undertaken, or derivatives used, both in the financial risk management policy documents and in the internal arrangements for delegation, identifying the specific authority in section 9A. Whatever the hedging policies adopted, and however the control and authorisation arrangements are organised, it is important that they should be accurately and fully documented.

4.5 Supervisory approach

Funding limits

4.5.1 G Whilst the section 7 funding limit is expressed as a minimum of 50% share account funding, societies should, for prudential monitoring purposes, draw up a funding policy which incorporates an internal policy limit based on a maximum level of deposit liabilities (i.e. an inversion of the "nature limit"). In order to avoid any possibility of an inadvertent breach of the 1986 Act, it is expected that such internal limits will be set at levels below the 50% statutory maximum.

4.5.2 G In setting funding limits, the board should consider wholesale and other deposit funding requirements over the period of their society's current corporate plan, and avoid setting limits at levels where usage is either unplanned or highly unlikely. Where societies have significant levels of offshore deposit funding or commercial deposit funding, boards should set policy sub-limits for these sources (e.g., a society might set an overall deposit liabilities limit of 30%, with sub-limits of 25% for wholesale funding and 10% for offshore funding - the total of the sub-limits exceeding the overall limit only on the basis that both could not be used to their full extent simultaneously).

Supervisory standards for treasury activities

4.5.3 G Under section 5 of the 1986 Act, a society's principal purpose is residential mortgage lending, financed by members' savings, not undertaking, and trading in, financial risk for profit. Societies should therefore adopt a risk-averse approach to maturity mismatch and to structural risk management. A degree of maturity mismatch and structural risk is inherent in normal building society operations, but boards should set risk limits which either:

(1) ensure that, as far as possible, such exposures are minimised; or

(2) where interest rate positions are to be taken, restrict potential reductions in income or economic value, estimated under robust stress testing scenarios, to levels which would not compromise the current or future viability of their societies.

4.5.4 G Societies should aim to eliminate, as far as is practicable, all exposures to risk arising from movements in currency exchange rates.

4.5.5 G To comply with rule 4.2.1, a society's system for financial risk management must be **adequate.** The policy statement required under rule 4.2.5 must be appropriate for the society's business needs and the complexity of its existing and proposed treasury activities. The FSA has devised five models, described as supervisory approaches, of increasing sophistication, to assist societies to comply with these rules. The approaches are described as "administered", "matched", "extended", "comprehensive" and "trading". A society that conducts its treasury activities in accordance with the most suitable (for it) of these five models, can readily demonstrate that it complies with rules 4.2.1 and 4.2.5. But these models are neither mandatory nor exhaustive. Guidance on the characteristics of each approach is set out in Annex 4A.

Supervisory discussions on change of approach

4.5.6 G The FSA anticipates that societies will wish to develop further their treasury expertise, and that a change of "approach" may be necessary. In this respect, the "approach" categories should be seen, not as discrete compartments, but rather as stages in the continuous evolution of financial risk management, with a change of "approach" marking a milestone in that progress. Societies should develop their financial risk management and systems to the level appropriate to support the scale and nature of their business and the FSA will be encouraging societies to enhance their treasury capabilities where this is considered to be necessary.

4.5.7 G Whilst the "approach" benchmarks have no legal significance, the process of moving between approaches provides a useful opportunity for the FSA to review a society's progress, and to satisfy itself that policies, limits and systems are appropriate for the treasury activities planned, and that therefore compliance with rule 4.2.1 is adequately established.

4.5.8 G Any society which wishes to move between approaches should contact the FSA at an early stage. The FSA will wish to be satisfied that the society has the requisite expertise, management information systems, accounting systems and controls before any significant change in the society's treasury activities is implemented.

4.6 Management responsibilities

4.6.1 G Senior management of a society are responsible for:

(1) ensuring that board policies for managing treasury risk are implemented through the operation of effective:

(a) control procedures;
(b) risk measurement systems; and
(c) risk reporting systems; and

(2) maintaining clear lines of authority and responsibility for controlling treasury risk, including:

(a) recruitment of sufficient personnel (including ensuring adequate cover for sickness and holidays) with appropriate specialist skills and expertise to control and monitor structural risk;

(b) setting and monitoring appropriate control limits within the board policy levels delegated; and

(c) maintaining effective internal controls though daily monitoring of treasury activities, and appropriate segregation of duties.

4.7 Risk management systems

4.7.1 G In order to demonstrate compliance with rule 4.2.1, a society should have in place information systems that are capable of:

(1) measuring the level of maturity mismatch and structural risk inherent in its balance sheet;

(2) assessing the potential impact of interest rate (and, if applicable, currency exchange rate) changes on its earnings and its economic value;

(3) reporting accurately, and promptly, on risk positions - to management, to the board and, if requested, to the FSA;

(4) recording accurately, and on a timely basis, all new transactions and/or cashflows which will affect calculations of structural risk exposures;

(5) managing the settlement timetable and processes for individual treasury instruments; and

(6) monitoring credit risk and settlement risk positions incurred with individual and groups of counterparties.

4.7.2 G The scale and scope of the risk measurement system employed should reflect the sophistication of a society's treasury operations, those societies wishing to adopt the

“Comprehensive” or “Trading” approaches requiring more complex techniques to capture different facets of risk.

Control limits

4.7.3 G Control limits confine structural risk positions within levels considered by board and management to be prudent, given the size, complexity and capital needs of the society’s business. Where applicable, limits should also be applied to individual instrument types, asset/liability portfolios, and to separate business activities or subsidiaries. The size of the limits set will be a factor in the FSA’s assessment of the overall risk profile of the society, and thus in the threshold solvency ratio which is set for it.

4.7.4 G The structure of limits should enable the board and management to monitor actual levels of sensitivity, under different pre-defined market index, interest rate and exchange rate scenarios, against the policy specified maxima, to ensure that corrective action can be taken if required.

4.7.5 G The number and type of limits which should be applied will depend upon the relative sophistication of a society’s treasury operations, and further guidance on the FSA’s expectations for each policy approach is set out in Annex 4A.

4.7.6 G Where limits are set as part of the overall board policy, these should be treated as absolute, and therefore no excesses should be tolerated. Any limit exceptions should be reported immediately to executive managers, and the policy should make clear what action is expected of management in such circumstances (including arrangements for informing the board and the FSA of the breach). Limits set by management should similarly be subject to clear guidelines covering the circumstances and periods for which breaches may be permitted (if at all) and the arrangements for notification of exceptions.

Stress testing

4.7.7 G The risk measurement systems put in place should evaluate the impact, on income or economic value as appropriate, of abnormal market conditions. The amount and type of such stress testing required will depend upon the sophistication of treasury operations undertaken, and the level of risk taken, but where required should be regular and systematic. Boards and management should, periodically, review the extent of such stress testing to ensure that any "worst case" scenarios remain valid. Contingency plans should be in place to deal with the consequences should such scenarios become reality.

Board information reporting

4.7.8 G The FSA attaches considerable importance to the quality, timeliness, and frequency of the management information which the board uses to inform itself of the society's risk positions and to satisfy itself that treasury activities are being undertaken in accordance with its policies and guidelines. Information obtained by the board should not be confined to the current position, but should include regular and systematic stress testing, as described above, which should be taken into account when policies and limits are established or reviewed.

4.8 Counterparty risk

4.8.1 G Counterparty limits should cover:

(1) full risk exposures (e.g. deposits or marketable instruments);

(2) market risk exposures (e.g. mark to market positive value of swaps, plus appropriate addition for potential future exposure increases arising from changes in market rates); and

(3) settlement risk exposures (e.g. currency deals where amounts are paid out before funds are received).

4.8.2 G Boards should determine the extent to which authority to set counterparty limits is delegated to management, but delegation to a single individual should not be permitted. Personnel with dealing mandates should not be given authority to set new or increased counterparty limits. No dealings should take place with counterparties which do not have a <u>pre-approved</u> limit.

4.8.3 G Limits should be established on the basis of a robust methodology, which should be fully documented and reviewed regularly. For societies with more active treasury operations, a separate credit risk committee with responsibility for preparing a credit policy statement and counterparty list may be appropriate - less active societies may incorporate a section on credit risk within their liquidity policy statements, with appropriate cross-references to other policy and procedures statements. In all cases, the counterparty list and individual limits should be subject to formal credit review at least annually, with interim arrangements in place to add, amend or remove limits as appropriate.

4.8.4 G Where reliance is placed on sources of information or opinion external to both the society and the counterparty (e.g. rating agencies), the nature of the source, and arrangements for ensuring that the information relied upon is kept up to date, should be made explicit in the credit risk policy document and in procedures manuals. Where ratings are reduced (or put on "watch" with "negative implications"), or where a society becomes aware of information on a counterparty which might affect its perceived creditworthiness, it should have systems for reviewing individual counterparty limits and, possibly, suspending/removing individual names from authorised lists in an expeditious manner. Arrangements for obtaining published information on counterparties should also be included in procedures manuals.

4.8.5 G Exposures to counterparties should be monitored on a consolidated basis, aggregating exposures of the society and any subsidiaries (where applicable), and setting total exposure limits for groups of connected counterparties (e.g. a commercial bank and its merchant bank subsidiary). Similarly, country, sector and market concentrations should be monitored continuously against agreed limits.

Large shareholdings and deposits

4.8.6 G Undue dependence on individual funding sources that account for a large proportion of a society's overall liabilities will involve risk of liquidity problems should those funds be withdrawn or not be available for roll-over. These potential problems apply whether the funds in question are raised from the retail or the wholesale markets.

4.8.7 G A small society is relatively more exposed to this type of risk, and should consider the implications of concentration on individual shareholders or depositors when assessing its liquidity levels and need for committed facilities. In the management of large retail investment accounts, a society should normally avoid:

(1) obtaining funding from a single shareholder or depositor which exceeds 1% of shares, deposits and loans; and

(2) allowing the aggregate total of funding, from those single shareholders or depositors which individually represent more than one-quarter of 1% of shares, deposits and loans, to exceed 5% of shares, deposits and loans.

Committed facilities

4.8.8 G A society with high levels of maturing funding, or vulnerability to withdrawal of individual deposits, should consider arranging committed facilities (or to maintain higher than average levels of liquidity). In arranging committed facilities, a society should consider:

(1) the credit standing and capacity of the provider of the facility;

(2) the documented basis of the commitment (i.e. is it an unconditional commitment or a "best endeavours" arrangement); and

(3) the cost/fee structure compared to alternatives.

In extreme cases , there remains a risk that a provider may renege on a contractual commitment to provide funding, or purport to rely on widely drawn "events of default" or "material adverse change" clauses, and face the legal consequences (if any) rather than lend money to a society in difficulties. Societies should not, therefore, become over reliant on committed facilities to plug short term cashflow difficulties.

4.9 Operational risk

General

4.9.1 G Treasury is an area which is particularly vulnerable to losses arising out of errors, fraud, or wilful override of controls in order to "trade out" of loss making positions.

Segregation of duties

4.9.2 G Societies should ensure that, for all transactions undertaken, separate individuals are responsible for agreeing the deal, for preparing settlement instructions and for authorising payments. Societies should aim to ensure that there is complete segregation of duties between:

(1) dealers,

(2) those responsible for confirming the deals with counterparties and making and receiving the payments resulting from the deals, and

(3) those reconciling bank statements.

4.9.3 G In more active treasuries duties should be split between a "front office" (dealing and deal support), a "middle office" (risk management) - essential only for those societies with more complex treasury operations - and a "back office" (confirmation, and settlement), with accounting and payment functions carried out either by the back office, or by a separate finance department. Physical segregation of the dealers from the settlement staff, to ensure that the former have no access to post or fax facilities used for confirmations, should be in place where accommodation and numbers of staff permit.

Reporting lines

4.9.4 G Where treasury activity and personnel numbers are high enough to allow the creation of separate "front" and "back offices", the reporting line for the latter should be independent of the former, so as to ensure that no conflicts of interest arise at the next level of management.

4.9.5 G A society adopting the “Comprehensive” or “Trading” approach should ensure that its “middle office” risk management function has clearly defined duties, and reports structural risk exposures directly to senior management and the board. The risk function should be independent of the profit centres of the society.

Remuneration policy

4.9.6 G Whilst it is clearly important that societies should offer salary levels sufficient to attract treasury personnel with the required qualifications and experience, remuneration policies should not encourage individual risk taking at the society’s expense. In particular, bonus schemes for treasury staff should not be based on numbers of transactions or gross income targets.

IT security

4.9.7 G Reliance on computerised dealing, information, treasury management and risk assessment systems renders societies particularly vulnerable to software or hardware failure. In accordance with Chapter 9 (Systems), boards of societies should:

(1) have in place tested contingency plans for business recovery in the event of unforeseen disaster;

(2) ensure that treasury IT systems access, both physical and logical, is subject to robust security;

(3) exercise strong control over the development and modification of treasury IT systems; and

(4) involve internal audit in reviewing the development or modification of treasury IT systems.

4.10 Independent review and controls

Internal audit

4.10.1 G Each board should ensure that its society's internal audit department has the skills and resources available to undertake an audit of the treasury function. Internal audit should evaluate, on a continuing basis, the adequacy and integrity of the society's controls over maturity mismatch, over the level of structural risk taken and should assess the effectiveness of treasury management procedures.

4.10.2 G Societies with complex treasuries or lacking internal auditors with treasury expertise may outsource treasury audit to an audit firm with the appropriate expertise and experience. The work of outsourced internal audit should be fully integrated into the society's overall audit procedures and plans, with appropriate reporting lines into the audit committee. However, in order to avoid conflicts of interest, internal audit should not be contracted out to the society's own external auditors – even if the function were to be performed by a completely different branch of the audit firm (see also chapter 11 on Outsourcing).

External audit

4.10.3 G The FSA may commission reports on treasury systems from external auditors under section 166 of the Act or from other appropriate skilled persons, whenever a society seeks to broaden the scope of its treasury operations. Societies which move to the "Comprehensive" or "Trading" approaches should carry out a post-implementation review in conjunction with their external auditors or other professional advisers. The FSA may, from time to time, commission an external review of a society's treasury, procedures and controls, in order to satisfy the FSA that these remain adequate and appropriate.

ANNEX 4A

4A.1 Supervisory approach categories

4A.1.1 G This Annex provides guidance on the five models, or supervisory approaches, to financial risk management described in paragraph 4.5.5G. Where societies have subsidiary treasury operations, it is expected that these will fall into the same approach category as that of the parent society. An outline description of each approach is set out below, and a table at the end of this Annex summarises the key features.

4A.2 "Administered" approach

4A.2.1 G Societies in this category are expected to have balance sheets where loan assets and funding liabilities are entirely in Sterling and predominantly (>95%) subject to administered rates. In general, it is anticipated that the "Administered" approach will:

(1) tend to suit small or very small societies;

(2) where balance sheet management is typically undertaken by the Chief Executive in conjunction with the board - existence of a specific finance function (and Finance Director) being unlikely.

4A.2.2 G Societies adopting this approach:

(1) should not offer fixed rate products (defined as repricing more than one year and one day later than the current date) on either side on the balance sheet;

(2) should have policies limiting the levels of deposit funding to less than 10% of share and deposit liabilities unless a higher limit of up to 35% has been discussed with the FSA to accommodate those societies who take significant commercial deposits but funding from the wholesale markets will be limited to 10% of share and deposit

liabilities;

(3) will hold a simple range of liquid assets (whether counting as prudential liquidity or not), with marketable fixed rate instruments held only provided that these have a residual maturity of 5 years or less; and

(4) should place no fixed rate time deposits having a maturity greater than 1 year.

4A.2.3 G Societies adopting the “Administered” approach do not need specific risk management reporting, but the market value of fixed rate investments with maturities of more than one year, as compared to their purchase price, will be monitored by the monthly monitoring returns.

4A.3 “Matched” approach

4A.3.1 G Societies adopting this approach should have balance sheets where assets and liabilities are entirely in Sterling and use hedging contracts (or internal matching of assets and liabilities with similar interest rate and maturity features) to neutralise the risk arising from loans or funding other than at administered rates, on a tranche by tranche, product by product basis. Characteristic of small to medium sized societies, with limited treasury skills or resources, typically the Chief Executive of such societies will be supported by a Finance Director or Finance Manager, and report direct to the board on treasury matters (or through a board sub-committee).

4A.3.2 G Societies adopting this approach should:

(1) have in place policy statements covering the intention to offer fixed rate (i.e. >1 year to repricing date) products on one or both sides of the balance sheet;

(2) set limits (as a % of total assets) for fixed rate loan assets and share or deposit liabilities, and for holdings of fixed rate liquid assets (whether counting as prudential liquidity or not);

(3) set an overall limit for hedging transactions (nominal value of transactions %SDL);

and

(4) have in place policies limiting the levels of deposit funding to less than 25% of share and deposit liabilities unless a higher limit of up to 35% has been discussed with the FSA to accommodate those societies who take significant commercial deposits but funding from the wholesale markets will be limited to 25% of share and deposit liabilities.

4A.3.3 G The policies of such societies can allow use of standard hedging products for transactions permitted by section 9A, e.g.:

(1) swaps (including FTSE index swaps);

(2) Forward Rate Agreements; and

(3) plain vanilla over the counter ("OTC") options such as swaptions, caps, collars and floors (options purchased only);

for the purpose only of matching individual products and within the exemptions permitted by section 9A - structural hedging of the whole balance sheet should not be permitted.

4A.3.4 G Risk management for such societies will be achieved internally through:

(1) matching reports (detailing individual products and the hedging instruments associated with them); and

(2) gap analysis - for gapping purposes, reserves will need to be treated as having no fixed repricing date, and gap limits should be set at the minimum level required to give flexibility in timing the hedges for individual mortgage and investment products, with some allowance for residual risks (those too small to be economic to hedge) and for holdings of fixed rate liquid assets. Basis risk should be minimised by setting cautious limits for fixed rate and market rate assets and liabilities.

4A.3.5 G Gap monitoring reports should be updated and considered by the board at least monthly. By implication, societies adopting this approach should not be taking an interest rate view for the purposes of determining a hedging strategy.

4A.4 "Extended" approach

4A.4.1 G The principal difference between the "Matched" and the "Extended" approaches lies in the capability to measure and hedge structural risk across the whole balance sheet, including reserves, rather than just hedging individual transactions. The approach will thus allow a society to allocate reserves to specific repricing bands representing a considered view of the characteristics of such reserves and/or the assets deemed to "represent" such reserves, or to manage interest rate gaps as part of a strategy for hedging the endowment effect of interest free reserves against adverse interest rate movements. Risk analysis should also enable it to position its balance sheet to take advantage of a particular interest view. Societies adopting this approach will have the capability to fund in currency and to hold a limited range of currency liquid assets (see Chapter 5, Liquidity), subject to aiming for elimination of all currency exchange mismatch, within an expected maximum limit of 2% of own funds.

4A.4.2 G As a result, a society adopting the "Extended" approach will:

(1) adopt policies and systems to enable it to undertake the hedging of individual transactions within the context of an overall strategy for structural hedging, based on detailed analysis of its balance sheet; and

(2) use the output of such analysis to enable it to position its balance sheet to take advantage of a particular interest view.

4A.4.3 G Management of interest risk for such societies will typically be controlled by the board acting through an Assets and Liabilities Committee (ALCO) or equivalent sub-committee, which will normally be responsible for agreeing any interest rate view. Reporting to the ALCO, there will typically be a Treasurer running a small treasury department with appropriate segregation between dealing and settlement activities.

4A.4.4 G Hedging instruments available to be authorised by the board will be the same as for the "Matched" approach, with the addition of (as far as permitted by section 9A):

(1) exchange traded futures/options and FTSE (or similar) OTC swaps/options (options to be purchased only); and

(2) foreign exchange swaps and forward contracts, used to hedge currency funding.

4A.4.5 G Risk management systems should be based on:

(1) full balance sheet gap analysis;

(2) possibly supplemented by static simulation.

4A.4.6 G Gap limits could allow leeway for risk positions - to be controlled by sensitivity limits covering potential changes in both earnings and economic value.

4A.4.7 G Basis risk should be controlled through limits on the minimum levels of administered rate assets and liabilities, and limits on the extent of mismatch between LIBOR-based and administered rate balances.

4A.4.8 G Positions should be monitored internally by way of frequent updates (monthly minimum).

4A.5 "Comprehensive" approach

4A.5.1 G The principal differences between the "Extended" and the "Comprehensive" approaches lie in:

(1) the depth and quality of the risk management systems put in place to monitor and control structural risk;

(2) the frequency of analysis undertaken; and

(3) the currencies in which treasury operations would be undertaken.

4A.5.2 G Like the "Extended" approach societies, "Comprehensive" approach societies will manage risk using a board/ALCO/Treasurer reporting structure, but the latter will typically subdivide the treasury department further with a separate "middle office" risk management function, segregated from "front office" (dealing) and "back office" (settlement/accounting).

4A.5.3 G Hedging instruments available for use under agreed board policy will include those for the "Extended" approach plus (as far as permitted by section 9A):

(1) currency options.

4A.5.4 G Risk analysis should extend beyond static gap/static sensitivity analysis to:

(1) dynamic simulation (projecting forward balance sheet elements and simulating the impact of different interest rate scenarios);

(2) possibly duration (modified or dollar, reflecting the change in percentage or money value of positions for a given change in interest rates) for individual portfolio elements, or present value of a basis point move (PVBP) calculations, to highlight sensitivity to non-parallel shifts in the yield curve; and

(3) possibly value at risk (VaR), using correlation/historic simulation and/or Monte Carlo simulation;

the impact on both earnings and economic value being assessed internally on a very regular basis.

4A.5.5 G Risk positions could reflect an interest view, subject to sensitivity limits set by board/ALCO and incorporating basis risk assessment/control. Foreign exchange mismatch (i.e.

exchange rate exposure) is expected to be limited to less than 2% own funds (within Capital Adequacy Directive de minimis levels).

4A.6 "Trading" approach

4A.6.1 G A category for those societies which wish to take advantage of the ability to trade in securities. Essentially, such societies will adopt the "Comprehensive" approach for the purpose of managing interest risk arising in their "banking books", but with additional policies, financial instruments, systems and expertise for managing the market risks inherent in running separate "trading books". Currency positions exceeding 2% of own funds are permitted, but are expected to be subject to overall board limits.

4A.6.2 G Such a society should control the additional market risks through a Market Risk Committee of the board and risk management systems should include complex portfolio management, option pricing and VaR models.

4A.6.3 G Societies adopting this approach will be subject to the Capital Adequacy Directive in respect of their trading books – see Chapter 1 (Solvency).

POLICY APPROACH	RISK MANAGEMENT	RISK ANALYSIS	HEDGING INSTRUMENTS	FUNDING	PRUDENTIAL & OTHER LIQUIDITY	LOAN ASSETS
ADMINISTERED	CE (+FD) & board Dealing/settlement segregation (minimum 2 persons)	None (But, if fixed rate liquid assets held, then mark to market value and sensitivity analysis required)	None	Sterling only Deposit Liabilities < 35%SDL No fixed rate (> 1 Year) provided that funds received from the wholesale market do not exceed 10% SDL	Sterling only No non-marketable > 1 Yr. No marketable > 5 Yrs	No fixed rate (1 Yr. +)
MATCHED	CE/FD (or FM), (ALCO) & board Dealing/settlement segregation (minimum 2 persons)	Matching report & Monthly (minimum) Gap analysis (Reserves NFR) - No structural hedging No Interest View Minimal limits (to cover residual balances + pipeline products only)	Interest rate & FTSE index Swaps/FRAs/ Caps/Collars/ Floors (purchase only)	Sterling only Deposit Liabilities <35%SDL provided that funds received from the wholesale market do not exceed 25% SDL	Sterling only	Limit on fixed rate (1 Yr. +)
EXTENDED	(CE)/FD/Treasurer + ALCO & board Treasury segregation (front office/back office)	Monthly (minimum) Static Gap (& Static Simulation) - Reserves hedged Interest view Sensitivity limits (earnings, economic value & basis risk)) No FX mismatch	Interest Rate & FTSE index Swaps/FRAs/ Caps/Collars/ Floors/Futures/FTSE Options (purchase only) FX Swaps/Forward Contracts Retail derivatives & FX contracts permitted.	Sterling + Currency Minimum level of administered rate liabilities	Sterling + Currency (limited range of currency instruments)	Minimum Level Of administered Rate Assets
COMPREHENSIVE	FD/Treasurer/Risk Manager + ALCO & board Treasury segregation (front office/middle office/back office)	Very frequent Gap (Reserves Hedged)+ Duration/ Simulation/ (VaR.) Sensitivity limits (earnings & economic value) Basis risk limits FX mismatch <2% Own Funds	Interest Rate & FTSE index Swaps/FRAs/ Caps/Collars/ Floors/Futures/FTSE Options Exotic Options FX Swaps/Forward Contracts/ Options Retail derivatives & FX contracts permitted.	Sterling + Currency	Sterling + Currency	Sterling + Currency
TRADING	FD/Treasurer/Risk Manager /+ Market Risk Committee/ ALCO & board Treasury segregation (front office/middle office/back office) + banking book/ trading book	Banking Book: Daily (minimum) Gap (Reserves Hedged)+ Duration/ Simulation/ (VaR) Trading Book: VaR - CAD capability	Interest Rate & FTSE index Swaps/FRAs/ Caps/Collars/ Floors/Futures/FTSE Options/ Exotic Options Retail derivatives/FX permitted. FX Swaps/Forward Contracts/ Options Equity Options	Sterling + Currency	Sterling + Currency	Sterling + Currency

Interim Prudential Sourcebook for Building Societies

5 LIQUIDITY

CONTENTS

5 Liquidity

5.1 Introduction

5.1.1 G This chapter replaces PN 1998/5 issued by the Commission and contains rules and guidance for societies on the management of liquidity. It contains guidance for societies on what is meant by "adequate resources" in the Threshold Condition set out in paragraph 4(1) of Schedule 6 to the Act – see also COND 2.4 - and in Principle 4, in respect of liquidity. The chapter explains the FSA's approach to liquidity for building societies and provides guidance on factors the FSA will take into account in assessing whether a society meets the rules set out in section 5.2.

5.2 Rules

5.2.1 R A society must maintain adequate liquid resources, including prudential liquidity, appropriate to the scale and nature of its business to enable it to meet its obligations as they fall due.

5.2.2 G "Adequate liquid resources" means of such amount and composition as will at all times enable the society to meet its obligations as they fall due.

5.2.3 G "Prudential liquidity" has the meaning set out in paragraph 5.3.4. A list of assets suitable for inclusion in prudential liquidity is set out in Annex 5A.

5.2.4 E (1) A society should keep at least 3.5%SDL in 8 day liquidity.

(2) Contravention of 5.2.4(1) may be relied upon as tending to establish contravention of 5.2.1.

5.2.5 G "SDL" is defined in paragraph 5.3.2.

5.2.6 G A list of assets acceptable as 8 day liquidity is set out in paragraph 5.4.3.

5.2.7 R A society must maintain, and submit to the FSA, a board-approved policy statement on liquidity.

5.2.8 G Guidance on the content of a liquidity policy statement is set out in paragraphs 5.6.2 to 5.6.4 and in Annex 5B.

5.2.9 R A society making any significant change to its policy statement on liquidity must provide the FSA with a copy of the amended policy statement as soon as possible after it has been adopted.

5.3 The Prudential Regime for Liquidity

5.3.1 G A building society specialises in long-term mortgage lending which is financed mainly by liabilities which are contractually short-term. This feature of societies' business creates maturity mismatches which can give rise to cash flow imbalances. To ensure that it can meet its obligations as they fall due, a society should therefore keep an appropriate amount and mix of liquidity to meet any sudden adverse cash flow; the level of liquidity held should be sufficient to maintain public confidence that the society can meet its commitments.

5.3.2 G The amount of liquid assets held by a society should be expressed as a percentage of its share and deposit liabilities (SDL). For the purposes of this chapter, SDL is defined as the total of share and deposit liabilities, excluding amounts that qualify as own funds but including accrued interest not yet payable. Societies should show the board-approved range for liquidity expressed as a percentage of SDL in their liquidity policy statement.

5.3.3 G Funds borrowed from the wholesale money markets have a specified maturity date on which they have to be repaid or rolled over and thus carry the risk that they will be unable to be refinanced on that maturity date on terms acceptable to the society. Societies should take this risk into account in planning the maturity profile of their prudential liquidity. The same consideration applies to large positions in retail funds where, for example, fixed-rate bonds or Tessa accounts are due to mature. Societies should not run large exposed funding positions without having sufficient liquidity to re-finance part or all of the position on maturity. An effective maturity diary should be established for both funding and prudential liquidity.

5.3.4 G Liquid assets should be genuinely liquid i.e. they should be capable of being realised at very short notice. Only instruments or assets that are marketable (i.e. realisable in a secondary market) or have three months or less to run to maturity should (subject to the guidance in Annex 5A and in paragraph 5.5.2) be included in the calculation of liquidity for prudential purposes. Societies may hold other assets, but as an investment rather than liquidity (although such assets might still fall within the "liquid assets" heading in the annual accounts, which has no restriction on maturity). The treatment in the annual accounts determines whether an asset is a liquid asset for the purposes of calculating the society's position in relation to the statutory limit in section 6 of the 1986 Act (the "lending limit").

5.3.5 G Committed standby facilities form an important element of societies' funding strategy and can be used to boost liquidity when needed. Societies should ensure that the lines are truly committed and that a diary is kept noting when the lines expire, allowing the facilities to be renewed on a timely basis. Societies not using committed standby facilities should increase their level of liquidity to compensate.

5.4 Short-term Liquidity

5.4.1 G The FSA operates a short-term liquidity regime for building societies from sight to 8 calendar days forward.

5.4.2 G An asset maturing on a non-business day should be regarded as maturing on the succeeding business day.

5.4.3 G The following liquid assets may be counted as short-term liquidity:

(1) cash, current account balances, Treasury, Local Authority and eligible bank bills;

(2) deposits with relevant authorities (as defined in Annex 1F), banks and building societies with not more than 8 days' notice, or within 8 days of maturity;

(3) all gilt-edged securities, subject to discounting according to maturity (see paragraph 5.4.4);

(4) CDs (banks and building societies) with 3 months or less to maturity, commercial paper with residual maturity up to 1 month.

5.4.4 G All gilt-edged securities can be included within 8 day liquidity, but discounted back to sight according to maturity. Such discounting should help to offset the greater price volatility which can affect gilts at the longer end of the maturity range. The discount factors which should be applied to market value of holdings of gilt-edged securities are as follows:

maturities less than 1 year	**maturities 1 to 5 years**	**maturities over 5 years**
Zero	5%	10%

5.4.5 G Societies on the "Administered" approach (as described in chapter 4 on Financial Risk Management) should not hold marketable fixed-rate instruments, including gilts, unless their residual maturity is 5 years or less. Where such societies have historic holdings of such investments, they may continue to be counted as prudential liquidity subject to the discount factor for gilt-edged securities.

5.4.6 G Societies with extensive treasury operations and large holdings of gilts will typically mark-to-market their gilt book daily. Societies with less sophisticated treasury operations which hold gilts as liquidity should mark-to-market their holdings at least once a week and more often during times of market volatility. Where such holdings are held as 8 day liquidity, market valuations should be taken daily to obtain an accurate value for purposes of discounting and to establish the amount of prudential liquidity at any given time.

5.4.7 G Societies should not include excessive amounts of inter-society holdings in their 8 day liquidity calculation. Societies should include sub-limits for the 8 day liquidity band within their overall sector limits in the liquidity policy statement.

5.5 Supervisory Approach to Liquidity

5.5.1 G Societies should adopt a risk-averse approach to the management of liquid assets. Societies should ensure that treasury systems and controls are adequate for the scale of activity undertaken and that treasury personnel have appropriate expertise and competence, including dealing, settlement and accounting skills. Chapter 4 suggests that dealings in certain categories of liquid assets should be confined to societies on an advanced approach to financial risk management.

5.5.2 G Annex 5A sets out the range of assets considered appropriate for societies to hold as prudential liquidity although each society should satisfy itself that any particular kind of asset is suitable to its needs. If a society wishes to hold an asset as prudential liquidity that is not listed in Annex 5A, it should consider the following factors:

(1) the suitability of the asset for the structure of the society's balance sheet, taking into account, inter alia, interest rate risk and any currency risk;

(2) the marketability of the asset i.e. the "depth" of its liquidity;

(3) credit risk and market risk (price volatility);

(4) the adequacy of the society's expertise and systems in the treasury area.

5.6 Board and Management Responsibilities

5.6.1 G Chapter 4 on Financial Risk Management refers to the potential risks to societies of treasury activities. In particular, the size and complexity of some transactions can make them vulnerable to losses and fraud, and the impact of losses on individual transactions in the treasury area can be significant and immediate. Boards have ultimate responsibility for deciding the degree of risk taken by their societies, including all categories of liquid assets and risks arising from the management of liquidity.

5.6.2 G Rule 5.2.7 requires each society to have a liquidity policy statement. This should be approved by the society's board and be consistent with the society's strategic plan and its financial risk management policy statement.

5.6.3 G Policy statements should set out the board's objectives for liquidity, the limits within which liquidity should be maintained, the range of instruments in which liquidity can be invested and conditions under which authority is exercised. The document should establish the framework for operating limits and high level controls, and should set out the board's policy on credit assessment, ratings and exposure limits. Guidance on the content of liquidity policy statements is set out in Annex 5B.

5.6.4 G A liquidity policy statement should be a working document and personnel in the treasury and settlement areas should be familiar with its contents, as should members of ALCO or Finance Committee. When aspects of the policy or limits become out of date, the policy document should be amended and the revised copy must be sent to the FSA (see rule 5.2.9).

5.6.5 G Boards should establish the objectives for liquidity including meeting obligations as they fall due (including any unexpected adverse cash flow), smoothing out the effect of maturity mismatches and the maintenance of public confidence. The need to earn a return may also be recognised as an objective, although this should be secondary to the security of the assets.

5.6.6 G Boards should decide the principles of remuneration for treasury dealing staff. Large bonuses linked to dealing-related profit targets should be discouraged as they can lead to unacceptable risk-taking on the part of those involved at the expense of the society.

5.6.7 G Management should regularly review the liquid asset portfolio. Some categories of asset are more complex than others and their characteristics (which can involve how the assets are held as well as the assets themselves, for example, securities subject to repo/reverse repo transactions) need to be fully assessed in any review of the portfolio.

5.6.8 G Board policies should be implemented through the operation of effective procedures and controls, risk measurement and reporting systems; senior management should maintain clear lines of authority and responsibility; sufficient personnel with specialist skills - in the settlements as well as in the dealing area - should be recruited; senior managers should have sufficient understanding of treasury operations to be able to carry out their responsibilities without relying exclusively on advice from the treasury team; and delegation of authority should be fully documented in procedures manuals and closely monitored.

5.7 Society-only Approach to Liquidity

5.7.1 G Societies need not calculate liquidity on a group basis for prudential purposes. Each subsidiary undertaking will have its own liquidity requirements reflecting the particular nature of its business and it will not normally be appropriate to combine these with the parent society or with each other. Liquidity held offshore, for example, may be managed with a degree of autonomy and subject to the rules of another regulator. In either case, this can lead to a loss of control and there may be circumstances where liquid assets are not immediately callable overnight. Liquid assets which are held offshore or in a subsidiary undertaking (or both) should be excluded from a society's calculation of its prudential liquidity.

5.8 Outsourcing of Liquidity Management and Brokers' Advice

5.8.1 G In considering whether to outsource a proportion of their liquidity to a fund manager, societies should take into account the guidance on outsourcing in chapter 11 and the following:

(1) any agreement should be fully supported by legal documentation and societies should take legal advice on the terms and conditions;

(2) the security of the assets should be no weaker when held to the order of a third party (the fund manager) than when held to the direct order of the society;

(3) societies should ensure that the safety of the assets is the responsibility of the fund manager while they are under management, including while securities are out for settlement;

(4) the assets under management should at all times be held in a separate client inventory identifying the society - there should be no credit exposure risk;

(5) the fund manager should be given the terms and conditions under which it can act; this should include, inter alia, a copy of the society's liquidity policy statement;

(6) the society should remain in control over policy decisions and be able to monitor the performance of the fund manager against independent benchmarks;

(7) periodic meetings should be held between the society's senior management and senior management of the fund managers to discuss performance;

(8) the board of the society should satisfy itself about procedures and controls, including internal audit, to obtain the level of comfort it needs over the operation.

5.8.2 G Most societies take advice from brokers regarding investment of their liquidity. Some, however, enter into a more formal arrangement where securities are delivered to and from the broker and a customer agreement between the broker and the society is completed. If so, societies should differentiate between advice and discretionary fund management. If the society has entered into an agreement involving the provision of advice, it should ensure that no transaction is undertaken without its prior consent. As with discretionary fund management, societies should make certain that all transactions are within the terms of its liquidity policy statement.

ANNEX 5A

Prudential Liquidity

5A.1 G The following list of assets is available to societies for the management of prudential liquidity, according to the society's approach to financial risk management, as set out in chapter 4.

	Administered	Matched	Extended	Comprehensive	Trading
1.1 Bank notes or coinage of any country or territory.	✔	✔	✔	✔	✔
1.2 Deposits with:					
(1) the central bank of any member country of the EEA and of Canada, Japan, Switzerland and the USA (sterling only);	✔	✔	✔	✔	✔
(2) National Savings Bank;	✔	✔	✔	✔	✔
(3) any credit institution authorised by the competent authorities of any member country of the EEA and Switzerland (sterling only);	✔	✔	✔	✔	✔
(4) wholly owned subsidiaries of UK banks and building societies in the Channel Islands and the Isle of Man;	✔	✔	✔	✔	✔
(5) any gilt-edged market maker or participant in the UK gilt market supervised by a regulatory authority in the EEA.	✔	✔	✔	✔	✔

1.3 Loans to: (1) the Department of Finance and Personnel (Northern Ireland); (2) any relevant authority ("relevant authority" is defined in Annex 1F).	✔ ✔	✔ ✔	✔ ✔	✔ ✔	✔ ✔
1.4 UK Government money market instruments (e.g., Treasury bills) and securities (gilts) (1) up to 5 years residual maturity; (2) over 5 years residual maturity	✔ ✖	✔ ✔	✔ ✔	✔ ✔	✔ ✔
1.5 Securities issued or fully guaranteed by the government of any other member country of the EEA and of Australia, Canada, Japan, New Zealand, Switzerland and the USA (sterling securities only). (1) either floating rate (of any maturity) or fixed-rate up to 5 years; (2) fixed-rate over 5 years.	✔ ✖	✔ ✔	✔ ✔	✔ ✔	✔ ✔
1.6 Securities issued, guaranteed or, in the case of bills of exchange, accepted by any credit institution authorised by the competent authorities of any member country of the EEA and Switzerland (sterling securities only). (1) either floating rate (of any maturity) or fixed-rate up to 5 years;	✔	✔	✔	✔	✔

(2) fixed-rate over 5 years.	✖	✔	✔	✔	✔
1.7 Securities issued by any relevant authority (as in 1.3(2)). (1) either floating rate (of any maturity) or fixed-rate up to 5 years; (2) fixed-rate over 5 years.	✔ ✖	✔ ✔	✔ ✔	✔ ✔	✔ ✔
1.8 National Savings Bonds.	✔	✔	✔	✔	✔
1.9 Foreign currency deposits with: (1) the central bank of any member country of the EEA and of Canada, Japan, Switzerland and the USA; (2) any credit institution authorised by the competent authorities of any member country of the EEA and Switzerland.	✖ ✖	✖ ✖	✔ ✔	✔ ✔	✔ ✔
1.10 Foreign currency securities issued or fully guaranteed by the government of any member country of the EEA and of Australia, Canada, Japan, New Zealand, Switzerland and the USA (this category does not apply to mortgage backed securities).	✖	✖	✔	✔	✔
1.11 Foreign currency securities issued, guaranteed or, in the case of bills of exchange, accepted by any credit institution authorised by the competent authorities of any member country of the EEA and Switzerland.	✖	✖	✔	✔	✔
1.12 Securities issued by international organisations the capital of which is subscribed in whole or in part by any member state of the EEA (known as “supranationals”).					

(a) securities in sterling	✔	✔	✔	✔	✔
(b) securities in foreign currencies	✖	✖	✔	✔	✔
1.13 Securities in the form of commercial paper (which should be redeemed before the first anniversary of the date of issue) issued or guaranteed by:					
(1) public companies whose registered office is domiciled in the EEA;	✖	✖	✖	✔	✔
(2) by public companies incorporated in Canada, Japan, Switzerland and the USA	✖	✖	✖	✔	✔
1.14 Mortgage backed securities.	✖	✖	✔[1]	✔	✔
1.15 Stocklending rights arising from the lending of securities issued in the UK by HM Government.	✖	✔	✔	✔	✔
1.16 Gilt repo	✖	✔	✔	✔	✔
1.17 Repo in non-gilt-edged securities.	✖	✖	✖	✔	✔
1.18 Stocklending rights arising from the lending of securities under the rules of any depository or clearing agent.	✖	✖	✖	✔	✔

Note 1: Foreign currency deposits and foreign currency securities:
Societies should aim to hedge or match their foreign currency exposures. Any residual currency position should not exceed 2% of own funds, unless the society is on the Trading approach.
Note 2: Equities, or equity related stocks are excluded as prudential liquidity.
Note 3: Any guarantee should be unconditional in respect of the payment of both principal and of interest on all securities.
Note 4: Non-marketable assets (i.e., items 1.2, 1.3 and 1.9) are restricted to those with three months or less to residual maturity.

[1] STERLING ONLY

ANNEX 5B

Policy Statement on Liquidity

5B.1 Overview

5B.1.1 G This Annex provides guidance on the issues which should be addressed in a liquidity policy statement. The list of issues is not exhaustive and not all points will be relevant to all societies.

5B.2 Policy Statement Contents

5B.2.1 G The <u>introduction section</u> should include:

(1) Background to the society's approach to liquidity management;

(2) Ratification process for obtaining board approval, including amendments to the policy statement as well as complete revisions;

(3) Arrangements for, and frequency of, review (which should be conducted at least on an annual basis).

5B.2.2 G The <u>objectives section</u> should set out the Board's objectives for liquidity (see section 5.6.5 of this chapter).

5B.2.3 G The <u>operational characteristics section</u> should set out the society's business and operational characteristics, which impact on the amount and composition of liquidity, and the intended range for liquidity and liquidity net of mortgage commitments as a percentage of SDL.

5B.2.4 G The <u>risk management section</u> should include:

(1) Exposure policies, including controls and limits as appropriate, for countries, sectors (with sub-limits for 8 day liquidity) and counterparties, including exposure to brokers;

(2) The policy adopted for credit ratings, stating the minimum quality acceptable and procedures for ensuring credit ratings are up to date;

(3) Policy of assessment to be adopted towards sectors that are non-rated, e.g., local authorities;

(4) Operational and settlement risk, including: framework of board authorisation, delegations and operating limits (including, inter alia, dealer limits, transaction and day limits); deal authorisation, confirmation checking, segregation of duties;

(5) Limits for pre-approved free of payment (FOP) exposures (NB: all FOP exposures should be pre-approved);

(6) Procedures and criteria for exceptional overrides in relation to dealing, operational rules, limits and authorisation;

(7) Policy for liquidity management information and reporting to the board.

5B.2.5 G The <u>maturity structure section</u> should include the policy for maturity mismatch and a "maturity ladder" covering prudential liquidity. This should give a clear view of the maturity pattern of the liquidity portfolio to be followed, showing the maximum proportions of liquidity to be included within each time band.

5B.2.6 G The <u>categories of assets and activities section</u> should set out the society's policy for the following:

(1) inter-society holdings;

(2) repo/reverse repo (both gilt-edged stock and non-gilt-edged securities);

(3) stocklending;

(4) mortgage backed securities (including, where applicable, US MBS);

(5) foreign currency securities and the handling of foreign currency exposures;

(6) commercial paper.

5B.2.7 G The society's policy for membership and use of any clearing system or depository should be set out clearly, including a section dealing with authorisation and operational controls.

5B.2.8 G Liquidity implications and the role of standby facilities should be included in the policy statement.

5B.2.9 G The role of external professional advisers should be clearly stated, where applicable.

ANNEX 5C

Inter-society Holdings

5C.1 G Societies may hold other societies' liabilities as prudential liquidity. Such holdings may include deposits and holdings of all forms of securities and money market instruments issued by other societies, including commercial paper, but should exclude Permanent Interest Bearing Shares and other forms of issued capital.

5C.2 G A society's aggregate holding of other societies' liabilities should not exceed 5% SDL or £5m whichever is the higher, including liquid assets which, although not counting as prudential liquidity (i.e., deposits with longer than 3 months to run to maturity) are held as other investments and fall within the "liquid assets" heading in the annual accounts. This measure is to be continuous.

5C.3 G The FSA expects societies to invest no more than 20% of their prudential liquidity (up to a limit of 5% SDL or £5m whichever is the higher) in aggregate holdings of other societies' liabilities.

5C.4 G Committed facility agreements with other societies should be reported to the FSA in the MFS1 return (table D2). Only the amount drawn down (lent) will constitute a liquid asset and should be taken into account when calculating the aggregate holding of other societies' liabilities.

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6 LENDING

CONTENTS

6 Lending

6.1 Introduction

6.1.1 G This chapter replaces PN 1998/6 Lending issued by the Commission.

6.1.2 G Building societies remain subject to the statutory nature limit for lending in the 1986 Act. A minimum of 75% of group business assets must be made up of loans fully secured on residential property (calculated by reference to sections 6, 6A and 6B of the 1986 Act). Each society should ensure that its lending policy and associated business control systems will deliver continuing compliance with this nature limit on the basis of proper, consistent classification of the loan assets of the society and its group. Further guidance on the application of this nature limit is given in section 6.6.

Scope of the Chapter

6.1.3 G The FSA's Principle 3 requires a firm to organise and control its affairs responsibly and effectively, with adequate risk management systems. Principle 2 requires a firm to conduct its business with due skill, care and diligence. Experience shows that one of the most common causes for the failure of deposit-taking institutions is a deficiency in systems for controlling lending and credit risk. Accordingly, the principal theme of this chapter is the need for adequate and appropriate systems for controlling and managing risks arising from lending. The chapter also establishes a framework within which the FSA will judge the risk profile of individual societies' lending, in particular for the purpose of setting and reviewing each society's threshold solvency ratio, and for assessing whether the society complies with Principles 2 and 3.

6.1.4 G This chapter also sets out the FSA's views on good practice in a range of areas related to societies' lending, which are drawn from the experience with societies' activities of its predecessor, the Commission, over a number of business cycles. Nothing in this chapter absolves the board of each society from its responsibility for developing and maintaining prudent controls over lending risk arising from its business activities and future business plans.

6.2 Rules

6.2.1 R A society must have adequate systems for managing and controlling risk arising from lending, including systems for assessing both the adequacy of security for loans and the ability and willingness of borrowers to repay their loans.

6.2.2 R A society must maintain, and submit to the FSA, a board-approved policy statement on lending, which must include plans for the management of arrears, and the procedures for making specific and general provisions against impaired loans.

6.2.3 R A society making any significant change to its policy statement on lending must provide the FSA with a copy of the amended policy statement as soon as possible after it has been adopted.

6.2.4 G Each society's lending policy should be reviewed, by or on behalf of the board, not less than once a year.

6.2.5 G Chapter 1 on Solvency explains, inter alia, the need for adequate capital to support risks that arise from societies' lending activities. That chapter states that the setting of a threshold ratio by the FSA does not absolve society boards from the responsibility to maintain such higher solvency ratio as they consider appropriate for their business and future plans. Societies should hold sufficient capital to support the risks in their lending book and those arising from new lending initiatives. The FSA will take this into account in assessing compliance with Principle 4.

6.3 Principles of Lending

6.3.1 G The basic principles of good lending practice that the FSA will take into account in assessing compliance with the rules in section 6.2 are as follows:-

(1) lending activities should be within the capabilities, experience and expertise of a society's management and its board;

(2) risk should be controlled at inception by sound underwriting procedures, exercised by individuals and/or a credit committee skilled in the type of lending mandated to them, or by fully tested credit scoring systems;

(3) the pricing of loans should take account of the perceived risks;

(4) adequate controls should be in place to avoid imprudent concentrations of risk in special products, non-traditional areas of lending and higher risk categories in traditional areas of lending;

(5) adequate procedures should be in place for monitoring the performance of lending related to source, type, and period of origination, and for ensuring that lending experience feeds into the formulation of policy for new lending;

(6) the frequency and quality of management and board information should be sufficient to monitor and control lending activities effectively;

(7) commercial loans should be regularly reviewed;

(8) systems should be in place for early and effective management of arrears cases and for managing the disposal of properties in possession;

(9) prudent provisioning methodologies should be used and actual provisions regularly reviewed in the light of experience;

(10) budgetary procedures should be in place to assess and control the effect on current and future profitability of lending at fixed or capped rates, at a fixed margin over a market reference rate and of price incentivised lending;

(11) systems should be in place to combat mortgage or other loan fraud;

(12) for subscribing societies, systems should be in place to ensure compliance with the CML Mortgage Code;

(13) where external advice is required, professional firms of solicitors, accountants, valuers and other types of adviser should have experience in the type of transaction for which they have been instructed.

6.4 Lending Policy Statements

6.4.1 G Rule 6.2.2 requires each society to have a statement of lending policy. Each society's board should determine, subject to the nature limit, the make up of its lending and its appetite for risk and should establish procedures for containing risk within this agreed policy. This section provides guidance on the content of lending policy statements and suggests factors that boards should consider when drawing up such statements.

6.4.2 G The statement should reflect the society's "philosophical" approach to lending, including the degree of risk the society is prepared to take to achieve a desired level of return, as well as more detailed aspects of controlling new lending risk and residual risk in a lending book. The statement should act as guidance to executives in designing new products as well as to staff involved in the underwriting process.

6.4.3 G The following paragraphs set out the broad areas societies should cover in their lending policy statement. Lending markets and the economic circumstances of borrowers, both personal and commercial, are subject to change and new lending risks may arise in the future. So, boards and management should review lending policy not less than once a year to take account of changing circumstances.

6.4.4 G A policy statement can usefully be structured in four parts: overview, organisation, risk management, and individual lending categories. The <u>overview</u> section could set the broad outline of the society's lending strategy, the degree of risk considered acceptable and the arrangements for its regular review. The <u>organisation</u> section could cover how lending is to be managed within the society, setting out which individuals or departments are responsible for which areas of lending or arrears management. The <u>risk management</u> section could describe how lending risk is controlled and monitored (including the use of exposure limits), how experience is to be fed back into policy and emphasise the importance of the borrower's covenant as the primary source of repayment (rather than the value of the security).

6.4.5 G The individual <u>lending categories</u> section could distinguish owner occupied residential lending, other lending secured on property and unsecured lending to individuals, each of which requires a different approach to product design and underwriting (see following table).

6.4.6 G Policies developed at the centre should be implemented properly and consistently across the organisation. The lending policy should be clearly explained to branch staff, including the society's attitude to risk. Ongoing adherence to the policy should be controlled by the lending function and reviewed by internal audit.

OWNER OCCUPIED RESIDENTIAL LENDING	OTHER LENDING SECURED ON PROPERTY	UNSECURED LENDING TO INDIVIDUALS
Property Types and Location	**Property types and location**	
Loan types and features	**Loan types**	**Loan types**
Underwriting procedures	**Underwriting procedures**	**Underwriting procedures**
Repayment Sources and methods	**Repayment and monitoring**	**Repayment methods**
Pricing Policy	**Pricing policy**	**Pricing policy**
Mortgage Indemnity Insurance	**Mortgage Indemnity Insurance (if applicable)**	
Other Insurance	**Other insurance**	
Intermediary Introducers	**Intermediary introducers**	**Credit brokers**
Valuations	**Valuations**	

OWNER OCCUPIED RESIDENTIAL LENDING	OTHER LENDING SECURED ON PROPERTY	UNSECURED LENDING TO INDIVIDUALS
Security	**Security**	
Management Information	**Management Information**	**Management information**

6.5 Risk Features of Mortgage Lending

6.5.1 G The Commission's prudential guidance drew attention to the intrinsic "double security" in normal mortgage lending, i.e. the mortgage on a property, which has been professionally valued and the personal covenant of a borrower, whose ability to repay has been assessed carefully. Both elements should be given appropriate weight. This basic principle of mortgage lending is explicitly incorporated into the rule in paragraph 6.2.1. This neither stipulates how the valuation or assessment should be carried out, nor that they should be done in all cases, but the society's policy and procedures should be clearly documented. The extent to which such valuations and assessments for lending are not carried out will be a factor considered by the FSA when assessing a society's threshold solvency ratio.

Covenant of Borrower

6.5.2 G Reliance on gross income multiples alone to measure a personal borrower's ability to repay provides only a limited indication of affordability and therefore of the strength of the borrower's covenant. Extending the assessment to a borrower's net income after fixed commitments will give a more reliable guide to the size of mortgage he or she can realistically service. When assessing affordability, the borrower's vulnerability to an increase in interest rates should also be taken into account.

6.5.3 G Assessing ability to repay is more difficult for personal borrowers who are self-employed, and more complex for commercial borrowers, both of which require skills in analysing financial accounts.

Valuation of Security

6.5.4 G Valuers should have sufficient experience and expertise and should be free from conflicts of interest.

Managing Aggregate Lending Risk

6.5.5 G Societies should be aware of the risk profile of their overall mortgage stock and of their new lending and should consider lessons arising from experience with their non-performing loans and adjust lending policy accordingly. These lessons should also inform general provisioning policies.

6.5.6 G Societies adopting a strategy for growth should have rigorous controls on quality of lending and should take care not to set up unbalanced incentive structures for staff which reward new business volumes without also recognising responsibility for maintaining quality standards. Societies should maintain strict and documented controls over discretionary overrides to lending criteria and scorecard decisions and should monitor the extent to which overrides occur in practice.

6.5.7 G Each society should determine how it controls lending risks and document this clearly in its lending policy statement. The FSA strongly recommends quantitative exposure limits as a way of achieving this. Outlined below are types of lending and aspects of lending risk where exposure limits can be set:

(1) Non-traditional lending: for example, secured lending to housing associations, lending on private rented properties or personal unsecured lending;

(2) Lending at higher LTV ratios or higher income multiples (i.e. lower affordability): societies should set an exposure limit for residential mortgage lending at 90%+ LTV;

(3) New or innovative products and incentivised loans;

(4) Fixed rate and other non-administered rate products including foreign currency mortgages;

(5) Large exposures: (see also Chapter 7 on Large Exposures);

(6) Remortgage business;

(7) Origination source;

(8) Geographical spread (larger societies) and out of area lending (regional and local societies);

(9) Business sector for commercial lending.

6.5.8 G If societies do not use exposure limits for controlling their mix of lending, they should have an alternative method, as effective as exposure limits, for controlling the risks in their lending books. Exposure limits should act as early triggers and should be set for lending periods (e.g. an annual limit) as well as for the lending book as a whole.

Management information

6.5.9 G Societies should produce adequate and focused management information to monitor the performance of new lending and of the whole lending book against the risk parameters set down in the society's lending policy.

Lending to staff or directors

6.5.10 G Societies should have a board-approved policy on staff lending, setting out whether or not the same criteria (e.g. on income or LTV), are used for staff as for other customers, how ability to repay is assessed, what concessionary terms are available and how staff in arrears will be treated. Staff lending on concessionary terms not available to ordinary borrowers should also be the subject of a separate periodic report to the board. Societies must meet the requirements of sections 65 and 68 of the 1986 Act regarding loans to directors and persons connected with directors.

6.6 Lending Nature Limit

6.6.1 G Societies remain subject to the lending nature limit i.e. at least 75% of business assets must be in the form of loans fully secured on residential property. "Business assets" is a convenient, but non-statutory, collective term for a society's total assets (or total group assets, where appropriate) plus any provision for bad or doubtful debts, less liquid assets, fixed assets, and any long-term insurance funds (see section 6 of the 1986 Act). “Residential property” is defined in section 5(10) of the 1986 Act as “land at least 40 per cent of which is normally used as, or in connection with, one or more dwellings, or has been, is being, or is to be developed or adapted for such use”.

6.6.2 G The Building Societies (Prescribed Equitable Interests) Order 1997 (SI 1997/2693) enables loans secured by any of three kinds of equitable security interests in property to qualify as fully secured on residential property if eligible in all other respects, and therefore count towards the lending nature limit. Loans fully secured on residential property in the European Economic Area (including here, the Channel Islands, the Isle of Man and Gibraltar) qualify for inclusion in the lending nature limit (section 6A(1)(c) of the 1986 Act).

6.7 Non-traditional Lending

6.7.1 G Societies entering into new areas of lending, including lending to business (whether secured on residential property or not) and unsecured personal lending, should:

(1) enter the new area in a carefully controlled way so that experience can be gained without incurring an unacceptable level of risk during the learning period;

(2) have the necessary range of skills at management and board levels adequately to assess, manage and monitor the risks that arise;

(3) have clearly defined and documented systems of control established before entering the new area, including the establishment of new organisational structures, such as a credit committee, where appropriate;

(4) ensure that they obtain an adequate return on the new business, taking account of the risks;

(5) employ appropriate professional advisers in the development of the activity, including legal advice on any new loan structures, documentation or security types, and specialist valuers.

Syndicated Lending

6.7.2 G Societies may undertake syndicated lending, secured or unsecured, with one or more other co-participant(s) and whether, if the lending is secured, the security is held jointly or through a trustee. Syndicated loan assets can count towards the lending nature limit as provided in section 6(13) of the 1986 Act.

6.7.3 G Lending policy statements should address the additional risk aspects of syndication, including:

(1) Limits: societies should set transactional limits for syndicated loans (e.g., size of participation and underwriting commitment) and an overall limit on the total of syndicated loan assets;

(2) Loan and borrower types;

(3) Systems and procedures: including experienced staff and access to appropriate professional advice;

(4) Specialist Documentation;

(5) Pricing;

(6) Other parties: societies should consider which other institutions (or category of institutions) are considered as arranger/agent/trustee in a syndicated loan.

6.7.4 G Syndicated lending for market/consortium type credits is a complex activity, requiring special expertise on the part of the lender. The amounts involved may be large compared to normal lending, and the margins can be small for prime borrowers or where there is competition between lenders to acquire the business. There can be significant benefits for lenders, but the associated risks also need to be considered. Societies should weigh these risks and rewards before deciding whether to put in place the personnel and systems to enable them to participate in the market.

6.8 Arrears Management

6.8.1 G Rule 6.2.2 requires that each society include an arrears management plan within its lending policy statement. Success in managing arrears is based on early contact with borrowers in difficulty and good management information.

6.8.2 G Management information for reporting arrears should be comprehensive so that senior management and the board can monitor trends in arrears cases as they flow through the various bands of severity. A society's arrears position should be reviewed at senior level not less than monthly. The analysis of arrears for traditional mortgage lending should also track the performance of groups of loans which have characteristics in common, such as analysis by product, by cohort of lending, by geographical region, by LTV band, by size of loan, by income criteria, and by source (introducer, branch, mandate holder). Societies with significant exposures to commercial lending should produce a similar analysis by features such as business sector.

6.8.3 G Regular arrears analysis allows societies to identify the characteristics of lending most likely to lead to arrears and societies should regularly review their lending policy statements (and, if applicable, credit scoring systems) to ensure that exposure to those types of loan identified by the arrears analysis as "riskier" is adequately controlled. If the analysis reveals that, for example, loans in the 95%+ LTV band consistently generate arrears significantly worse than average, steps should be taken to minimise the risks from those loans, including the possibility, if arrears are extreme, of ceasing to undertake such business completely.

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7 LARGE EXPOSURES

CONTENTS

7 Large Exposures

7.1 Introduction

7.1.1 G This chapter replaces PN 1998/7 issued by the Commission. It implements the large exposures provisions of the BCD for building societies. It also sets out rules and guidance on monitoring, controlling and reporting of large exposures by societies to the FSA.

7.2 Scope of this Chapter

7.2.1 G The purpose of the large exposures provisions of the BCD is to limit and control the extent to which credit institutions may commit themselves to large exposures to counterparties individually and in aggregate. Large exposures to a single counterparty and to a limited number of counterparties can create concentrations of risk in the balance sheet of a credit institution. It is the responsibility of each society's board to set its own limits for large exposures, within the general framework set by the BCD and the rules and guidance specific to societies contained in this chapter. The limits set out in this chapter are maxima. Each society should set its own prudential limits in order both to avoid the over-concentration of risk referred to above and to allow a margin for manoeuvre so as to ensure that the limits set out in this chapter can never be exceeded. Each society should set its own internal limits at a lower level than the maxima set out in this chapter.

7.2.2 G The large exposures provisions of the BCD cover all commercial asset exposures, liquid asset exposures, off balance sheet items and exposures to connected undertakings. The limits set out in this chapter therefore apply to all these areas. It should be noted that asset exposures where no counterparty is involved are not covered by the BCD (for example, fixed assets).

7.3 Definitions

7.3.1 G Under the terms of the BCD an exposure means any of the assets or off balance sheet items referred to in Article 43 or Annexes II and IV of the BCD respectively, before the application of risk weightings and credit conversion factors. Those items that are relevant to building societies are identified in Annexes 1B and 1C of chapter 1. In the BCD, an exposure to a counterparty or group of connected counterparties is defined as a large exposure where its value is equal to or exceeds 10% of own funds. The calculation of own funds for building societies is explained in chapter 1, particularly in Annex 1A.

7.3.2 G The BCD excludes from the definition of "exposure" the following:

(1) all elements entirely covered by own funds provided that such own funds are not included in the calculation of the solvency ratio or of other monitoring ratios provided for in Community acts;

(2) in the case of foreign exchange transactions, exposures incurred in the ordinary course of settlement during the 48 hours following payment;

(3) in the case of transactions for the purchase or sale of securities, exposures incurred in the ordinary course of settlement during the five working days following payment or delivery of the securities, whichever is the earlier.

7.3.3 G A society considering the use of the option in paragraph 7.3.2(1) should consult the FSA well before it commits itself to a large exposure. The FSA will consider requests from societies wishing to exercise the option on a case by case basis.

7.3.4 G The calculation of the amount attributable to an off-balance sheet exposure follows the methodology established in the BCD and explained in Annex 1C. Full risk items are counted at full nominal value. For interest rate and foreign exchange contracts, the method set out in Annex 1C is to be used, but without any risk weighting by counterparty.

7.3.5 G Exposures are connected where a group of counterparties are connected: a group of connected counterparties is defined in the BCD as:

(1) "two or more natural or legal persons who, unless it is shown otherwise, constitute a single risk because one of them, directly or indirectly, has control over the other or others; or

(2) two or more natural or legal persons between whom there is no relationship of control but who are to be regarded as constituting a single risk because they are so interconnected that, if one of them were to experience financial problems, the other or all of the others would be likely to encounter repayment difficulties".

7.3.6 G Control in this context means the relationship between a parent undertaking and a subsidiary undertaking, as defined in Part VII of the Companies Act 1985 or Part VIII of the Companies (Northern Ireland) Order 1986 (which implemented Article 1 of Directive 83/349/EEC), or a similar relationship between any natural or legal person and an undertaking. All individual exposures to the same counterparty or to a group of connected counterparties should be aggregated for the purpose of calculating a large exposure.

7.4 Controls on Large Exposures

7.4.1 G In accordance with the BCD, large exposures of societies which do not have any subsidiary undertakings should be monitored on an unconsolidated basis. Large exposures of societies with subsidiaries should, in general, be monitored on a fully consolidated basis. The basis of consolidation should be that set out in chapter 1. For convenience, the term "supervised group" is used in the following paragraphs to refer to a society and those subsidiaries subject to consolidated supervision, taken together, and in relation to a supervised group "own funds" means the consolidated own funds of the group. Intra-group exposures (i.e. exposures to connected undertakings) are covered separately in paragraphs 7.5.1 to 7.5.3.

7.4.2 G In accordance with the BCD the following limits will apply:

(1) A society or supervised group should not incur exposure to an individual counterparty or group of connected counterparties in excess of 25% of own funds;

(2) the aggregate of all large exposures of a society or supervised group should not exceed 800% of own funds; the aggregate of these exposures should not exceed 300% without the FSA's written approval.

7.4.3 G The BCD allows certain exemptions from the limits on large exposures, giving the competent authorities in each Member State the discretion to use these as appropriate. It also allows for certain exposures to be reduced by the application of weighting factors (in effect, partially exempting those exposures). The exemptions which the FSA allows societies are set out in section 7.8.

7.5 Exposures to Connected Undertakings

7.5.1 G The BCD takes a different approach to the control of exposures by a credit institution to counterparties with which it is connected (i.e. typically to other companies in the same group). Under Article 49.2, subject to applicable exemptions, all such exposures, collectively, are subject to a single aggregate limit of 20% of own funds. Building societies, however, have two particular features which are not shared by the generality of credit institutions. First, a building society will always be the parent entity in a group; it cannot be a subsidiary nor form a minor part of a diversified non-financial conglomerate. Second, under the 1986 Act, as originally enacted, building societies were able to carry out certain activities only through subsidiary companies or other associated undertakings. Although subsequent legislation allows activities to be carried out by the parent society which previously had to be carried out by subsidiaries, the FSA anticipates that societies may still wish to carry on certain activities in dedicated subsidiaries. Given this, the FSA applies, in relation to the single aggregate limit of 20% of own funds, an exemption for all exposures to a society's own subsidiaries that are subject to consolidated supervision. At the same time, the FSA limits exposures to individual subsidiaries to 20% of own funds.

7.5.2 G The FSA's approach to consolidated supervision in relation to capital adequacy is set out in chapter 1, including the criteria for excluding a subsidiary undertaking from the calculation of the consolidated solvency ratio. The same approach will apply to the control of large exposures. The limits on a society's exposures to counterparties connected with it are therefore as follows:

(1) in relation to any single subsidiary undertaking or sub-group of subsidiary undertakings within the supervised group, the society may not incur an exposure in excess of 20% of own funds;

(2) the aggregate of all exposures of the supervised group to counterparties connected with the society but outside the supervised group may not exceed 20% of own funds;

(3) large exposures to counterparties connected with the society still count towards the overall limit of 300% of own funds (or 800%, if the FSA agrees as set out in paragraph 7.4.2(2)) unless otherwise exempted.

7.5.3 G The FSA will also allow further partial exemption to societies in respect of exposures of the kind referred to in paragraph 7.5.2(1). This exemption will draw upon the principle of solo consolidation described in section 1.11. An exposure of the kind referred to in paragraph 7.5.2(1) will be exempt from the limits on large exposures in paragraphs 7.5.2(1) to 7.5.2(3) where it is agreed by the FSA that the subsidiary undertaking concerned may be solo consolidated. Subsidiary undertakings which fall into this category will probably be those undertaking core business but where the society has decided for structural reasons to undertake the business through a subsidiary. Section 1.12 sets out the criteria under which the FSA considers applications for solo consolidation for mortgage subsidiaries. In other cases, societies will need to explain on what basis they consider it appropriate or necessary for solo consolidation to be granted. In all cases, the society should specify the maximum exposure that it is planning to incur.

7.6 Reporting and Notification of Large Exposures

7.6.1 G The FSA may require large exposures to be reported quarterly and has included reporting of large exposures on a consolidated basis in Table L of the quarterly return QFS1 for building societies. Table L of QFS1 also collects additional information on off balance sheet exposures.

7.6.2 R A society contemplating a new exposure which will exceed 20% of own funds (or when aggregated with an existing exposure to the same counterparty or group of connected counterparties would exceed 20% of own funds) must give prior notification to the FSA of such exposure, before making any commitment, using the standard reporting form, LEPR1.

7.6.3 R Exposures of between 10% and 20% of own funds must be reported by each society to the FSA. This information should be reported quarterly by means of Table L of QFS1.

7.6.4 G If a society exceeds the 300% aggregate limit (or the 800% limit, if the FSA so agrees), this should be reported immediately to the FSA in writing.

7.6.5 G Societies should also report to the FSA within two months of the end of their financial year:

(1) confirming that the criteria under which solo consolidation was granted continue to apply. If any do not continue to apply, details of the changed circumstances should be provided;

(2) confirming that the activities of the subsidiary undertaking(s) continue to be limited to those engaged in at the time that the FSA approved solo consolidation;

(3) in respect of each case where solo consolidation has been granted, the amount of the current exposure.

7.7 Systems: Rules and Guidance

7.7.1 R Each society must maintain adequate systems and controls which enable it to:

(1) monitor and control its large exposures in accordance with its large exposures policy (referred to in Rule 7.7.3); and

(2) make timely and accurate reports to the FSA on its large exposures.

7.7.2 G Each society should ensure its internal audit programme covers the system for monitoring and control of large exposures.

7.7.3 R Each society must set out its policy on large exposures as part of its Financial Risk Management, Liquidity and Lending Policy Statements.

7.7.4 G Paragraphs 4.2.5, 4.2.6, 5.2.7, 5.2.9, 6.2.2 and 6.2.3 contain rules about policy statements and rule 7.7.3 should be read in conjunction with those rules.

7.8 Exemptions

7.8.1 G This section sets out the exemptions which the FSA allows to societies. In some cases, the FSA allows partial exemption by applying a weighting to the asset amount. The weighting of asset items means multiplying the asset value in the balance sheet by the percentage weight and including the weighted amount in any calculation of large exposures. This process is distinct from, though having some similarities to, the risk weighting of asset items for solvency ratio purposes and it is important that the two processes, and the respective weightings, are not confused.

7.8.2 G Assets constituting claims on the central government or central banks of Zone A countries are fully exempt. Annex 1G defines Zone A and contains a full list of current Zone A countries. Although the Channel Islands, Gibraltar, Bermuda and the Isle of Man may be regarded as OECD members for the purpose of calculating a society's solvency ratio they may not be so regarded for large exposure purposes.

7.8.3 G Assets constituting claims carrying the explicit guarantee of the central governments or central banks of the countries set out in paragraph 7.8.2 are fully exempt.

7.8.4 G Other exposures attributable to, or guaranteed by, the central governments or central banks of the countries set out in paragraph 7.8.2 are fully exempt.

7.8.5 G Asset items and other exposures effectively and legally secured by cash deposits with the society or with any subsidiary undertaking of the society which is also a credit institution (defined in the BCD as an undertaking with both a deposit taking and a lending business) are fully exempt. Societies should note that this definition excludes most existing subsidiaries.

7.8.6 G Claims on and exposures to other credit institutions (including to other building societies) are subject to weightings, for the purpose of calculating exposures, as follows:

(1) Maturity of one year or less: 0% (i.e. fully exempt);

(2) Subject to prior written agreement from the FSA, societies' derivative exposures to banks, other building societies and investment firms subject to the Capital Adequacy Directive (CAD) (or subject to a regime that the FSA deems to be equivalent to CAD) with a maturity of over one year but under three years: 20% (i.e. partially exempt)

except where the exposure represents the own funds (as defined in the BCD) of the other institution (e.g. subordinated debt), in which case the exemption does not apply.

7.8.7 G Societies should note that the exemptions in paragraph 7.8.6 do not apply to their own subsidiaries, which also happen to be credit institutions or investment firms subject to CAD.

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8 MORTGAGE INDEMNITY INSURANCE

CONTENTS

8 Mortgage Indemnity Insurance

8.1 Introduction

8.1.1 G This chapter replaces PN 1998/8 issued by the Commission and contains rules and guidance for societies on mortgage indemnity insurance. The acronym MIG (Mortgage Indemnity Guarantee) is used throughout, as it is widely understood as shorthand for mortgage indemnity insurance.

8.1.2 G The chapter outlines the types of cover available to societies to protect themselves against the risks of high loan to value ("LTV") lending. These include the use of a captive insurance company, excess of loss and self-insurance as well as MIG provided by an external insurer, which may be the preferred option for most societies. The chapter sets out factors the FSA will take into account in assessing the adequacy of a society's policy for protecting itself against high LTV risk and comments briefly on capital adequacy and systems.

8.2 Rules

8.2.1 R A society undertaking any new lending at a high LTV ratio must have an adequate policy in place to provide protection against the greater risks involved with such lending. In this rule, "high LTV" means lending with an LTV ratio in excess of 80%.

8.2.2 G The extent of the protection in place will be a factor in determining the society's threshold solvency ratio. Factors that the FSA will consider in assessing the adequacy of the policy required in 8.2.1 are set out in the guidance in the rest of this chapter.

8.3 Factors the FSA will consider in assessing compliance with rule 8.2.1

8.3.1 G In deciding how to manage risk from high LTV lending, societies should assess the monetary value to them of the types of cover available and consider the risks and benefits associated with each type of cover, including the losses they could bear. They should assess the systems and accounting implications of changes to the type and level of cover provided.

8.3.2 G Societies have a number of options for managing risk from high LTV lending. They may dispense with MIG altogether, in conjunction with a change to lending policy to "re-balance" the risk profile of the society's loan portfolio. They may continue MIG cover on the best terms available or approach alternative MIG insurers, to establish whether cover on better terms than the standard MIG contract is available. They can consider other forms of insurance, such as excess of loss, self-insurance, and use of a captive insurance company.

8.3.3 G Whilst societies should regard the covenant of the borrower as their principal source of repayment, a comfortable margin in the value of the security is of vital importance. Past experience suggests that it would be imprudent to continue with high LTV lending without obtaining some form of additional protection against the risks involved.

8.3.4 G Therefore, societies undertaking high LTV lending that end their MIG cover and put nothing else in its place, should reduce substantially the proportion of new high LTV lending they undertake. If societies in this position decide not to reduce the level of high LTV lending, the FSA will take into account the society's increased risk profile in setting its threshold solvency ratio.

8.3.5 G The remainder of this chapter focuses on the types of protection against high LTV risk which are available.

8.4 Captive Mortgage Indemnity Insurance Companies (MIG Captives)

8.4.1 G The use of a MIG captive can be a sensible way to manage risk from high LTV lending. This section sets out the factors the FSA will take into account when assessing whether the use of a captive by a society meets the requirement in rule 8.2.1.

8.4.2 G A captive is a means of retaining and managing risk, wholly or partially, within the group. A society should first consider whether, and to what extent, it wishes to retain risk before deciding on any particular mechanism for risk retention. It should consider what its objectives are for high LTV risk and then assess how various forms of cover, including a MIG captive, could meet the objectives. Under the standard MIG contract, the lender retains a significant portion of risk and a captive may be a suitable means for managing that risk.

8.4.3 G A captive could take on all or part of the society's mortgage indemnity business. A wholly-owned captive should not provide unlimited MIG cover to its parent society: cover should be capped in some way, perhaps with a limit on claims arising from any one year's lending. The terms of cover provided by the captive to the parent, and the premiums charged, should be reviewed at least annually. Very generous cover may mean that the captive cannot fully meet the claims on it, and if a captive is unable to meet those claims the loss will revert to the society.

8.4.4 G For smaller societies an "association captive", owned by a group of societies, can be suitable for handling their mortgage indemnity risks. There may be practical difficulties involved, for example, the need for each society to be comfortable with the lending policy of its fellow-owners and the need to pool information. Proper oversight is likely to be more difficult when a captive is multi-owned.

8.4.5 G Society MIG captives should normally be wholly-owned by one or more building societies and provide MIG cover only to the owner society/societies (or to respective subsidiaries). Any scheme which envisages wider ownership, writing MIG business for other lenders or other lines of insurance business should address the different risks involved. Such a company would, of course, not be a pure MIG captive and the FSA's capital requirements are likely to reflect this.

8.4.6 G Societies should consider how the captive will set its premiums. A sensible starting point might be the amount paid for the equivalent external MIG cover and information about the society's lending book, and its claims propensity, should be collected to enable the business to be rated accurately in future. Initial assumptions about the size and frequency of claims should be tested against actual experience. If the captive underprices the cover it may be difficult for the society, because of borrower resistance or competitive pressures, if the captive were to increase premiums later.

8.4.7 G Societies should consider over what period income can prudently be recognised by the captive, having regard to industry good practice for this kind of business and the likely timescale for emergence of claims. Regular reviews should compare the profit earning period chosen with actual claims experience. Societies should undertake detailed financial modelling to show what premium the captive can be expected to receive and what claims will arise for each annual tranche of lending over, say, a 10 year period. This will involve a full analysis of the performance of the society's mortgage book and societies should take the appropriate professional, including actuarial, advice.

8.4.8 G A captive is an appropriate vehicle for carrying normal MIG losses but is unsuitable for bearing exceptional losses over and above the normal level. Societies with or intending to establish MIG captives should obtain reinsurance to cover the risk of exceptional losses. Societies should consider what price the captive can pay for reinsurance and still remain commercially viable. Societies should also assess the terms on which reinsurance cover is offered, especially any restrictions on lending criteria, the financial standing of the re-insurer and its commitment to the MIG market.

8.4.9 G A captive may be exposed to greater risk in its early years of operation and societies should consider additional protection during this period. A captive may, for example, take out financial reinsurance or finite risk insurance to smooth cashflow.

8.4.10 G A captive needs capital to ensure that it can meet claims in all circumstances. In setting capital for a captive, societies should consider whether the captive is robust enough to weather exceptional losses arising from a "severe adverse case". Such a case might include high interest rates, a high level of borrower default and falls in both house prices and turnover - comparable to the worst experience during the period 1989-1992. It would be reasonable to assume that the "severe adverse case" would affect three consecutive years' lending.

8.4.11 G The captive should assess its probable maximum liability to claims at any one time, on each year of lending, based on a "severe adverse case". The residual risk to the captive from each year of lending can be calculated taking into account this probable maximum liability, capped by reinsurance if used, and offset by the amount built up from net premiums and investment income. This is the “risk gap” for that year of lending. The relevant local insurance supervisors (most captives are located offshore) will impose their own capital requirements, and the FSA expects societies to comply with these. However, societies and their advisers should develop their own methodologies for assessing the prudent level of capital for the captive over and above the regulatory minimum. The FSA will take into account the society’s methodology for setting capital (including the concepts set out above) in assessing the adequacy of a society’s policy for managing high LTV risk.

8.4.12 G A society may either make the full amount of its capital commitment available immediately to the captive as fully paid share capital or keep part of its commitment in reserve. At least the capital requirements of the local insurance supervisor should be met through fully paid share capital. Societies can provide part of the overall capital commitment in the form of issued but uncalled, or partly paid share capital - where the captive is entitled to call for payment at any time and at its sole discretion.

8.4.13 G For solvency ratio purposes, a subsidiary MIG captive should be included in the consolidated calculation in accordance with Chapter 1 (Solvency). In calculating the society only solvency ratio, the FSA has adopted a composite treatment for building societies which recognises both that the capital invested in the captive bears a heavier risk of loss than the generality of investments in subsidiaries, and that the captive bears only the society's own lending risk and is not using its capital to "gear up" and assume new external liabilities. Of the total capital committed to the captive, whether fully paid or not, 25% (or, if greater, the capital requirement of the local insurance supervisor) should be deducted from the society's own funds, in the society-only calculation. The remainder should be risk-weighted at 100% as an investment in a subsidiary.

8.4.14 G Societies should consider where any captive should be domiciled and the choice of location should be made according to clear criteria (including convenience to facilitate effective oversight). Whichever location is chosen, the captive will need to obtain authorisation from the local supervisory authority and the FSA will communicate with that body about any application for authorisation.

8.4.15 G The society should put in place controls to oversee the operation of its captive. The captive should be overseen at a high level within the society and within a department (e.g. finance) independent of the lending/marketing function. The society should consider what regular information the captive should provide to the parent to enable proper oversight.

8.4.16 G The captive managers should meet regularly with the captive's board to discuss issues such as the adequacy of reserves and premium rates. The FSA also expects societies to commission an external review of the performance of the captive including actuarial advice on the same issues, say every two years, with a minimum of every three years.

8.4.17 G Local insurance supervisors have detailed rules about the type of asset which count towards the captive's solvency margin. The captive's investment policy should be clearly documented, specifying acceptable types of instrument and counterparties. The captive's directors should set investment policy rather than the captive managers or fund managers. In the early years of the captive's life, the funds should be invested in a prudent combination of bank/building society deposits, government securities and other high quality securities. The captive may deposit funds with the parent society provided the society meets the criteria specified in the captive's investment policy (although local insurance supervisors are unlikely to permit the captive to deposit 100% of its funds back with the parent).

8.4.18 G Societies may consider arrangements whereby a third party, such as a UK composite insurer, owns a captive insurance company which "rents" underwriting capacity to a society for its own MIG business (known in the market as a "rent-a-captive"). Any society intending to follow this route should consider the basis of the cover and the availability of reinsurance cover and, as a result of these factors, how much risk it retains.

8.4.19 G The activities of society-owned MIG captives may be expanded to enable them to write other business including insurance of other risks incurred by the parent society or another part of the society group and reinsurance of other lines of business originated by the parent society group.

8.4.20 G Where such business is written by society-owned MIG captives, sufficient capital and reserves should be maintained to enable the risk gap for MIG business to be met in full.

For these new lines of business, at least the capital requirements of the local insurance supervisor should be met through fully paid share capital.

8.4.21 G To avoid "double gearing", a society's investment in these new lines of business, and loans of a capital nature to finance such business, should be excluded, in full, when calculating its solvency ratio as set out in Chapter 1 (Solvency).

8.4.22 G Capital and reserves maintained for MIG business should be legally "ring-fenced" from the capital and reserves held to meet new lines of business. Captives should therefore adopt an appropriate and effective legal structure.

8.5 Self-Insurance and Non-Insurance

8.5.1 G Self-insurance is another way of containing high LTV risk. This section sets out the factors that the FSA will have regard to when assessing the adequacy of any policy for managing high LTV risk which uses this approach.

8.5.2 G With self-insurance some or all of the risk is retained by the society and either borrowers are charged a "premium" (e.g. a fee or additional interest) or the society absorbs the cost through self-charging. The FSA will consider either to be a prudent approach, provided charges to borrowers or the level of self-charging is adequate.

8.5.3 G With non-insurance some or all of the risk is retained by the society, but no charge or self-charge is made. In such cases, the society will be deemed to have no protection against the risk associated with high LTV lending and should follow the guidance in paragraph 8.3.4.

8.5.4 G Societies may combine an external MIG policy with self-insurance or non-insurance. This will arise, for example, under the co-insurance arrangements applied by many insurers, where the external MIG covers 80% of the risk but the society retains the remaining 20%. Where a society has a co-insurance arrangement or a cap on claims with their MIG insurers, it should consider what action should be taken in respect of that proportion of the risk it retains.

8.6 Charging for Self-Insurance

8.6.1 G Societies which retain some or all of their MIG risk without using a captive will need a methodology for determining the amount of risk being accepted and the level of charge to borrowers (or self-charging) for carrying that additional risk.

8.6.2 G To assess the level of charge or self-charging required, societies should devise a methodology to assess the relative risk from differing loan products, borrower types and types and location of property. Such a methodology should use historical statistical information evaluated using a range of assumptions (future interest rates, property prices etc). Independent specialist advice (e.g. from a firm of actuaries) is highly desirable.

8.7 Excess of Loss Insurance

8.7.1 G Excess of loss or stop loss insurance is another way of protecting against risks arising from high LTV lending. Such policies meet claims once a certain threshold loss to the society (the excess or deductible) has been reached. They usually have a defined upper limit, after which losses revert to the society, and they may involve an element of co-insurance.

8.8 Mortgage Book Acquisitions

8.8.1 G Societies should also consider the risks arising from high LTV lending where they have acquired the loans through a mortgage book acquisition. Following completion of the transaction, the principles of this chapter should be applied to the portfolio of loans acquired. Societies should also ensure that any captive acquired meets the rule and guidance in this chapter within a reasonable time of the acquisition.

8.9 Capital Adequacy

8.9.1 G As set out in Chapter 1 (Solvency), the FSA will consider the lending policy and the MIG arrangements of each society when reviewing its threshold solvency ratio. The assessment will focus on the degree of risk accepted or retained by the society rather than the mechanism used to manage the risk.

8.9.2 G However, the FSA considers that the magnitude of risk retained by a society that either self-insures its entire MIG risk on-balance sheet, or places its entire MIG risk with a captive without reinsurance or takes no action to cover the uninsured portion of MIG risk under the standard external contract, is such that, other things being equal, the FSA is likely to raise that society's threshold ratio.

8.10 Systems

8.10.1 G Societies should ensure that their systems are adequate to monitor and control the risks arising from high LTV lending. (Systems should, of course be adequate to monitor and control all lending, but this chapter focuses on high LTV lending). For example, where societies self-insure, they should operate adequate systems for collecting charges from borrowers (or self-charging) and should set up systems to collect data on the performance of the loan book to help them set appropriate charge levels and assess likely future losses. Where any kind of captive arrangement is used, a society's systems should collect data on the performance of the loan book to refine the underwriting, pricing and reserving/reinsurance policies of the captive.

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9 SYSTEMS

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9 Systems

9.1 Introduction

9.1.1 G This chapter replaces PN 1996/4 issued by the Commission. It contains rules and guidance on societies' systems of business control and accounting records. It supplements, for building societies, Principle 3 and the rules and guidance on senior management arrangements and systems and controls in SYSC, in particular, rule SYSC3.1.1 ("a firm must take reasonable care to establish and maintain such systems and controls as are appropriate to its business").

9.2 Rules and Evidential Provisions

9.2.1 R A society must have, and ensure that its subsidiary undertakings, if any, have, a fully-documented system of control.

9.2.1(1) G The guidance in section 9.4 applies to the society and any subsidiary undertakings, unless the context clearly dictates otherwise. It is recognised that it may be more convenient for systems of control of the society and any subsidiary undertakings to be integrated, rather than maintained separately.

9.2.2 G Guidance on the documentation of systems of control is given in section 9.5.

9.2.3 E (1) A society should have an internal audit function (this may be either in house or outsourced to a third party).

(2) Contravention of 9.2.3(1) may be relied upon as tending to establish contravention of SYSC3.1.1.

9.2.4 G Guidance on internal audit is given in section 9.6 and in SYSC 3.2.16.

9.2.5 E (1) A society should establish an audit committee consisting of at least three members who are also non-executive directors;

(2) Contravention of 9.2.5(1) may be relied on as tending to establish contravention of SYSC3.1.1.

9.2.6 G Guidance on audit committees is given in section 9.7 and in SYSC3.2.15.

9.2.7 R A society must maintain, and submit to the FSA, a board-approved corporate plan.

9.2.8 R A society making any significant change to its corporate plan must provide the FSA with a copy of the amended plan as soon as possible after it has been adopted.

9.2.9 G Guidance on corporate planning systems is given in paragraphs 9.4.13 to 9.4.18.

9.3 Accounting Records and Systems

9.3.1 G A society is required by SYSC3.2.20 to take reasonable care to make and retain adequate records (including accounting records) and should have appropriate systems and controls in place to fulfil its obligations with respect to adequacy, access, periods of retention and security of records.

9.3.2 G Every building society is also required, under section 71(1) and (2) of the 1986 Act, to keep accounting records which:-

(1) explain the society's transactions;

(2) disclose, with reasonable accuracy and promptness, the state of the business of the society at any time;

(3) enable the directors properly to discharge the duties imposed on them by or under the 1986 Act and their functions of direction of the affairs of the society;

(4) enable the society properly to discharge the duties imposed on it by or under the 1986 Act.

9.3.3 G The records should contain (see section 71(3) of the 1986 Act) entries in respect of all payments and receipts together with descriptions thereof, entries of all transactions giving rise to, or likely to give rise to, assets or liabilities and a record of the assets and liabilities of the society, in particular of any class relevant to the “nature limits” in sections 6 and 7 of the 1986 Act.

9.3.4 G The main reasons why a building society should maintain adequate accounting and other records are:

(1) to provide the directors and management of the society with adequate financial and other information to enable them to conduct its business in a prudent manner on a day-to-day basis;

(2) to safeguard the assets of the society and the interests of investors;

(3) to assist directors of the society to fulfil their statutory duties in relation to the preparation of annual accounts;

(4) to provide the directors and management of the society with sufficient timely and accurate information to assist them to submit the information required or requested by the FSA.

9.3.5 G To achieve this, the society’s accounting systems should disclose, in an orderly and integrated way, with reasonable accuracy and promptness, the state of the business at any time. The records should be maintained to enable financial and business information to be extracted promptly, so that directors and management can monitor and control the performance of the business, the state of its affairs and the risks to which it is exposed. The nature of, and frequency with which, information is prepared, its level of detail, and the amount of narrative analysis and explanation, and who should receive it, is for directors and senior management to decide.

9.3.6 G More detailed guidance on accounting records and systems is set out at Annex 9A, which is derived from the FSA’s guidance in the Interim Prudential Sourcebook for banks. References in Annex 9A to “banks”, and where appropriate “companies”, are taken to include building societies.

9.4 Systems of Business Control

9.4.1 G A society should have systems to enable the directors to control the conduct of its business and to control the accounting and other records. To exercise proper control over the business, the directors should understand the underlying business activities, and how they are carried out. Directors should have procedures in place to identify and assess the risks which may arise through the conduct of that business. Control objectives should be set for each area of the business, controls established and maintained which address appropriately the identified risks to ensure the prudent conduct of the business in accordance with the society's policies, and compliance with all relevant laws and regulations and the FSA's rules.

9.4.2 G A society is required by SYSC3.1.1 to take reasonable care to establish and maintain such systems and controls as are appropriate to its business. In addition, SYSC3.2.6 requires a society to take reasonable care to establish and maintain effective systems and controls for compliance with regulatory requirements and standards. More detailed guidance on internal control systems is set out at Annex 9B, which is derived from the FSA's guidance in the Interim Prudential Sourcebook for banks. References in Annex 9B to "banks" are taken to include building societies.

Organisational control systems

9.4.3 G Societies are required by SYSC2.1.1 to take reasonable care to maintain a clear and appropriate apportionment of significant responsibilities among its directors and senior managers. In addition, SYSC2.1.3 requires the apportionment of the responsibilities and establishment and maintenance of systems and controls to be overseen by a senior individual. SYSC2.2.1 requires societies to keep an up-to-date record of such arrangements.

9.4.4 G Societies should have:

(1) clearly defined organisational arrangements and a defined structure of authorities, mandates and responsibilities, including reporting lines, which distinguish between decisions to be reserved for the board and those to be delegated to board committees, or managers and employees; and

(2) arrangements for reviewing the compliance with and effectiveness of organisational controls.

9.4.5 G The composition and operation of the board of a society, and the maintenance of a properly defined structure of board committees, are important elements of high level organisational controls (see chapter 3 Boards and Management).

9.4.6 G The directors of a society should ensure that:

(1) the society's overall organisational arrangements are adequately defined and documented, usually through an organisation manual;

(2) the society's decision-making processes, including authority limits and responsibilities, are properly defined and documented, usually through operating manuals; and

(3) compliance with approved authority limits and stipulated segregation of duties is effectively monitored and controlled.

Management information systems

9.4.7 G More detailed guidance on information for management is set out at paragraphs 6-8 in section 3.2.3 of Annex 9A.

9.4.8 G The board and management of a society should satisfy themselves that:

(1) the information available is sufficient to enable the board to measure, manage and control risks identified in accordance with paragraph 9.4.1;

(2) the information available is sufficient for a proper assessment of the potential risks for the society and the proper determination of its need for capital and liquidity;

(3) the information available is sufficiently comprehensive to provide the board with a clear statement of the performance and financial position of the society;

(4) management information reports are prepared for the board and management on a regular and timely basis, consistent with the dynamics of the business area reported on. Such reports should allow exposure to be monitored against limits and other parameters set by the board;

(5) actual performance is compared with prior periods and with budgeted performance at least quarterly and that significant variations are highlighted and explained;

(6) sufficient attention is focused on key factors affecting income and expenditure, including capital expenditure, and that appropriate performance indicators are employed;

(7) management information is accurately prepared from the underlying accounting and other records and is presented in a clear, consistent and understandable way.

9.4.9 G The form and content of management information should be reviewed regularly. It should be appropriate and relevant to the current business of the society and to market conditions. Such information should include financial information and other matters such as current market conditions and trends, reporting on the control environment and the status of any current control issues, and the extent of achievement of quantitative and qualitative business targets. Information should clearly indicate the extent of future commitments, as well as the current position arising from treasury management operations.

9.4.10 G In forming a view on whether the management information system is sufficiently comprehensive, the board and management of a society should consider whether the information made available to them provides, for both the society and, where applicable, the group, a clear statement of:

(1) the capital position;

(2) the liquidity position;

(3) the exposures arising from treasury management operations, including an analysis of off-balance sheet positions;

(4) profits and losses, assets and liabilities, and funds flows;

(5) the profitability of products, services and subsidiary undertakings;

(6) the balance sheet ratios in relation to the lending and funding limits in sections 6 and 7 of the 1986 Act;

(7) the society's actual exposure, in those areas where the board has set a limit, compared to that limit.

9.4.11 G The above matters should be compared against limits, ratios and other parameters set by the board and notified to the FSA or other regulatory authorities.

Information for the FSA

9.4.12 G Information reported to the FSA should be accurate and timely. Societies must complete returns in accordance with the FSA's requirements, set out in chapter 16 of the Supervision Manual, and submit them within the specified timetable. Returns should be reviewed prior to their submission to the FSA at a sufficiently senior level. The procedures should check for consistency between different returns, between the various tables in the same return, and between the returns and information prepared for the board.

Planning systems

9.4.13 G A satisfactory planning system should help a society to comply with its regulatory obligations. It is for each society to decide what is an appropriate planning horizon and to maintain and develop planning systems appropriate to its individual circumstances and the changing business environment.

9.4.14 G Rule 9.2.7 requires each society to maintain, and send to the FSA, a corporate plan. This should deal with longer-term strategic issues, should be reviewed and updated annually and should include:

(1) views on the markets in which the society competes and the society's position in those markets;

(2) identification of the society's strengths and weaknesses, market and other opportunities open to it, and threats to the society's business;

(3) a clear enunciation of the society's strategic aims and action to achieve those aims;

(4) the resource implications of the strategic aims (including information technology, senior management and staff, and financial resources);

(5) financial projections, including sensitivity analyses.

9.4.15 G A corporate plan should not simply consist of a number of desirable aims, but should set out the process for achieving these and within what timescale. The board should ensure that there are appropriate policies and procedures in place to implement the strategic plan, as well as mechanisms to monitor achievement against the plan so that, if necessary, appropriate corrective action may be taken.

9.4.16 G The planning systems of a society should also set, review and revise short and medium-term financial and other objectives, consistent with the society's longer-term strategic aims.

9.4.17 G The planning, detailed budgeting and financial accounting systems and processes should be integrated to enable outcomes to be monitored against plan, and for the feedback of results into management decisions and into the planning process. Some of the key features of such processes are:

(1) There should be clearly-defined short, medium and long-term planning systems, with an unambiguous allocation of responsibilities within the organisation for the development, review, approval and implementation of plans, and for subsequent monitoring of performance against them.

(2) The elements of any plan should be supported by adequate data, obtained from internal and external sources, and by critical analysis.

(3) A range of possible outcomes should be considered, relating to varying levels of risk and/or uncertainty, and their financial impact on profitability and capital strength assessed.

(4) Key indicators should be identified against which actual performance will be tracked. Actual data should be prepared on a basis consistent with the plan, to enable proper comparison to be made.

9.4.18 G Comprehensive arrangements, documented in business recovery plans, should be in place to ensure continuity of business in the event of some unforeseen disaster such as a fire or bomb damage. Information technology ("IT") is an extremely important element, and any business recovery plan should include the possibility of major hardware or software failure. Planning should cover all aspects of a society's business that might be affected, including premises, personnel and external communications. These arrangements should be regularly reviewed and tested to ensure that they work in practice.

Information Technology

9.4.19 G IT is a major feature of any society's business. Mistakes in this area could be very costly to a society, in terms of money, staff resource and market share. The board of a society should be sufficiently knowledgeable and experienced to appreciate the issues involved and be in a position to exercise proper control over IT systems and developments.

9.4.20 G The board and management of a society should address a wide range of IT issues, some of which are set out below:

(1) The society should have an IT strategy which is consistent with its longer-term strategic aims.

(2) Procedures should be in place to ensure that a comprehensive evaluation is made of proposed major IT investment and that the technical and business cases for the investment are clearly demonstrated.

(3) There should be an appropriate allocation of responsibility for IT issues and an organisation structure which is conducive to a strong IT control environment.

(4) The security of data and systems is of paramount importance. Controls should be in place to minimise the risk of unauthorised physical and logical access, or the loss of data. Such controls should cover not only centralised mainframe processing but also remote terminals and stand-alone or linked PCs.

(5) The board should exercise strong control over the development and implementation of new or significantly modified systems. Appropriate technical and project management skills are required and boards should consider seeking expert outside assistance.

(6) Internal audit should have skills and experience to assess the effectiveness of IT controls. Internal audit should be involved in an advisory capacity during

the development of significant new IT systems, to ensure that appropriate controls are in place.

9.5 Documentation of Systems

9.5.1 G Rule 9.2.1 requires a society's system of control to be fully documented. Documents setting out the systems of control should be available to the board at all times. The documentation helps boards to assess if systems are maintained and controls are operating effectively. It also helps those reviewing the systems to ensure that the controls are those that have been authorised, that they are complete and adequate for their purpose. The use of policy statements documenting the society's policy in a particular area (e.g. lending) is an important element of high level controls.

Form of documentation

9.5.2 G The board and management of a society should determine the form of documentation to be adopted. Considerations should including the following:

(1) It should be comprehensive. It should cover all material aspects of the operations and business of the society.

(2) It should be integrated. Separate elements of the system should be interrelated and cross-referred so that the system can be viewed as an integrated totality.

(3) It should identify risks, and the controls and other arrangements established to manage those risks. The controls should be identified and their purpose defined so that their effectiveness can be evaluated and so that the relationship and interdependence with other controls can be established.

(4) It should attribute responsibility for operating the controls. There should be named persons or posts for each control operation, alternatives in case of absence, and continuity of standards of control during absence.

(5) It should state how operation of the control is to be evidenced. Evidence would normally require signatures or initials; records and registers; retention of control documents; staff attendance records.

(6) It should establish a comprehensive and unambiguous control discipline. The instructions should be clear and precise, avoiding expressions in relation to control functions such as “normally” and “if possible”.

(7) It should be suitable for practical, day to day use. The separate specifications of controls should have a practical role in the review and improvement of systems, for example, through the inspection function.

(8) It should be up to date. There should be an accurate description of the system that has been established and is operating. When changes are made to the systems the appropriate systems of control need to be both established and documented by the time the changes become operative.

(9) It should require confirmation of compliance. Managers in branches and other areas of a society’s business are key control points within the overall control system. They should periodically be required to confirm to the board, to the best of their knowledge and belief, compliance with the controls within the system which has been established.

9.5.3 G The content and level of detail required in documentation prepared for directors and senior management may be different from that required in documentation prepared for the use of more junior staff. In the latter case the main purpose of system documentation is typically to guide staff through the clerical and IT procedures. Such material may be detailed and contain only limited coverage of the control procedures applying to the work of that staff member. The board and senior management require a summarised version, with a wider scope and with a greater emphasis on controls. Whatever form of documentation is adopted it should facilitate an understanding of the society’s systems, procedures and controls, at the level appropriate to the user.

9.5.4 G Societies should make explicit the accounting and other controls which are applicable to their systems, in a separate section of a procedures manual or in a separate document devoted to controls.

9.5.5. G Documentation should not be restricted to “lower-level” clerical and authorisation controls applied in transaction processing, but should also cover “high level” supervisory controls and accordingly should deal with:

(1) powers to be exercised only by the board, and powers delegated to others;

(2) the purpose, composition and reporting lines of committees of directors and senior management to whom powers or responsibilities are delegated;

(3) the specific roles, responsibilities and reporting lines of board members, including the Chairman, executive and non-executive directors;

(4) the timing, form and purpose of meetings of the directors and the mechanism whereby agreed board strategies, policies and decisions are recorded and their implementation monitored.

IT controls

9.5.6 G The documentation of IT controls should be integrated within the overall documentation of a society's system of business control. Operating manuals provided by a IT supplier can form a useful part of a society's procedures documentation but it is less likely that such manuals will be in a form which enables them to comprise part of the control documentation. The criteria set out in paragraph 9.5.2 apply equally to the controls surrounding IT systems.

9.5.7 G There will be a number of key controls performed within the IT and computer programs and a society should ensure that it documents all such controls if reliance is being placed on them.

9.6 Internal Audit

Purpose of internal audit

9.6.1 G The purpose of internal audit is to:

(1) provide regular appraisal for management and the board as to the overall effectiveness of the control systems, including all proposed changes, and to recommend improvements where considered desirable or necessary;

(2) determine whether the systems and controls established by management and the board have operated as laid down (in the society's control documentation)

and comply with policies, procedures, laws, regulations and any other relevant requirements;

(3) assess whether financial and operating information supplied to management and the board is accurate, pertinent, timely and complete.

9.6.2 G Societies should ensure that their internal audit function adequately covers, in addition to detailed operational activities, the following areas:

(1) Controls to verify the accuracy and completeness of monitoring returns and other information provided to the FSA.

(2) Controls to ensure compliance with all regulatory requirements.

(3) Broader management controls, such as the controls over business planning, systems for monitoring and reporting on financial performance and other key business indicators.

(4) Controls over new areas of business and other initiatives, whether carried out within the society or through subsidiaries or other associated undertakings.

(5) "High level" controls, including those referred to in section 9.4.

9.6.3 G The board and management of a society should satisfy themselves that the following considerations have been satisfactorily addressed within the context of the scale, range, complexity and pace of development of the society's business and accounting systems:

(1) To maintain its objectivity, the internal audit function should be independent of the functions it inspects.

(2) The internal audit function should have sufficient manpower resources available to it so that it can achieve its agreed objectives.

(3) Qualifications, experience and training of the individuals performing the internal audit function should be adequate in relation to the objectives.

(4) The status and reporting relationship of the head of the internal audit function should be sufficient to maintain the independence and objectivity of the function. The head of internal audit should have the right of direct access at

any time to the highest level of management and the board, including in particular the chairman of the audit committee and the chairman of the society.

9.6.4 G Audit committees have a key role to play in controlling the work of the internal audit function and receiving its reports.

Key elements of an internal audit function

9.6.5 G The key elements of a system of internal audit include:

(1) terms of reference: these should be specified with precision and should include, amongst other matters, scope and objectives of the internal audit function, and reporting requirements. They should be approved by management and the board. Internal auditors will require a wide-ranging access to records and documents, including material prepared for and by the board. They will also need to be empowered to obtain information and explanations from staff at all levels, including directors. The terms of reference should, accordingly, be framed so as to provide such access.

(2) risk analysis: risks identified and the controls put in place by management to address those risks should be considered in each area of the society's business. In this context risk will be much wider than just the risk of pecuniary loss, or error or mis-statement in the accounting records. Reputational risk and wider operational and business risks should also be considered. The adequacy of the controls should be assessed. Weaknesses in control should be drawn to the attention of the audit committee or the board as specified in the terms of reference. Full consideration should be given to the high level controls in place within the society.

(3) audit plan: an audit plan should be developed, covering all aspects of the society's business. The audit plan should identify the scope and frequency of work to be carried out in each area. Audit effort should be focused on those areas identified in the risk analysis as higher risk. However, over a set time-frame, all areas should be covered. The plan should be reviewed and approved by the audit committee before work commences.

(4) detailed programmes: these should set out the specific tests to be performed in each area of the audit plan.

(5) working papers: adequate working papers should be maintained to record the audit planning and execution, principal findings and follow-up action. They should evidence the individual who performed the programmed work, how it was controlled and supervised, and record the conclusions reached, with cross-referencing to the reports made and action taken.

(6) system of reporting: the results of the work performed should be reported to the audit committee, or the board, in accordance with the terms of reference. Such reporting should be carried out on a regular, at least quarterly, and timely basis; obviously serious matters should be raised immediately. The reports should briefly describe the area(s) covered, significant matters arising, recommendations and overall conclusions. Procedures should be established to ensure that recommendations have been implemented or non-implemented validly justified.

9.6.6 G The key elements required for a system of inspection are not affected if internal audit services are outsourced, in whole or in part, to an auditing firm. For smaller societies, in particular, this can be a cost-effective way of obtaining the required level of resource, including appropriate technical skills. However, boards of societies which pursue this route should take into account the guidance in chapter 11 on Outsourcing and consider the following issues:

(1) It is particularly important that clear and comprehensive terms of reference are laid down. These should specify the anticipated total resources to be provided by the audit firm, including total number of man-weeks and staff grades and/or specialisms. The terms of reference should also make clear how, and under what circumstances, the audit firm would be involved in assignments which may not have been specifically contemplated when the annual internal audit plan was drawn up.

(2) Boards should satisfy themselves that the timing and frequency of visits by the audit firm is appropriate for the level of assurance which the board requires,

and will also enable the audit firm to be fully up to date regarding business, and control, developments.

(3) Where there is outsourcing of only one particular element of internal audit – for example, computer audit, or audit of the treasury function - such assignments should be fully integrated into the overall internal audit plan.

Reporting and review

9.6.7 G The board should satisfy itself that the internal audit function is being properly carried out. To enable it to review the overall effectiveness of the inspection function it should consider on an annual basis, or more regularly, the following aspects:

(1) Adequacy of resources, including number, experience and skills of staff within the internal audit function. There may be circumstances, in situations where specific skills are believed to be deficient, when the board considers it appropriate to obtain these skills from an external source. Societies in these circumstances might consider looking to their external auditors. However there is clearly potential for a conflict of interest to arise, regardless of whether the work would be carried out by persons not directly involved in the audit. External auditors should not be involved in this way, except under exceptional circumstances. Societies should discuss such a proposal with the FSA.

(2) Adequacy and scope of planning and work performed, including the allocation of audit effort to each area of the society's business.

(3) Frequency, quality and timeliness of reporting on matters arising from the work of the internal audit function.

(4) Resolution of points and recommendations raised, and reasons for any rejection of major points.

(5) Review of overall effectiveness of the internal audit function.

9.7 Board Review and Oversight

Audit committees

9.7.1 G Ultimate responsibility for the effective operation of a society's systems of control rests with the society's board of directors. As with any board committee, the audit committee should have clear and full written terms of reference, that make clear its role, responsibilities and reporting lines.

9.7.2 G A society's board should establish an audit committee of non-executive directors consisting of at least 3 members. Executive directors should not be members of the committee. If the society's chairman is an audit committee member, he or she should not chair the committee. The internal auditor should report directly to the committee and it is usual for the chief executive, and other executives as appropriate, to attend by invitation at least part of the committee meetings. The external auditors should have direct access to the committee, with or without executives present, and should attend some, if not all, meetings, particularly those where matters such as the year end accounts, or systems, are being discussed. The matters with which an audit committee might be involved include:

(1) the adequacy of the society's systems of business control and, in particular, its arrangements for evaluating risks in relation to its existing and future business and related capital requirements;

(2) the effectiveness of the society's internal audit function, including an assessment of the scope of work performed by internal audit, the nature and timing of internal audit reports and the adequacy of internal audit resources;

(3) the preparation and supervision of internal audit's plan and programme;

(4) the receiving of reports from the internal auditor and reporting to the board on the audit plan together with recommendations for improvements;

(5) the review of the adequacy of management information and other reports made available to the board;

(6) the review of the annual accounts prior to their approval by the board;

(7) assessment of the external audit function.

3.2 Accounting and other records

3.2.1 Introduction

3 The scope and nature of the accounting and other records which a bank should have for its business to be conducted in a prudent manner should be commensurate with its needs and particular circumstances. They should have regard to the factors identified in SYSC3.1.2 and to the manner in which the business is structured, organised and managed, and to the nature, and complexity of its transactions and commitments.

4 The accounting and other records should be located where they will best assist management to conduct the business of the bank.

If the accounting and other records are kept overseas (for example at a UK branch's overseas head office) or by another entity (for example, where processing is outsourced), there should be arrangements which allow local management of the bank to have immediate and unrestricted access to them. In addition, reporting accountants should be allowed access.

3.2.2 General

5 The FSA does not believe it is appropriate to prepare a comprehensive list of the accounting and other records which a bank should maintain. However, they should:-

(a) capture and record on a timely basis and in an orderly fashion, every transaction and commitment which the bank enters into, with sufficient information to explain:

   (i) its nature and purpose;

   (ii) any asset or liability, actual or contingent, which respectively arises or may arise from it; and

   (iii) any income or expenditure, current or deferred, which arises from it;

(b) provide details, as appropriate, for each transaction and commitment, showing:-

   (i) the parties, including, in the case of a loan, advance or other credit exposure, whether (and if so to whom) it is sub-participated;

   (ii) the amount and currency;

   (iii) the contract, rollover, value and settlement or repayment dates;

(iv) the contracted interest rates of an interest rate transaction or commitment;

(v) the contracted exchange rate of a foreign exchange transaction or commitment;

(vi) the contracted commission or fee payable or receivable, together with any other related payment or receipt;

(vii) the nature and current estimated value of any security for a loan or other exposure; the physical location and documentary evidence of such security; and

(viii) in the case of any borrowing, whether it is subordinated, and if secured, the nature and book value of any asset upon which it is secured;

(c) be maintained in such a manner that financial and business information can be extracted promptly to enable management to:-

(i) identify, measure, monitor and control the quality of the bank's assets and safeguard them, including those held as custodian;

(ii) identify, measure, monitor and control its exposures by related counterparties across all products;

(iii) identify, measure, monitor and control its exposures to liquidity risk, and foreign exchange and other market risks across all products;

(iv) monitor the performance of all aspects of its business on an up-to-date basis; and

(v) make timely and informed decisions;

(d) contain details of exposure limits authorised by management which are appropriate to the type, nature and volume of business undertaken;

(a) These limits should, where relevant, include counterparty, industry sector, country, settlement, liquidity, interest rate mismatch and securities position limits as well as limits on the level of intra-day and overnight trading positions in foreign exchange, futures, options, future (or forward) rate agreements (FRAs) and swaps.

(e) provide information which can be summarised in such a way as to enable actual exposures to be readily, accurately and regularly measured against these limits;

(f) contain details of the factors considered, the analysis undertaken and the authorisation or rejection by management of a loan, advance or other credit exposure; and

(g) provide, on a memorandum basis, details of every transaction entered into in the name of or on behalf of another party on an agency or fiduciary (trustee) basis where it is agreed that the bank itself is not legally or contractually bound by the transaction.

3.2.3 Information for management

6 Every bank should prepare information for directors and management so that they can monitor, assess and control the performance of its business, the state of its affairs and the risk to which it is exposed.

(a) This information should be prepared on an individual company and, where appropriate, on a consolidated basis.
(b) The frequency with which information is prepared, its level of detail and the amount of narrative analysis and explanation will depend upon the level of management to which it is addressed. Some types of information will be needed on a more frequent basis than others and it may be appropriate for some to be presented on a basis of breaches from agreed limits by way of exception reports.

7 It is the responsibility of directors and management to decide what information is required and to decide who should receive it. Appropriate management information should be provided to:-

(a) persons responsible for exercising managerial functions or for maintaining accounting and other records;
(b) executives who, either alone or jointly, are responsible under the immediate authority of the directors for the conduct of the business of the bank; and
(c) the directors of the bank.

8 This information should be prepared:-

(a) to show the state of affairs of the bank;
(b) to show the operational results of the business both on a cumulative basis and by discrete period, and to give a comparison with budgets and previous periods;
(c) to provide an analysis of assets and liabilities showing how they have been valued;
(d) to provide an analysis of its off-balance sheet positions showing how they have been valued;
(e) to provide an analysis of income and expenditure showing how it relates to different categories of asset and liability and off-balance sheet positions; and
(f) to show the bank's exposure to each type of risk, compared to the relevant limits set by management.

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3.3 Internal control systems

3.3.1 Introduction

9 The scope and nature of adequate control systems should take account of the matters covered in SYSC3.1.2 and:

(a) the amount of control by senior management over day-to-day operations;

(b) the degree of centralisation and the extent of reliance on information technology.

10 A system of internal control should be designed and operated to provide reasonable assurance that:

(a) all the bank's revenues accrue to its benefit;

(b) all expenditure is properly authorised and disbursed;

(c) all assets are adequately safeguarded;

(d) all liabilities are recorded;

(e) all statutory requirements relating to the provision of accounts are complied with and all prudential reporting conditions are adhered to.

3.3.2 Control environment

11 The strength of the control environment is important for banks, as a weak control environment can undermine an otherwise adequate control system.

(a) A working definition of 'control environment' is provided in Statement of Auditing Standards ('SAS') 300, issued by the Auditing Practices Board:

'Control environment' means the overall attitude, awareness and actions of directors and management regarding internal controls and their importance in the entity. The control environment encompasses the management style, and corporate culture and values shared by all employees'.

12 Factors relevant to the control environment include:

(a) the importance which is attached to controls by management;

(b) the way in which staff are assessed and rewarded (including remuneration and bonus schemes as well as promotion policies);

(c) controls training, and the methods for reviewing control, including internal audit.

3.3.3 High level controls

13 High level controls are the controls which are primarily exercised at director and senior manager level, as distinct from the detailed controls, the operation of which is delegated to others. High level controls typically include:

(a) the setting of strategy and plans. The strategic plan should be documented and consider the external factors that might impact on the business in the near future, for example macro economic factors and competition. The strategic plan should be reviewed annually and is a key document for the production of the annual business plan that will set out how the bank will achieve its goals for the coming year. Some banks may also consider it appropriate to establish trigger points on key indicators to identify adverse trends in the business that would cause the Board to revisit its strategy or business plan. For banks that are part of a larger group, the strategic plan and annual business plan may be produced on an integrated, group-wide basis;

(b) approval of risk policies;

(c) establishment and review of the organisational structure;

(d) the system for delegation;

(e) review of high level management information;

(f) maintaining the framework for monitoring and/or periodic review of risk management and detailed control systems and for the implementation of action points following such a review.

The FSA's requirements for adequate internal control systems will apply to high level as well as to detailed control systems.

3.3.4 The control system: General

14 The FSA does not believe it is appropriate to prepare a comprehensive list of internal control procedures which would then be applicable to any bank, nor is it possible to prepare a detailed list of particular procedures which should be undertaken, where appropriate, by all banks. Nonetheless, internal control systems should provide reasonable assurance that:-

(a) the business is planned and conducted in an orderly and prudent manner in adherence to established policies;

(b) transactions and commitments are entered into in accordance with management's general or specific authority;

(c) management is able to safeguard the assets and control the liabilities of the business;

(d) there are measures to minimise the risk of loss from irregularities, fraud and error, and promptly and readily to identify them when they occur;

(e) the accounting and other records of the business provide complete, accurate and timely information;

(f) management is able to monitor on a regular and timely basis, among other things, the adequacy of the bank's capital, liquidity, profitability and the quality of its assets;

(g) management is able to identify, regularly assess and, where appropriate, quantify the risk of loss in the conduct of the business so that:-

  (i) the risks can be monitored and controlled on a regular and timely basis; and

  (ii) appropriate provisions can be made for bad and doubtful debts, and for any other exposures both on and off balance sheet;

(h) management is able to comply with the FSA's reporting rules (that is to complete returns fully and accurately and in accordance with the FSA's reporting instructions, and to submit them on a timely basis); and

(i) the bank is able to comply with the other notification requirements under the Act.

15 In seeking to secure reasonable assurance that their internal control objectives are achieved, management needs to exercise judgement in determining the scope and nature of the control procedures to be adopted.

  (a) They should also have regard to the cost of establishing and maintaining a control procedure in relation to the benefits, financial or otherwise, that it is expected to provide.

16 It is a responsibility of directors and management to review, monitor and test its systems of internal control on a regular basis in order to assure their effectiveness on a day-to-day basis and their continuing relevance to the business.

  (a) In many banks an internal audit function assists management by providing an independent review of such systems.

  (b) Such a review should be designed to monitor the effectiveness and operation of the systems and to test compliance with daily procedures and controls (see below).

3.3.5 Control objectives

17 The scope and nature of the specific control objectives which should be adopted for the business to be conducted in a prudent manner should be commensurate with a bank's needs and particular circumstances, and should have regard to the manner in which the business is structured, organised and managed, to its size and the nature, volume and complexity of its transactions and commitments.

18 It is not appropriate for the FSA to provide an exhaustive and prescriptive list of detailed control requirements which should apply to all banks. However, the FSA considers that each bank should address the following control objectives:-

(a) Organisational structure: Banks should have documented the high level controls in their organisation which:

  (i) define allocated responsibilities;

  (ii) identify lines of reporting for all aspects of the enterprise's operations, including the key controls and giving outline job descriptions for key personnel.

  (a) The delegation of authority and responsibility should be clearly specified.

(b) Risk management: A bank should document its risk management framework setting out how the risks in the business are identified, measured, monitored and controlled. At a high level this might be documented in a matrix, setting out the key risks in the business e.g. credit, interest rate etc, key control procedures, the person responsible for monitoring the risk, and the type and frequency of management information to monitor each risk (see below).

(c) Monitoring procedures: A bank should have procedures in place to ensure that relevant and accurate management information covering the financial state and performance of the bank and the risk exposures which the bank has entered into is provided to appropriate levels of management on a regular and timely basis. Procedures should also be in place which are designed to provide reasonable assurance of compliance with the bank's policies and practices, including any limits on delegated authority referred to above, and with statutory, supervisory and regulatory requirements.

(d) Segregation of duties: A prime means of control is the separation of those responsibilities or duties which would, if combined, enable one individual to record and process a complete transaction. Segregation of duties reduces the risk of intentional manipulation or error and increases the element of checking.

  (a) Functions which should be separated include those of authorisation, execution, valuation, reconciliation, custody and recording.

  (b) In the case of a computer-based accounting system, systems development and daily operations should be separated.

(c) For smaller banks, segregation of duties can be difficult due to limited number of staff. In such circumstances, the Board should satisfy itself that the bank is not running undue risk and that there are compensating controls in place e.g. frequent review of the area by internal audit and/or executive directors.

(e) Authorisation and approval: All transactions should require authorisation or approval by an appropriate person and the levels of responsibility should be recorded as prescribed above.

(f) Completeness and accuracy: Banks should have controls to ensure that all transactions to be recorded and processed have been authorised, are correctly recorded and are accurately processed.

(a) Such controls include:

(i) checking the arithmetical accuracy of the records,

(ii) checking valuations,

(iii) the maintenance and checking of totals,

(iv) reconciliations,

(v) control accounts and trial balances, and

(vi) accounting for documents.

(g) Safeguarding assets: A bank should have controls designed to ensure that access to assets or information is limited to authorised personnel. This includes both direct access and indirect access via documentation to the underlying assets.

(a) These controls are of particular importance in the case of valuable, portable or exchangeable assets and assets held as custodian.

(h) Personnel: There should be procedures to ensure that personnel have capabilities commensurate with their responsibilities. The proper functioning of any system depends on the competence and integrity of those operating it.

(a) The qualifications, recruitment and training as well as the innate personal characteristics of the personnel involved are important features to be considered in setting up any control system.

3.3.6 Controls in an Information Technology Environment

19 The information held in electronic form within a bank's information systems is a valuable asset that needs to be protected against unauthorised access and disclosure. It is the responsibility of management to understand the extent to which a bank relies upon electronic information, to assess the value of that information and to establish an appropriate system of controls.

(a) The control objectives described above apply equally to operations undertaken in both manual and electronic environments, although there are additional risks associated with electronic environments.

(b) The FSA recognises that this will usually be achieved by a combination of manual and automated controls, the balance of which will vary between banks, reflecting the need for each to address its particular risks in a manner which is cost effective.

20 The types of risk most often associated with the use of information technology in financial systems may be classified as follows:

(a) fraud and theft:

(a) Access to information and systems can create opportunities for the manipulation of data in order to create or conceal significant financial loss. Additionally, information can be stolen, even without its physical removal or awareness of the fact, which may lead to loss of competitive advantage. Such unauthorised activity can be committed by persons with or without legitimate access rights.

(b) Errors:

(a) Although they most frequently occur during the manual inputting of data and the development or amendment of software, errors can be introduced at every stage in the life cycle of an information system.

(c) Interruption:

(a) The components of electronic systems are vulnerable to interruption and failure; without adequate contingency arrangements this can lead to serious operational difficulty and/or financial loss.

(d) misinformation.

(a) Problems may emerge in systems that have been poorly specified or inaccurately developed. These might become immediately evident, but can also pass undetected for a period during which they could undermine the veracity of supposedly sound information. This is a particular risk in systems where audit trails are poor and the processing of individual transactions difficult to follow.

21 Management should be aware of its responsibility to promote and maintain a climate of security awareness and vigilance throughout the organisation. In particular, it should give consideration to:

(a) IT security education and training, designed to make all relevant staff aware of the need for, and their role in supporting, good IT security practice and the importance of protecting company assets;

(b) IT security policy, standards, procedures and responsibilities, designed to ensure that arrangements are adequate and appropriate.

3.3.7 Money laundering deterrence

22 It is a requirement of the Money Laundering Regulations 1993 that authorised banks have policies and procedures in place to guard against their business and the financial system being used for the purpose of money laundering. The Joint Money Laundering Steering Group Guidance Notes ('Money Laundering Guidance Notes for the Financial Sector' revised and consolidated by the Joint

Money Laundering Steering Group in June 1997) provide a practical interpretation of the Regulations. The FSA expects banks to adopt policies and procedures in line with those Guidance Notes.

(a) See also the sourcebook on money laundering.

3.3.8 Outsourcing

23 Authorised banks are required to adequately record and control their business. Where a bank has outsourced an aspect of its operations to another part of the group, or to an external supplier, it should ensure that its records and controls adequately cover that business.

24 Banks should put in place procedures for monitoring and controlling the outsourced operations, and for ensuring that the information requirements of the authorised bank's management with respect to the outsourced operations are satisfied (see chapter OS).

10 Securitisation

10.1 Introduction

10.1.1 G This chapter contains new guidance for building societies on securitisation. It replaces the consultation draft Prudential Note issued by the Commission in June 1994.

10.1.2 G This chapter consists of the guidance for banks on securitisation (chapter SE of the Interim PSB for banks) as amended by additional guidance specific to building societies set out in paragraph 10.1.3 and in section 10.3 of this chapter.

10.1.3 G Save as mentioned in paragraph 10.1.3(2), all of the guidance in chapter SE of the IPSB for banks applies to building societies, with the following amendments:

(1) All references to “banks” should be taken to include building societies.

(2) Section 1.4 (Grandfathering) of chapter SE does not apply to building societies.

(3) In paragraph 5 in section 4.3 of chapter SE, the reference to “a bank’s minimum (or “trigger”) capital ratio” should be read as “ a building society’s threshold solvency ratio”.

(4) In paragraph 7 in section 4.4 of chapter SE, the liquidity implications of securitisation transactions will be assessed for societies by reference to chapter 5 (Liquidity) of this IPSB.

10.2 Areas of the bank guidance which are particularly relevant to societies

10.2.1 G Section 3 of chapter SE outlines the various roles that a bank may play in a securitisation transaction. The following paragraphs direct societies to the parts of the bank guidance that are likely to be most relevant to them.

(1) Societies planning to securitise mortgages currently on their own balance sheets will act as an "originator", as described in section 3.2.1 of chapter SE.

(2) Societies will also act as "servicing agents", as set out in section 3.3.2, where they continue to administer the mortgages after securitisation.

(3) Societies may undertake some or all of the secondary roles described in section 3.3.3.

10.3 Additional guidance for building societies

10.3.1 G This section sets out additional guidance on securitisation for building societies over and above that set out in chapter SE of the IPSB for banks. These additions arise as a result of the particular constitutional structure of building societies and the provisions of the 1986 Act. The FSA will expect societies, when planning to securitise, to consider these issues and to adopt a policy to deal with them.

Principal Purpose and Nature Limits

10.3.2 G Section 5(1) of the 1986 Act provides that *"a society may be established ... if its purpose or principal purpose is that of making loans which are secured on residential property and are funded substantially by its members".* The 1986 Act also gives the FSA certain powers of control in respect of a failure to comply with these provisions. A society will therefore need to ensure that any programme of securitisation does not threaten its continued compliance with its principal purpose.

10.3.3 G The principal purpose is a continuing purpose: it is not just viewed at a single point in time. Whether a society is fulfilling its principal purpose depends on what business it is doing on a continuing basis. For example if, for an extended period of time, a society diverted all its new mortgage business to a special purpose vehicle as part of a securitisation programme, it would arguably not be meeting its principal purpose.

10.3.4 G Sections 6 and 7 of the 1986 Act describe, respectively, the "lending" and "funding" limits, together known as the "nature limits", which are quantitative criteria which help to determine whether an individual society is complying with its principal purpose. Societies should ensure that any programme of securitisation does not threaten compliance with the nature limits. Sections 6(3) and 7(3) of the 1986 Act respectively make clear that only items included in total assets or total liabilities in a society's accounts count towards the nature limits.

Provisions of section 9A of the 1986 Act

10.3.5 G Paragraph 6 (i) in section 6.3 of chapter SE sets out some additional guidance for banks which play a primary role in securitisation transactions in respect of undertaking swaps. In addition to the guidance in that paragraph, building societies should also ensure that any swaps they undertake comply with section 9A of the 1986 Act.

Membership of the society

10.3.6 G As mutual institutions, societies have a special responsibility to their customers which, in the context of securitisation, the FSA considers should include maximum openness with affected borrowers. The relationship between a society and its borrowers is qualitatively different to that between a bank and its borrowers because society borrowers are members of the society. Because of this, the FSA will expect societies, when planning to securitise, to consider the issue of membership and to adopt a Board policy to deal with it, which should include a strategy for handling the affected borrowing members.

10.3.7 G The membership issue will not arise if a society intending to undertake a securitisation transaction originates mortgages directly into a vehicle, so that the borrower does not become a member of the society in the first place. In these circumstances, the FSA considers that societies should make clear to borrowers, when they take out the loan, that they do not have membership rights.

10.3.8 G Societies should bear in mind that if they securitise mortgages by means of an equitable transfer, paragraph 5(2) of Schedule 2 to the 1986 Act means that the relevant borrowers will still be members of the society.

10.4 Transitional provisions

10.4.1 G Any securitisation transaction undertaken by a society before 20 June 2000, which conformed to the guidance on securitisation issued by the Commission, is grandfathered. Accordingly, such a transaction may be treated for capital purposes as conforming with the guidance set out in this chapter, without the need to restructure the transaction. A society should, however, satisfy itself that any new pool of assets securitised through a grandfathered structure conforms with the guidance in this chapter.

SECURITISATION AND ASSET TRANSFERS

1 INTRODUCTION

1.1 Application

1 This chapter applies to a UK banks acting in a *primary role* in respect of a transfer of a single asset, pool of assets or securitised portfolio. Where a bank does not meet the terms of this policy, it should regard the assets as remaining on the solo and consolidated balance sheet.

See s3.2

a) Further details on *primary roles* are set out below.

b) The FSA's policy does not apply to banks incorporated outside the United Kingdom, even if the special purpose vehicle (SPV) is UK-incorporated.

2 Where a UK bank acts in a *secondary role* in respect of a transfer of a single asset, pool of assets or securitised portfolio, this policy only applies in the following circumstances:

(a) Where the bank also acts in a primary role. If the bank fails to follow this policy, the FSA will regard the assets as being on the solo and consolidated balance sheet; or

(b) Where the performer of the primary role is a member of the *consolidated group*. If the bank fails to follow this policy, the FSA will regard the assets as being on the consolidated balance sheet.

See s3.3

a) Further details on *secondary roles* are set out below.

See ch CS

b) The details regarding *consolidated groups* are explained in chapter CS.

3 Where a member of the consolidated group acts in a secondary role in respect of a transfer of a single asset, pool of assets or securitised portfolio, this policy will only apply when the UK bank acts in a primary role. Failure to follow the policy would result in the assets being on the consolidated balance sheet.

4 Where the role policy is followed, the capital consequences are explained below.

1.2 Legal Sources

5 For relevant legal sources see the Legal Sources section of the Capital Overview chapter.

1.3 Notification policy

6 A bank should give prior notification to the FSA when it proposes to act in any of the primary roles, either solely or jointly with one or more other parties. This should take place in reasonable time to allow the FSA to consider the proposal and raise any concerns that it may have.

a) The responsibility for achieving supervisory non-objection to a proposal rests with the bank itself.

1.4 Grandfathering

7 All securitisation transactions completed prior to the 30th December 1999 will be grandfathered.

8 A bank should satisfy itself that a new pool of assets securitised through a grandfathered structure complies with this policy.

1.5 How this chapter is organised

9 Section 2 outlines the principles and objectives that lie behind the FSA's approach to securitisation and asset transfers. Section 3 then explains the various roles that a bank may take within a securitisation. Section 4 highlights the wider implications of the risks to banks that result from securitisation and loan transfers.

Sections 5, 6, 7 & 8 explain the FSA's general policy applicable to a bank acting in a primary role. Section 5 details the methods of transferring risk effectively and the FSA's policy in each case. Section 6 outlines the FSA's policy for all basic asset transfers or securitisations other than on effective transfers. Section 7 details the policy specifically applying to revolving credit securitisations. Section 8 deals with other specialist schemes.

- Sections 9, 10 & 11 outline the policy applying to banks acting in specific secondary roles. Section 9 outlines the policy on the provision of credit enhancement. Section 10 outlines the policy on the provision of liquidity facilities. Section 11 outlines the policy on dealing and underwriting of asset backed securities.

2 SECURITISATION, ASSET TRANSFERS AND THE FSA'S APPROACH

2.1 Background

2.1.1 General

1 An *asset transfer* occurs where an asset owned by a bank is *sold* to another legal entity. In doing so, a bank may remove the asset from its supervisory balance sheet, where the conditions of this chapter are met.

See s5

a) *Sold* means the legal and economic methods of transfer discussed in more detail below.

2 *Securitisation* is generally a process by which assets are sold to a *bankruptcy remote special purpose vehicle* (SPV) in return for an immediate cash payment. The cash payment is raised by the SPV issuing debt securities, usually in the form of tradable notes or commercial paper. A bank performing such a transaction may remove the assets from its supervisory balance sheet, where the conditions of this chapter are met.

a) In a securitisation, the assets are usually transferred to a vehicle existing specifically for the purpose of securitisation called a *special purpose vehicle* (SPV).

b) A *bankruptcy remote* SPV is an entity that is considered by the rating agencies to be unlikely to be subject to voluntary or involuntary bankruptcy proceedings.

c) Although securitisable assets may take other forms, they are generally those with associated streams of principal and interest e.g. mortgages, credit cards and corporate loans.

3 Although this policy is primarily concerned with the sale of loans, the policy also applies to the transfer of other forms of assets.

2.1.2 Rationale for Securitisation

4 A bank may undertake a securitisation for a number of reasons. These include:

- portfolio management;
- reducing the need for capital to support assets on the balance sheet;
- risk management;
- enhancing equity return by allowing the redeployment of capital;

- restructuring the balance sheet for reasons connected with large exposures or sectoral concentrations;
- issuing securities as a means of funding with benefits for both cost and diversification of sources; and
- to provide funding of assets when the originator cannot obtain funding on its own part, for example to fund an acquisition.

2.1.3 The risks involved

5 In the process of transfer, the functions normally carried out by a lending bank are unbundled. Normally, the various risks in a bank's banking book other than credit risk do not warrant special treatment, as the capital needed to cover credit risk helps to protect a bank against these other risks as well. This is no longer the case, however, where the credit risk lies with a third party and a bank solely carries the risks associated with asset administration or promotion.

6 Banks should be aware that although this policy is primarily concerned with capital adequacy, operational and reputational risk may also be incurred. For example, in the transfer of a single asset, the originating bank may have difficulty in avoiding close association with the asset; for a pool of assets, the level of association depends upon the structure used and the number of roles performed. The FSA believes that the risks from close association, which may take a variety of forms with a securitisation scheme, can assume material proportions.

7 The solution for the FSA has been to implement the policy of "clean break". A bank, once it has securitised assets, should not have any further involvement with those assets except in accordance with the policy in this chapter. This should be the case both explicitly and implicitly i.e. any reputational linkage between the assets of the originator/sponsor should be broken so far as is possible.

2.2 Objectives

7 The framework of the FSA's rules is designed to achieve the following objectives, in that:

(a) asset sales and packaging achieve their intended effect of passing rights and obligations from the seller to the buyer. Ideally, a completely clean break should be achieved;

(b) all the parties to the transaction fully understand the responsibilities and risks they have assumed or retained; and

(c) any material risks to buyers or sellers are properly treated in the FSA's supervision of banks.

8 The FSA believes that these objectives are best achieved by ensuring that a transfer achieves the following:

(a) the immediate legal separation of the seller from the assets and their new owner (or the effective economic separation in the case of a transfer by sub-participation);

(b) as far as possible, the complete economic separation of the seller from the assets and their new owner;

(c) presentational or "moral" separation of the seller from the assets and their new owner; and

(d) the identification of the retained risks for capital or other coverage purposes.

3 PRIMARY & SECONDARY ROLES

3.1 General

1 This section outlines the various roles that fall within the scope of this policy.

3.2 Primary roles

3.2.1 Bank as originator

See s3.2.2(b)

2 A bank acts as an *originator* when it transfers from its balance sheet a single asset, an asset package or assets that are not investment grade third party financial instruments.

a) The terms *seller* and *originator* are used interchangeably to mean the bank that is seeking to move assets off its own balance sheet. Note that the terms *seller* and *buyer*, for the party taking on the risk, are used throughout this chapter although in a strict legal sense they may be inaccurate where transfer is by way of sub-participation.

3 Where a bank lends to an SPV in order for that SPV to grant a loan to a borrower as though it were the bank, the bank will be regarded as an originator.

a) This method of lending is known as *remote origination*.

b) The bank is regarded as the originator as the SPV is creating an asset that is branded by the bank. The bank will incur reputational risk through the association with the product.

3.2.2 Bank as sponsor or repackager

4 A bank acts as a *sponsor* or *repackager* when:

(a) As a sponsor, it repackages *third party* assets *directly* into a *conduit scheme* that funds the purchase by an issue of securities.

See s1.1

a) *Third Party* means parties other than the members of the bank's wider accounting group.

b) *Directly* means that the assets have never appeared on the bank's balance sheet.

c) In a *conduit scheme*, the term sponsor is used to describe the bank promoting the securitisation scheme. A sponsor may be connected to the scheme in ways that may open it to "moral" pressures in the same way as an originator.

d) Where there is more than one originator in the securitisation the SPV is known as a *multi-seller vehicle*.

e) The various sellers usually continue to service the assets, carrying out the functions of collection, administration and the pursuit of arrears.

(b) As a repackager, it sells *investment grade* third party *financial instruments* via its balance sheet to an SPV that then rebundles them and resells them to investors.

a) In a *repackaging scheme*, the repackager is *not* the original lender and is therefore subject to fewer limitations than an originator.

b) Where the assets are influenced in credit quality by reference to the repackaging bank, the bank will be regarded as an originator.

See ch TI s9

c) For a definition of *investment grade* see the Interest Rate position risk chapter. Where the securities to be repackaged are not rated, the bank should be able to demonstrate that the assets are of a comparable quality.

See ch CB s3.2.2

d) For the purposes of this paragraph, *financial instruments* are as defined in Section B of the Annex to the ISD.

5 Where a bank repackages assets that are not investment grade third party financial instruments via its balance sheet the bank will be treated as an originator and should comply with the policy relating to that role except where:

(a) the bank acts as sponsor and originates up to 10% of the total assets into the scheme; or

(b) the bank acts as repackager and repackages up to 10% of the total assets in the scheme that are either sub-investment grade securities or securities where it has acted as originator.

Banks should apply the originator treatment for assets falling within this exception, albeit without jeopardising the overall treatment for the scheme.

a) The rule will be applied at the level of the conduit irrespective of any prior SPVs.

3.3 Secondary Roles

3.3.1 General

6 A bank acting in a primary role may also carry out one or more of the secondary roles associated with a securitisation or asset transfer. The number and scope of roles carried out by a bank under a securitised structure affect its treatment under the FSA's policy.

7 If a bank is carrying out only one role, it may be acceptable for it to have greater latitude in that role than if it was carrying out several roles, as the FSA considers the totality of a bank's involvement when assessing the completeness of the clean break and any residual risks.

3.3.2 Servicing agents

8 A bank acts in the secondary role of *servicing agent* when it administers or services the securitised assets.

a) The terms *servicer, servicing agent* and *administrator* are used interchangeably to describe a bank which carries out an administrative function with regard to a securitisation scheme.

9 Where a bank acts as servicing agent, it should satisfy itself that it does not have a reputational obligation to support any losses incurred by the scheme. If a bank is unable to do so, it should comply with the policy applying to an originator.

a) A bank acting as servicing agent can run explicit operational and reputational risks as its identification with the assets can mean that its commercial reputation is committed. The extent of the association depends upon the extent of involvement and the sophistication of the underlying borrowers. The FSA is concerned that a bank in this position may give in to pressure to support losses incurred by the investors/buyers to protect its name.

10 Where a bank acts as serving agent, the bank should be able to demonstrate to investors that it has no reputational obligations to support losses by a clear and unambiguous statement in the offering circular in respect of any implied support.

3.3.3 Other secondary roles

11 A bank acts in a secondary role when it carries out any of the following functions:

See s9 (a) the provider of *credit enhancement*;

a) A *credit enhancement* is provided to an SPV to cover the losses associated with the pool of assets. The level of the enhancement is reflected in the rating given to the notes by a rating agency.

See s10 (b) the provider of *liquidity facilities*;

a) *Liquidity facilities* enable SPVs to assure investors of timely payments. These include smoothing timing differences in the payment of interest and principal on pooled assets and ensuring payments to investors in the event of market disruptions.

See s11 (c) the *underwriter* and *dealer* in securities issued by the SPV;

a) *Underwriting* is the arrangement under which a bank agrees to buy, before issue, a specified quantity of securities in a new issue on a given date and at a given price if no other purchaser has come forward.

b) *Dealing* is acting as principal in both the sale and purchase of notes, in the secondary market of an issued security.

See s10.4.3 (d) the provider of *bridging loans* to the SPV;

a) A *bridging loan* is a loan made to an SPV, before the issuance of the notes, to cover a mismatch in time between the date of purchase of the underlying assets and the date of issue of the securities.

See s6.2.2 (i) (e) the counterparty in swap transactions.

4 IMPLICATIONS OF SCHEMES FOR A BANK'S GENERAL RISKS

4.1 Introduction

1 The following sections of this chapter cover banks acting in a primary and secondary role.

2 No consideration of a securitisation or asset transfer can be concerned solely with the technical rules regarding its structure. It also has wider implications for a bank's risks.

3 The extent of the risks for a bank involved in a securitisation or asset transfer vary according to the comparative size of the bank and the assets involved, as well as the complexity of the structure of transfer.

4.2 Systems & Controls

4 The FSA needs to be satisfied that a bank acting in a primary role has adequate systems and controls in place to deal with all aspects of the securitisation taking place.

a) Some of the systems implications may be significant. The arrangements for controlling the securitisation should be carefully assessed and monitored, and be subject to internal audit.

b) Where appropriate, the FSA may use section 166 reports as part of the monitoring of these systems.

4.3 Operational risks

See ch CO

5 The FSA takes into account any significant operational risks not related to balance sheet items when setting a bank's minimum (or "trigger") capital ratio. In exceptional cases it may wish to apply an explicit capital requirement against this sort of risk.

4.4 Liquidity

6 Where assets may eventually return to the bank's balance sheet, there are particular issues for banks' management of their liquidity.

7 Before the FSA allows assets to be treated as off balance sheet, it needs to be satisfied that the bank can deal with the liquidity implications. These should be handled within a bank's normal liquidity management and assessed using the standard maturity mismatch approach or, in those cases where it is relevant, the sterling stock liquidity approach.

See s7

a) The liquidity treatment of revolving-credit securitisations is dealt with in more detail below.

See s10.4.2 (d)

8 The FSA may require sponsors or repackagers that report on a mismatch basis to meet mismatch guidelines out to six months. Similarly the FSA may require sponsors or repackagers reporting on a sterling stock basis to submit additional information (on a mismatch basis) covering the bank's liquidity out to six months.

See ch LM

9 A bank may be required to arrange committed facilities to be drawn down to the extent necessary to fund assets returning to its balance sheet. The requirements governing these committed facilities will generally be consistent with the FSA's liquidity approach.

a) Likewise the FSA follows its normal approach on the question of the weighting of such committed facilities by the lending bank for capital adequacy purposes.

b) Since such commitments need to be available in circumstances where a replacement securitisation does not prove possible, they should not include a "material adverse change" condition in relation to the bank.

4.5 Capital planning

10 Where assets may eventually return to the bank's balance sheet -such as in a liquidity asset repurchase agreement - there are particular issues for banks' management of its capital. Returning assets could affect the capital adequacy of the bank.

See s10.4.2 (e)

11 Where assets could return to the balance sheet the FSA may request a bank to submit a plan to take account of the possible return of the assets to the balance sheet.

a) A plan should detail how the bank intends *either* to sell the assets, sell other assets or to raise the requisite capital.

4.6 Remaining asset base

12 The process of securitising a significant portion of a bank's assets may lead to a change in the profile of the assets on its supervisory balance sheet, in terms of both quality and spread. These implications are considered when assessing any securitisation scheme and may need to be discussed with the bank.

13 The FSA may impose limits on the extent to which assets may be securitised in terms of total volume and/or the types of assets securitised in comparison to the total asset base.

a) The FSA may regard assets removed from a bank's balance sheet through securitisation, even where the bank complies with the policy in this chapter, as carrying some residual risk to the originator.

5 BASIS OF THE POLICY: METHODS OF TRANSFER

5.1 Introduction

1 The FSA considers that the method of transfer of an asset can have an important bearing on the risks assumed by buyer and seller since different methods achieve the desired 'clean break' to varying extents.

2 Each of the four methods set out below may be used to make an effective transfer of a loan off the supervisory balance sheet. The considerations raised in each case apply in all forms of securitisation or asset transfer; the policies set out in section 6 and elsewhere are additional to the policy for identifying adequate forms of transfer.

Sections 5.2 to 5.4 give the FSA’s position on transfer methods for on-balance sheet items; section 5.6 for assets which are undrawn.

3 Methods of transfer, other than the four described below may be valid, especially with reference to transfers carried out in other jurisdictions. If a bank proposes to rely upon any other method, it should be supported by legal opinion and the prior approval of the FSA should be obtained.

5.2 Novation

4 A transfer of an asset through *novation* is regarded as a clean transfer and the asset may be therefore excluded from the selling bank’s capital ratio and added to the buying bank’s.

a) In a ***novation***, the existing agreement between the originator and the borrower is cancelled and a new agreement between the investor and borrower is substituted. This effectively transfers all the seller’s rights and obligations to the buyer.

b) In the FSA’s view, the cleanest transfer of risk is achieved by novation.

5.3 Assignment

5 A legal or equitable *assignment*, if properly structured, can also achieve an effective transfer of the seller’s rights - but not his obligations - and the remedies available to him to enforce those rights.

a) An ***assignment*** transfers from seller to buyer all rights to principal and interest. A loan agreement may impose restrictions on assignability and these bind the buyer. Thus if assignment is prohibited without the consent of the borrower, the borrower’s consent should be obtained. In any case, there may be difficulties in assigning the benefit of rights other than the right to principal and interest. The buyer’s rights may be impaired by any rights of set-off that exist between the borrower and the seller.

b) The seller retains any outstanding obligations (for example, to advance further funds).

6 A transfer through an *assignment duly notified* to the borrower is regarded as a clean transfer, provided that the buyer has taken reasonable precautions to ensure that his rights under the transfer are not impaired by an intervening right; for example, a right of set-off between seller and borrower.

a) At a minimum there should be a warranty from the seller that no such right of set-off exists.

7 A *silent assignment* (i.e. where the borrower is not notified) is usually regarded as a clean transfer. This is subject to the following:

(a) the volume of assets to individual borrowers sold on a silent assignment basis should be subject to appropriate internal controls;

(b) the seller should keep under careful review the risks that follow on from this position as it remains the lender of record and therefore will be the focal point for pressure from the borrower.

a) The additional risks for the seller as lender of record are that he remains subject to requests to reschedule or renegotiate or advance further funds.

b) The buyer also faces additional risks because the absence of notice to the borrower removes some legal protection he would otherwise have had. These need to be kept under careful review.

If it is not satisfied on these points, the FSA may disregard a transfer of an asset through a silent assignment in calculating the capital ratio of the seller.

5.4 Declaration of trust

8 A declaration of trust is regarded as a clean transfer of the assets that is equivalent to a silent assignment, subject to the following:

(a) The policy on silent assignments detailed above is fulfilled in relation to the trust.

(b) The bank receives a legal opinion confirming that the trust is effective to transfer the beneficial interest.

If it is not satisfied on these points, the FSA may disregard a transfer of an asset through a declaration of trust in calculating the capital ratio of the seller.

5.5 Sub-participation

9 Where an asset is funded in whole or in part via a *sub-participation*, the FSA recognises the transfer of credit risk by excluding it (or the relevant part) from the original lender's capital ratio, and including it in the sub-participant's as a claim on the underlying borrower.

a) Sub-participation does not transfer any of the seller's rights, remedies or obligations against the borrower to the buyer, but is an entirely separate, back-to-back, non-recourse funding arrangement, under which the buyer places funds with the seller in exchange for acquiring a covenant from the latter under which he passes on to the buyer payments under the underlying asset which the borrower makes to him, but the asset itself is not transferred.

b) Sub-participation is accepted as meeting the FSA's criteria for effective transfer as, although not transferring in a legal sense the rights of the original lender, an asset sub-participation aims to have the same economic effect.

c) The sub-participant may, but is not required to, obtain a charge over the underlying assets. Such a charge would, among other things, allow the sub-participant to report on the basis of the capital charge on the underlying assets.

d) The sub-participant also faces additional risks since it assumes an exposure to the borrower, but is also at risk to the seller, because it relies on the seller to pass through funds received from the borrower.

5.6 Undrawn commitments

10 Where banks transfer an *undrawn commitment* to lend (or part thereof), the commitment (or part thereof) is excluded from the selling bank's capital ratio only when:

(a) the transfer is by novation; or

(b) the transfer is by an assignment accompanied by a release by the borrower of the seller from its obligations, an assumption by the buyer of the seller's obligations and a formal acknowledgement from the borrower of a transfer of obligations from the seller to the buyer.

a) An acknowledged assignment is regarded as amounting to, in substance, a novation and therefore effectively transfers this obligation.

11 A transfer by means of silent assignment, declaration of trust or sub-participation does not lead to the exclusion of the commitment from the selling bank's capital ratio. Instead the commitment is regarded as being to the buyer rather than to the potential borrower.

a) This treatment is adopted because an undrawn commitment is an obligation on the part of a lender, whilst an assignment is a transfer of rights only. As explained further below, the seller will face a credit risk in the event of the failure of the buyer.

See chs BC s4 & LE

b) Note that undrawn advised facilities are not extinguished through sub-participation.

12 The buyer's assumption of a commitment (or part) is included in its capital ratio as a claim on the borrower, irrespective of the method of transfer used.

a) In the case of an effective transfer of the obligation, this is clearly the necessary corollary, as the risk is no longer being taken into account against the seller.

b) A form of transfer which does not transfer an undrawn commitment, i.e. under silent assignment or sub-participation, gives the appearance of a double counting of the credit risk since it is taken into account for both the seller and the buyer. This is because there are two, legally separate transactions, even if the intention in entering into them is to achieve a combined effect. There are, therefore, two credit risks.

6 BASIS OF THE POLICY: LIMITING THE ASSOCIATION WITH THE ASSETS

6.1 Scope

1 This section covers the general policy applying to banks acting in a primary role. It covers single assets, parts of assets and the packaging, securitisation and sale of asset pools as well as the transfer of risk under sub-participation agreements.

See s7 & 8

a) This chapter includes guidance applying to specialist schemes for particular asset types, additional to that set out in this section.

See s5

b) This section should be read in conjunction with the sections covering effective forms of transfer; the policy in this section should be met <u>in addition</u> to that in section 5.

2 There are a number of general policies applying to both single asset and asset packages, set out in s6.2, and further general policies for asset package schemes only, set out in s6.3.

3 References to assets in the singular are for convenience only, unless specifically stated.

6.2 Policy relating to all types of assets

4 The following conditions for the transfer of a single asset, part of an asset or package of assets should be met:

(a) The transfer should not contravene the terms and conditions of the underlying asset agreement and all the necessary consents have been obtained;

(b) The performer of the primary role has no residual economic interest in the principal amount of the asset (or that part which has been transferred) and the buyer has no formal recourse to the seller for losses;

a) When a secured asset is transferred and further advances are made by the originator, if these additional advances are to be secured there should be a separate formal agreement with the borrower. A side letter is insufficient for these purposes.

(c) The performer of the primary role has no legal or moral obligation to purchase or repurchase the asset (or fund the repayment of a sub-participation), or any part of it, at any time;

a) The performer of the primary role may not retain an option to repurchase the assets, except where the loan portfolio has reduced to less than 10% of its maximum value and the option extends only to fully performing assets.

b) The inclusion of a 'step up' will only be permitted for mortgage securitisations and will be considered on a case by case basis pending a fuller review of the policy. Where a bank can demonstrate that the economic characteristics for the assets that it proposes to securitise are the same as for mortgages, the inclusion of a step up may be considered.

See s6.4

c) The details regarding the repurchase or purchase of assets are explained below.

d) An exception to the conditions in this paragraph is where the obligation arises from warranties given in respect of the asset at the time of its transfer, provided that these are not in respect of the future credit-worthiness of the borrower.

   i) The FSA would not regard this condition as met if warranties were provided by the originator on matters outside its control.

   ii) Environmental warranties should restrict liability to legislation in force at the time of sale, not at any time in the future otherwise they may be regarded as constituting a warranty on matters outside the originator's control.

(d) The performer of the primary role can demonstrate, to the satisfaction of the FSA, that it has given notice to the buyer that it is under no legal obligation to repurchase the asset (or fund the repayment of a sub-participation), nor support any losses suffered by the buyer, and that the buyer has acknowledged the absence of obligation;

a) Penalty interest imposed at the administrator's option does not constitute a loss caused by borrower default and may therefore be met by the performer of the primary role.

b) An SPV has an ongoing credit exposure to the performer of the primary role, because it is dependent on it passing on payments it receives in respect of the securitised assets. A bank may provide a guarantee to the SPV in respect of such an obligation by its subsidiary (if all or part of the assets are originated by the subsidiary) if the effect is only to bring the credit rating of the subsidiary up to that of the parent bank. The commitment by the parent may go no further than commitments the subsidiary could have given itself within the limitations of the FSA's policy.

(e) The documented terms of the transfer are such that, if the asset is rescheduled or renegotiated, the buyer and not the performer of the primary role would be subject to the rescheduled or renegotiated terms; and

(f) Where payments are routed through it, the performer of the primary role is under no obligation to remit funds to the buyer unless and until they are received from the borrower.

a) Payments voluntarily made by the performer of the primary role to the buyer in anticipation of payments from the borrower should be made on terms under which they can be recovered from the buyer if the borrower fails to perform.

6.3 Additional policy relating to asset packages

5 The process of packaging assets together and selling them as a block or pool can compound risks that are often negligible when a single asset is transferred. The commercial reputation of the performer of the primary role is committed because of its close association with the scheme; such a commitment may jeopardise the existence of a clean break and there may be pressure to support any losses of investors.

6 When performing a primary role for a package of assets, a bank should meet the following additional conditions, in order to ensure that its role is not seen as being more than acting as an agent, whether or not it retains the servicing role:

(a) The FSA expects the performer of the primary role to have evidence available in its records that its legal advisers are satisfied that the terms of the scheme protect it from any liability to investors in the scheme, other than liability for breach of express contractual performance obligations as servicing agent or originator or for breach of warranty made with respect to the assets in conformity with the policy in this chapter, or liability for any other matter wholly within the control of the originator.

(b) The FSA expects the performer of the primary role to have evidence available in its records that it auditors are satisfied that the terms of scheme comply with FRS5.

(c) The FSA expects the performer of the primary role to confirm in writing to the FSA that it has evidence available in its records that its auditors and legal advisers are satisfied, so far as it is within their professional competence, that the terms of the scheme comply with the FSA's policy.

a) Regardless of the bank having obtained opinions from professional advisors andits auditors under the sub-paragraph above, the responsibility for ensuring that the scheme meets these provisions rests with the bank.

b) The FSA may request sight of the opinions of the auditors and legal advisers.

c) The evidence in the bank's records may be included in a section 166 report.

(d) The performer of the primary role should be able to demonstrate that it has taken all reasonable precautions to ensure that it is not obliged, nor will feel impelled, to support any losses suffered by the scheme or investors in it.

a) This may be met by any offering circular (or other analogous documentation) containing a highly visible, unequivocal statement that the performer of the primary role does not stand behind the issue or the vehicle and will not make good any losses in the portfolio.

b) Where an existing funding is part of a proposed securitisation scheme, the FSA may consider that the statement need not be made retrospectively, although it should be inserted in subsequent funding issues.

c) The provision of insurance cover by a bank or a subsidiary of the bank against loss, e.g. mortgage indemnity insurance, will be considered on a case by case basis.

(e) The performer of the primary role may not own any *share capital* or other form of proprietary interest in or control over, either directly or indirectly, any company used as a vehicle for the scheme.

a) Where the bank acts in a primary role, this also applies to members of the consolidated group.

b) *Share capital* includes for this purpose all classes of ordinary and preference share capital.

(f) The Board of a company used as vehicle for a scheme should be independent of the performer of the primary role, although may have one director representing it.

a) Where the bank acts in a primary role, this also applies to members of the consolidated group.

(g) The name of a company used as vehicle for a scheme should not include the name of the performer of the primary role nor imply any connection with it.

a) Where the bank acts in a primary role, this also applies to members of the consolidated group.

(h) The performer of the primary role should not bear any of the recurring expenses of the scheme.

See s9

a) Credit enhancements are considered below.

b) The failure of the performer of the primary role to charge appropriate fees or other compensation may amount to funding. The agreement should specify fees and, if costs are not covered, should be subject to the approval of the FSA as being at an acceptable level.

c) If a bank wishes to securitise a mortgage book which includes staff mortgages which are subsidised, such a subsidy will not count as funding the vehicle if paid to the employee; it may do if paid directly to the buyer. The different treatment arises due to the likely events upon default.

(i) The performer of a primary role may not enter into swap agreements with the SPV that intentionally bear losses.

a) However, the bank may enter into interest or exchange rate swap at market prices with the vehicle, either directly or through a third party.

b) There should be provision for unintended temporary losses arising from normal administrative procedures, for example delays in changing mortgage rates, to be recovered by the servicing agent as soon as possible;

(j) The performer of a primary role may not fund a vehicle or scheme (except within the terms of condition (h) above) and in particular may not provide temporary finance to cover cash shortfalls arising from delayed payments or non-performance of loans which it administers.

a) This section does not apply to sponsors or repackagers.

6.3.1 Asset replenishment

7 An originating bank may structure a securitisation scheme to allow for further tranches of assets to be placed into the scheme. It should be able to demonstrate to the FSA that at the time of subsequent transfer:

(a) the asset quality of the pool is not materially altered by the addition;

(b) any change to the quality of the assets remaining with the originating bank is either not material or is acceptable to the FSA;

(c) (for revolving credit securitisation only) there is no change in the liquidity implications of the securitisation resulting from the addition; or

(d) there are no unacceptable changes to the “moral” risks to the originator signalled by the addition.

a) The test of material alteration of the quality of asset pool is to be applied to the pool at the time of the proposed addition, not to the quality of the pool at the original securitisation.

b) A bank may discuss and receive non objection from the FSA for asset replenishment either at the time of each replenishment or once only to establish a framework to apply for several replenishments.

6.4 Repurchasing the assets

6.4.1 Repurchasing by an originator

8 An originator should not repurchase the asset securitised from the SPV unless one of the following circumstances apply:

See 6.2.(c)

(a) The repurchase is for a breach of warranty;

(b) The repurchase is of fully performing or defaulted assets when the loan portfolio has sunk to less than 10% of the maximum face value of the assets;

a) The total size of the pool for these purposes is equal to the maximum total face value of the assets during the life of scheme, prior to the calculation.

b) Defaulted assets may be bought back for nominal consideration.

c) Repurchases for further advances or product switches from a mortgage pool will be agreed on a case by case basis pending a fuller review of the policy.

Any repurchase should be performed at market prices with no preference of any kind being shown in the terms and is subject to the bank's normal credit approval and review process;

9 A bank may restructure or refinance a securitisation only if the assets remain, at all times, off the balance sheet.

a) A bank should notify the FSA when wishing to restructure or refinance a securitisation. The restructuring or refinancing will be considered on a case by case basis.

6.4.2 Repurchasing by a sponsor or repackager

10 A sponsor may purchase or a repackager may repurchase or purchase the assets from a scheme. At the time of (re)purchase the following conditions should apply:

(a) The assets are either investment grade or defaulted, in the case of financial instruments, or fully performing or defaulted, for non-financial instruments;

See 6.2.(c)

a) If the repurchase occurs due to a breach of warranty, the policy in this section need not be followed.

b) Defaulted assets may be bought back for nominal consideration.

(b) The repurchase is performed at market prices with no preference of any kind being shown in the terms and is subject to the bank's normal credit approval and review process.

7 SPECIAL STRUCTURES: REVOLVING CREDITS

7.1 Introduction

1 Compared with other types of securitisation, schemes to securitise *revolving credits* introduce the possibility of increased legal and moral risk. This arises from the complexity of the arrangements, the shared interest of the originating bank and investors, and the eventual reversion in full to the originating bank of the pool of accounts. Additionally, the speed at which assets return to the balance sheet of the originating bank may cause liquidity problems.

2 Although most securitisations to which this policy applies are of credit cards, it is not limited to any particular type of assets but applies whenever the structure has the characteristics described in the above paragraph.

3 If carefully constructed, however, such schemes can result in the originating bank successfully transferring the risk on the share of the pool assets to the investors. This section outlines the conditions that should be met in respect of revolving credit securitisations in order for the assets to be given off-balance sheet treatment for supervisory purposes.

The policy in this section is additional to the general policy set out in section 6 and the conditions for effective transfer in section 5.

a) The term *revolving credits* refers to loan facilities which permit borrowers to vary the drawn amount within an agreed limit. Repayment may be at the borrower's discretion, subject in some cases to a minimum amount per payment period, or by fixed schedule.

b) *Securitisation* of such receivables is especially complex because of the nature of the assets as fluctuating and of indefinite maturity.

c) Typically, schemes insulate investors in the notes from the effects of fluctuating balances by assigning shares in the receivables that are the subject of the securitisation both to the investors (the *investor interest*) and to the originating bank (the *seller interest*). The amount of the investor interest in the outstanding balances normally stays fixed at the amount of their funding (until the notes start to amortise) whereas the amount assigned to the selling bank goes up or down as borrowers make net drawings or repayments.

d) Schemes are given a fixed maturity by dividing their life into a revolving (or interest-only) period and an amortisation period.

   i) During the *revolving period*, the investors receive their share of interest payments, but their share of principal repayments by borrowers is reinvested in the pool.

ii) During the *amortisation period*, the investors' share of principal repayments is used to redeem the securities, with the result that at the end of the scheme the full interest in the outstanding balances has reverted to the originating bank.

7.2 Principles

4 In setting the conditions for off balance sheet treatment of the share of the balances funded by investors, the FSA considers it a fundamental principle that the arrangements for the securitisation should ensure the full sharing of interest, principal, expenses, losses and recoveries on a clear and consistent basis.

a) This principle implies, among other things, the need for full loss-sharing on the stock of receivables in the pool throughout the revolving period of the securitisation, since the investors' share of the receivables is removed in full from the originating bank's balance sheet for the whole of that period.

5 There is no specific limit on the total volume of outstanding revolving credits that a bank may remove from its balance sheet using securitisations. It is therefore important to ensure:

(a) that adequate standards apply to the structure of securitisation schemes; and

(b) that the implications of securitisation for the bank's risks generally are adequately handled.

7.3 Features and treatments

7.3.1 Pooling

6 Schemes typically involve the transfer of a pool of receivables into a trust.

a) The trust directs the flows on the accounts to the originating bank and to a special purpose vehicle (SPV) according to the proportion of the funding that they are providing.

b) The SPV in turn directs the flows to the investors who hold the securities.

c) Schemes usually contain provisions concerning the selection of the original pool of receivables from the assets on the originating bank's balance sheet and the subsequent replenishment, as necessary, of the pool of accounts.

7 These arrangements form the basis of an acceptable structure to allow the share of the balances funded by the SPV to be removed from the originating bank's balance sheet for supervisory purposes.

8 A bank may take back the full financing of a pool at the end of the scheme if there is no reason to assume that its performance will have deteriorated in the meantime.

a) For a scheme to be acceptable, therefore, the FSA needs to be convinced that it contains no features - for example for the substitution of higher-quality accounts into the scheme - as a result of which the performance of the pool systematically favours the investor interest.

b) Adequate seasoning of the accounts transferred into the pool - so that they are likely to display the characteristics of fully operational accounts - is usually required; together with the random selection of the assets transferred into the pool, this should normally ensure that investors are not systematically advantaged.

c) In addition, the scheme's documentation should ensure that servicing practices are applied consistently to securitised and unsecuritised loans.

7.3.2 Aggregated and disaggregated

9 Schemes may incorporate one of two main approaches concerning the payments received by the SPV in respect of the pool of accounts transferred:

- Under the *aggregated* approach, the payments received during a period are aggregated and in distributing them shares are applied to that aggregate, treating the receivables as a homogeneous pool.

  a) The pool of assets is looked upon as though it were one and receipts/advances apportioned between originator and investor.

- Under the *disaggregated* approach, the amounts paid to investors and the originating bank are linked to particular receivables that they have financed.

  b) Each advance/receipt is allocated to either the originator or the investor.

Schemes using either approach may be eligible for off balance sheet treatment by the FSA.

7.3.3 Scheduled amortisation

10 Under the *scheduled amortisation* of the securities, the outstanding balance of receivables reverts to the originating bank after a scheduled date fixed in the terms of the securitisation, in a controlled manner.

The FSA considers that the following conditions should be met by the provision for scheduled amortisation in a scheme:

(a) There is a need to ensure full loss-sharing on the stock of receivables throughout the revolving period of a securitisation, which has implications for the rate at which schemes may be amortised at the end of that period.

a) If an SPV is able to a large extent to derive repayment flows from borrowers who turn over their balances quickly, and relatively little reliance on borrowers who pay only the minimum amount each month, it might be able to make a very rapid exit from the scheme.

b) If the borrowers who paid their debts slowly had different risk characteristics from those repaying and renewing credit at a fast rate, this might allow the investors to avoid their full share of losses on the pool at the end of the revolving period.

c) The pace of repayment during any set amortisation period should not in normal circumstances be more rapid than would be allowed by straight-line amortisation over the period.

(b) Amortisations providing for a *clean-up call* - by which an originating bank has the option to buy back the remaining securitised assets - are considered to be acceptable so long as the clean-up can occur only when 10% or less of the receivables at the start of amortisation remain outstanding.

(c) If the scheme is based on the disaggregated approach, this is an acceptable structure (as long as any assumption that it includes about the length of the amortisation period is reasonable).

a) The investor interest is not eliminated until each borrower in whose debts the SPV shares has made sufficient principal payments to cover the balances outstanding at the end of the revolving period - or these have been recognised as in default.

(d) If the scheme is based on the aggregated approach, this is more complex but may still be acceptable. There is a need to allay the concern that the SPV may be able to exit from the scheme while a substantial proportion of the total amount outstanding at the start of the scheduled amortisation period remains outstanding.

a) This may be the result of a scheme in which, after the start of the amortisation period, investors are repaid from a fixed share of the repayments arising from the aggregate gross flows on the accounts, including repayments of new borrowings incurred during the amortisation period.

(e) For aggregated structures, the originating bank should be able to demonstrate (either on a theoretical basis or on the basis of historical statistics) to the FSA that, by the end of the scheduled amortisation period, borrowers in the pool should have made sufficient payments to ensure that in aggregate at least 90% of the total debt outstanding at the beginning of the amortisation period will have been repaid or recognised as in default.

a) Payments are taken to include both principal and interest.

7.3.4 Early amortisation

11 *Early amortisation* of the securities provides for the repayment of the investor interest to be brought forward on the occurrence of certain circumstances defined in the terms of the securitisation. Such an occurrence is called a *trigger event*.

12 Various early amortisation triggers have been included in past securitisations, in the United Kingdom and elsewhere. They may be divided into two main kinds: *economic* and *non-economic* triggers.

(a) *Economic* triggers activate early amortisation because of a deterioration in the performance of the pool of receivables: for example, a fall below a certain level in the yield of the pool net of provisions, interest and other expenses. The FSA considers that e*conomic* triggers may, therefore, be included only if:

(i) there is full sharing of interest, principal, expenses, losses and recoveries on the balances outstanding at the start of the amortisation period, using either the disaggregated approach or the aggregated approach applying the same conditions as outlined in paragraph 10 above; and

(ii) that at the point that early amortisation is triggered losses on the pool will have reached a level where the bank will feel able, if necessary and without putting its reputation at risk, to reduce its new lending broadly in line with the amortisation of the investor interest. The bank should be able to demonstrate to the FSA that this is the case.

a) In some cases, such triggers allow investors to reduce their participation once they begin to experience losses and commit the originating bank to taking back the full financing in these circumstances. Because the FSA is seeking to ensure full loss-sharing, it considers that certain conditions should be met on the inclusion of *economic* triggers if the assets securitised are to be given off balance sheet treatment. The conditions are intended to prevent the inclusion of such triggers providing, in effect, implicit credit support. The aim is to ensure that investors share in losses for as long as these remain unusually high or until the originating bank decides, and feels able, to run down its portfolio in line with the amortisation of the investor interest.

(b) *Non-economic* early amortisation triggers relate to changes, other than in the performance of the securitised assets, which have significant implications for the securitisation.

a) Past examples include tax-event and legal-change triggers, triggers relating to the originating bank's material non-performance in its role as servicing agent to the SPV, and triggers relating to the insolvency of the originating bank or SPV.

b) In the FSA's view, the presence of these particular types of trigger does not amount to credit support. It therefore considers that such early amortisation triggers may be included in acceptable schemes, and in these limited cases a form of *rapid amortisation* - by which the investor interest may be repaid as fast as is allowed by its share of the inflow of principal payments – may be included.

c) The FSA needs to be convinced of the case for allowing any other forms of *non-economic* early amortisation trigger.

7.4 Implications of schemes for a bank's general risks

7.4.1 Context

13 This subsection explains the particular concerns relating to banks involved in revolving credit securitisations. It should be read in conjunction with Section 4 which discusses the implications for securitisations generally; the policy in this section is in addition to that set out in Section 4.

7.4.2 Systems

14 Systems needs are more complex than in other securitisations, because of the active nature of the assets, the consequent need for the identification of loans and payments, and the monitoring of the portfolio's performance.

7.4.3 Liquidity

15 The eventual return in full of the revolving-credit balances to the bank's balance sheet - as a result of either their scheduled or early amortisation - means that such securitisations raise particular issues for originating banks' management of their liquidity.

a) These liquidity implications should be handled within a bank's normal liquidity management and assessed as under Section 4.4.

b) In the case of securitisations of credit-card (and similar) receivables, this approach is combined with the FSA's normal liquidity approach for credit cards.

c) Before the FSA is able to assess whether it is appropriate to treat such assets as off balance sheet, it needs to be satisfied that the bank can deal with these liquidity implications.

16 Each scheme should be included in a bank's liquidity management assuming, in normal circumstances, that during its amortisation the bank may be required to find replacement funding for the full amounts previously provided by the investor interest.

a) This is because it may not be possible to arrange a replacement securitisation, and an across the board withdrawal or reduction of borrowers' facilities would put its reputation at risk.

b) In each case, the FSA will consider whether an extra margin based on the likely maximum net growth in lending should be added to the funding requirement, and will, if necessary, set this margin in consultation with the bank including whether to include in the funding requirement an estimate based on the likely maximum net growth in lending.

17 For <u>scheduled amortisations</u>, before off balance sheet treatment is adopted, a bank should outline how it expects to manage its liquidity. A bank should satisfy the FSA that its liquidity arrangements could cope with the additional need for funding and, where appropriate, that it would build up additional liquid assets for the periods covering amortisation payments.

a) This should include, at the appropriate maturities, the cash outflows resulting from the scheduled repayments to investors plus any additional growth margin decided on.

b) The FSA examines banks' proposals to ensure that schemes do not unwind at times and in amounts that would pose difficulties for the bank concerned.

18 For <u>early amortisation</u> triggers in a securitisation scheme there are additional complications, since they render uncertain the timing of the potential need for replacement funding.

(a) For a bank originating a scheme incorporating an early amortisation trigger or triggers, and having it treated as off balance sheet the bank should be able to demonstrate to the FSA that it has adequate funding plans in place to cope with their implications.

(b) Where schemes include early amortisation triggers, the FSA wherever possible agrees with the originating bank 'warning indicators' that early amortisation might be triggered.

a) For example, if the scheme allows early amortisation to be triggered after three successive months of negative net yield on the portfolio, a warning indicator might be one month of negative net yield. Following a signal from one of these warning indicators, the maturity of the scheme will be advanced in the bank's liquidity reporting; in this example, its presumed maturity immediately after the warning indicator would be two months.

b) For those banks operating using the stock liquidity approach, the FSA where appropriate will seek to agree with the bank the additional liquidity that should be maintained in the event of a signal from a warning indicator.

(c) Where a scheme includes an early amortisation trigger that does not permit any warning indicator, the originating bank should likewise explain how it would cope with the liquidity implications of its being triggered.

19 There is additional liquidity risk in the case of originators of more than one securitisation with the same early amortisation trigger(s) (whether 'economic' or 'non-economic').

a) Because the potential liquidity demand on such banks is multiplied if the early amortisation triggers in each can be triggered at the same time, in such cases the FSA needs further reassurance as to the liquidity implications before being able to agree the appropriate off balance sheet treatment of subsequent issues.

20 In order for a bank to satisfy the FSA that it can deal with the liquidity implications of the amortisation of schemes, it may need to arrange committed facilities to be drawn down to the extent necessary to fund receivables returning to its balance sheet.

a) The policy governing these committed facilities generally is that used elsewhere in the FSA's liquidity approach. Likewise the FSA follows its normal approach on the question of the weighting of such committed facilities for capital adequacy purposes. Since such commitments need to be available in circumstances where a replacement securitisation does not prove possible, they should not include a material adverse change condition in relation to the bank.

7.4.4 Capital

21 For a bank carrying out revolving-credit securitisations amounting to a high percentage of its solo capital base, the FSA monitors and where appropriate discusses with its management the potential capital implications of its involvement in the securitisation market. Consideration here takes account of the size and development of that market.

a) This is a particular issue where the presence of common early amortisation triggers makes it possible that a significant volume of assets could revert to the bank at the same time, thereby threatening to cause problems both for the bank's liquidity and its capital requirements.

8 OTHER SPECIAL STRUCTURES

8.1 Transfers of receivables arising from the finance of equipment or consumer goods

8.1.1 Introduction

See s2

1 The FSA's principal policy objective is to ensure that in any securitisation, all parties fully understand the responsibilities and risks which they assume or retain, and that any material risks to buyers or sellers are properly treated in the supervision of banks.

2 The financing of the purchase of equipment or consumer goods (including hire-purchase) can involve particular risks, which it is difficult legally to transfer to a buyer of the receivables, which may adversely affect this objective.

3 The policy in this section is additional to the general policy set out in section 5 and 6.

8.1.2 Concerns

4 The following concerns are particular to a securitisation of this type of loan:

(a) This type of lending can involve lenders in continuing liabilities for the "merchantability" of goods or equipment.

(b) If defective goods were to cause personal injury, very substantial costs could arise.

(c) In addition to liabilities for the quality of equipment, institutions involved in the finance of equipment hire or leasing may have contractual obligations towards the borrower - for instance to arrange for the servicing or taxation of vehicles.

(d) It is difficult legally to transfer these obligations, unless the transfer is done through novation.

8.1.3 The FSA's policy

5 The FSA views the following as the necessary steps to address these concerns:

(a) The FSA believes that for assets to be viewed as off-balance sheet, sellers should either receive an indemnity from the buyer to cover any liability, or otherwise take steps to minimise the risk of loss (such as taking out insurance to cover the risk).

a) Lenders against whom claims are made as a result of their liability for the quality of goods or equipment usually have recourse to the manufacturer which, provided the manufacturer has appropriate liability insurance, may limit the risk to the lender. In addition, the FSA has been given to understand that the loss experience of lenders under such claims is historically very small. Nevertheless, the FSA does not view the risk retained by the seller as unimportant.

(b) In situations where the seller is left with responsibilities of the kind outlined in paragraph 4 above, the FSA has some concern over the position of the buyer (if the buyer is a bank). The FSA reminds buying banks that risks of this nature need careful evaluation. Buyers should satisfy themselves of the seller's competence to fulfil its obligations towards the borrower in a timely manner.

a) There is a clear possibility that the borrower will exercise a right to reduce or withhold payments on the loan to reflect his costs - for instance, the cost of repairing the vehicle - if the original lender fails to meet his obligations under the loan agreement.

8.2 Securitisation of a reverse repo

See s6

6 Where the benefits of a reverse repo are transferred, the transaction is considered to be the securitisation of a single loan. The originator therefore should comply with the policy above for standard schemes.

a) A reverse repo is where a bank has bought (or borrowed) trading book securities from a counterparty subject to buyback (or a return clause);

7 Whether the securitised loan is considered to be secured or unsecured depends on the structure of the transaction.

a) A sub-participation is deemed to be unsecured.

b) Where the transactions are through a trust structure (the trust having legal title) it will usually be secured.

See s7

8 Where the transaction is through a trust structure and the originator retains an interest in the reverse repo, the concerns raised in respect of sharing of interest, principal and losses for revolving schemes should also be addressed by the bank.

9 SECONDARY ROLES: CREDIT ENHANCEMENTS

9.1 Background

See s6.3 (h)

1 The policy on credit enhancements is part of the wider policy on securitisation published by the FSA, and therefore feature in a previous section. Because of their importance and the variety of possible constructions, this section expands upon the basic rules.

9.2 Overview

2 A credit enhancement is an arrangement provided for the SPV that, in form or substance, covers the losses and risks associated with the pool of assets. The level of the enhancement is reflected in the rating given to the notes by a rating agency.

a) Where a bank demonstrates a pattern of providing (implicit) support, it will be deemed to have provided credit enhancement.

b) An enhancement can be an integral part of the structure used to manage funds or securitise assets (i.e. driven by cash flow) or may be provided from outside the structure (i.e. provided by the originator or another third party).

c) Ratings agencies require banks to provide credit enhancement in order to make the paper issued in securitisations more attractive to investors.

3 A bank acting in a primary role may provide credit enhancement to support an SPV (and its investors). The capital charges against the credit risk that should be made are detailed below.

9.3 Structure of credit enhancements

4 A credit enhancement may be structured in a number of forms, examples include:

(a) A subordinated loan or note facility issued by a bank equal to a maximum amount of credit support being provided.

(b) Over-collateralisation, where the face value of the assets is greater than the securities issued. The securitisation will amortise more quickly and a buffer is created against losses. On maturity, any residual assets revert to the originator.

a) The credit enhancement, for calculating capital requirements, is the over-collateralisation.

(c) Spread accounts. The interest rate on the assets is usually higher than the coupon on the securities issued, with the difference being used to cover costs and provide for losses. Utilising all or part of this for credit enhancement purposes means leaving it in the SPV rather than returning it to the originator.

a) If the funds are to be returned to the originator, the FSA considers that the SPV should not have recourse to the monies thereafter.

b) The conditions detailed in 9.4 do not apply to credit enhancement in the form of a spread account retained by the SPV.

See ch TI s9

5 Securities issued that are deemed to be investment grade by relevant rating agencies, as defined, are deemed not to constitute credit enhancement if there is already sufficient credit enhancement within the terms of this section.

See 9.6.1

a) The limitations on the ability to hold such securities are detailed below.

See s11

b) The limitations on the ability to trade such securities are detailed below.

9.4 Detailed policy

6 Any bank providing credit enhancement should ensure that:

(a) the facility is limited in amount and duration;

(b) there is no recourse to the bank beyond the fixed contractual obligations provided for in the facility;

(c) the SPV and/or investors in a bond issue have the clear right to select an alternative party to provide the facility;

(d) the facility is documented separately from any other facility provided by the bank;

(e) the transaction should be undertaken at the initiation of the scheme;

a) However, in the event of a scheme having subsequent tranches of assets being placed in to the SPV, within the terms set out above, the credit enhancement can increase at that time, if detailed in the offering circular. The new credit enhancement should not be used to provide, in a disguised way, enhancement for earlier tranches of assets and schemes seeking to be structured in this way should be discussed in advance with the FSA.

(f) the details of the facility should be disclosed in any offering circular or other appropriate documentation; and

(g) payment of any fee or other income for the facility is not further subordinated, or subject to deferral or waiver, beyond what is already explicitly provided for in the applicable order of priority and other payment entitlement provisions.

See s9.6 & 9.7 7 If the above conditions are met, the relevant capital treatment that should be applied is detailed below.

9.5 Definitions of first loss & second loss credit enhancement

9.5.1 General

8 The distinction between the types, *first loss* and *second loss*, is drawn to allow for an understanding of the underlying structure, and for the other implications resulting from this.

9.5.2 Definition of first loss credit enhancement

9 A *first loss facility* represents the first level of financial support to a SPV.

a) A first loss facility bears, in effect, all of or the bulk of the risk associated with the assets held by a SPV, as part of the process in bringing the paper issued by the SPV to investment grade. Hence the high capital cost.

b) A payment by a bank to provide cover against losses incurred by an SPV (e.g. to fund a reserve account) or the sale of assets to an SPV for below their book value in the bank's books (where not written down or off against profits) is regarded as a *first-loss facility*.

c) Capital is not required for *spread accounts* where the funds are held in the SPV.

d) Additional capital is not required for *over collateralisation* beyond the assets that are effectively written off in providing the margin of assets.

9.5.3 Definition of second loss credit enhancement

10 A *second-loss facility* represents a credit enhancement providing a second (or subsequent) tier of protection to an SPV against potential loss. The share of risk of a second loss facility depends on the coverage provided by any first loss facility. In order to limit the possibility of the second loss facility carrying a disproportionate level of risk, a credit enhancement facility is deemed a second loss facility only if:

(a) it enjoys the benefit of protection from a substantial first loss facility; <u>and</u>

(b) it can only be drawn after the first loss facility has been exhausted.

a) For the purposes of this section, a first-loss facility will be considered substantial where it covers some multiple of historic losses or worst case losses estimated by simulation or other techniques.

b) A bank providing a second loss facility needs to assess the adequacy of the first loss facility on an arm's length basis in accordance with its normal credit policies. A review of first loss facilities might refer to such factors as:

i) the class and quality of the assets held in the SPV;

ii) the history of default rates on the assets;

iii) the output of any statistical models used by banks to assess expected default rates on the assets; the types of activity permitted the SPV (i.e. whether the risk underlying the credit enhancement facilities extends beyond the asset held);

iv) the quality of the parties providing the first loss facility; and

v) the opinions or rating letters provided by reputable third parties, such as rating agencies, regarding the adequacy of the first loss protection.

c) Where a second loss facility provided by a bank would substitute for a first loss facility provided by another party, in the event of that party failing to meet its obligations, the bank should treat the facility it provides as equivalent to a first loss facility.

9.6 Credit enhancements supplied by an originator

9.6.1 Restrictions upon an originator

11 An originator should only make a one-off contribution to enhance the credit-worthiness of a vehicle. Any transactions should be funded at the initiation of the scheme and disclosed in the offering circular.

a) The agent or originator may lend on a long-term subordinated basis to the vehicle only if the loan is made at the outset of the scheme and is repayable only following winding up of the scheme.

See s11 12 An originator may not hold any of the securities issued by the SPV unless it has received a waiver to deal, as detailed below.

a) Any holdings in excess of the agreed dealing limits will be deducted from capital.

9.6.2 Treatment for first loss

13 The originating bank may make a choice of either deducting the amount of the credit enhancement from capital or including the assets within their risk weighted asset ratio under normal rules as if there had been no securitisation. The choice should be made at the outset, maintained for the duration of the credit enhancement facility and be advised to the FSA.

9.6.3 Treatment for second loss

14 An originator providing a second loss facility (in an acceptable form) should deduct the amount of the facility from capital.

9.7 Credit enhancements supplied by a sponsor or repackager

9.7.1 General

15 Due to the complexity of conduit and repackaging schemes, the definitions of first and second loss facilities may be difficult to apply. In such circumstances, the FSA should be consulted.

a) For the purposes of this section, the holding of sub-investment grade paper will be deemed to constitute credit enhancement unless there is already sufficient enhancement within the scheme.

9.7.2 Treatment for first loss

16 First loss credit enhancement facilities provided by a sponsor or repackager should be deducted from capital.

9.7.3 Treatment for second loss

17 A bank acting as sponsor or repackager which provides a second loss facility, as defined above, may weight the facility as normal, provided that the extent of the bank's involvement is fully and properly explained in any offering circular for the scheme, or is otherwise notified to investors, and it is made unequivocally clear to investors:

(a) that the bank's responsibilities do not go beyond that which is provided for in the second loss facility in question (as explained in the offering circular); and

(b) the bank will not support losses beyond the requirements of the second loss facility or generally stand behind the scheme.

10 SECONDARY ROLES: LIQUIDITY FACILITIES

10.1 General

1 *Liquidity facilities* enable SPVs to assure investors of timely payments. These include smoothing timing differences in the payment of interest and principal on pooled assets and ensuring payments to investors in the event of market disruptions. Such facilities can be particularly important where SPVs hold long term assets funded by the issuance of short-term securities.

a) Ratings agencies require banks to provide liquidity facilities in order to make the paper issued in securitisations more attractive to investors.

b) The Commercial Paper (CP) markets display some degree of volatility. For example, in the United States, this may cause the $CP rates to diverge from $LIBOR from time to time, particularly over the year-end, quarter ends and US tax payment days. SPVs are sometimes therefore set up in such a way that they are not tied to an obligation to fund assets for a full quarter on specific days each quarter so as to avoid such difficult days. A liquidity facility may be key to the flexibility an SPV needs in such circumstances.

10.2 Detailed Policy

2 To guard against the possibility of a facility functioning as a form of credit enhancement, a liquidity facility when provided should satisfy the following conditions:

(a) the facility is provided on an arm's length basis and is subject to the bank's normal credit review and approval processes;

(b) the facility may be reduced or terminated should a specified event relating to a deterioration in asset quality occur, e.g. the facility should not be available to be utilised if the assets of the SPV have deteriorated in quality to the extent there is no longer a sufficient level of credit enhancement to cover the amount of any new or existing drawdowns under the facility.

(c) the facility should be conducted on market terms and conditions;

(d) the facility is limited in amount and duration;

(e) there is no recourse to the bank beyond the fixed contractual obligations provided for in the facility;

(f) the SPV and/or the note trustee representing the investors have the clear right to select an alternative party to provide the facility;

(g) the facility is documented separately from any other facility provided by the bank;

(h) payment of any fee or other income for the facility is not further subordinated, or subject to deferral or waiver, beyond what is already explicitly provided for in the applicable order of priority and other payment entitlement provisions;

(i) the facility may not be drawn for the purposes of credit support;

(j) the documentation clearly defines the circumstances under which the facility may be drawn and prohibits drawing in any other circumstances;

(k) the facility will provide for repayment of advances within a reasonable time period;

(l) funding is provided to (or via) the SPV and not directly to investors;

(m) proceeds of drawings under the facility cannot be used to provide permanent revolving funding, or be for the express purpose of purchasing underlying assets held by an SPV (although it is permissible for a liquidity facility to be structured as an arrangement in which underlying assets held by the SPV are purchased by the liquidity provider, provided that the assets in question are investment grade);

(n) funding cannot be used to cover losses recorded by the SPV; and

(o) drawings under the facility are not subordinated to the interests of investors, except that drawings may be subordinated to other liquidity facilities if a tiered liquidity facilities are used in a scheme. Such subordination should be clearly set out in the offering circular or other appropriate documentation.

3 Failure to satisfy these conditions will cause the facility to be deemed to be serving the economic purpose of a credit enhancement facility and therefore be treated in the same way as a credit enhancement for capital purposes.

a) The facility may be deemed to be a first or a second loss facility, as appropriate.

10.3 Restrictions on originators

See s6.3 4 An originator should not provide a liquidity facility as it is deemed to be funding. If it does, it is deemed not to have achieved a clean break with the assets, which will then be considered by the FSA as being on its balance sheet.

a) The provision of a liquidity facility to cover very short-term timing differences may be considered acceptable. However, there should be no obligation on the bank to make the payment, the vehicle should have sufficient funding to meet any clawback claims and the structure should be covered in the scheme's documentation.

b) Although originators may not provide a liquidity facility, the workings of the securitisation vehicle may still require one which may, therefore, be provided by a third party bank.

10.4 Restrictions upon sponsors and repackagers

10.4.1 General

See ch BC s4

5 A sponsor or repackager may provide a liquidity facility to a scheme. The facility will be calculated as 100% weighted asset drawn and 0% or 50% undrawn (in the normal way), provided that the extent of the bank's involvement is fully and properly explained in any offering circular for the scheme, or is otherwise notified to investors, and it is made unequivocally clear to investors:

(a) that the bank' responsibilities do not go beyond that which is provided for in the liquidity facility in question (as explained in the offering circular); and

(b) the bank will not support losses beyond the requirements of the liquidity facility or generally stand behind the scheme.

6 If these conditions are not met, the bank should treat the scheme as a fully consolidated subsidiary for capital adequacy purposes.

a) If a bank acting as sponsor is seeking to use the concessionary treatment of section 3.2.2 paragraph 5, (as a partial originator in a multi-seller vehicle, providing a part of the liquidity facility) and fails the tests in this section, then any assets it originates will be considered as remaining on its balance sheet.

10.4.2 Large Exposures

7 Conduits can grow to considerable sizes and consequently a liquidity facility provided by a sponsor or repackager to such a conduit could potentially exceed the bank's large exposures capital base. A bank should only dissagregate facilities where the following general conditions are fulfilled:

(a) The facilities are provided to separate legal entities;

See Ch LE s5.2

(b) The legal entities are not closely related counterparties for large exposure purposes;

a) The details regarding large exposures are explained in chapter LE.

See s4.2

(c) The bank has systems and controls in place to monitor the assets within the conduit;

a) The need to aggregate the underlying assets involves the use of complex systems and controls. A bank should be able to satisfy the FSA that it is able to control the securitisation properly primarily at notification and through the section 166 process.

See s4.4

(d) There are internal systems in place, that have undergone stress testing on mismatch limits, to monitor and/or manage the bank's liquidity out to at least six months; and

a) It is possible for CP conduits to grow to a significant size. Should there be a disruption to the CP market that requires the drawing of a facility, sizeable funds will be needed to meet the demand. The drawing of these funds may accelerate as each CP fund matures. The sponsor should be able to monitor its liquidity to ensure that it is able to cope with such an effect.

b) Conduits should manage their CP maturities so that they do not have significant amounts of CP maturing during any one day or week. If the liquidity lines' renewal dates are not concentrated the bank may be less exposed to market disruption as drawing will take place over a longer period of time.

See s4.5

(e) The sponsor's capital planning takes account of possible drawings under the facilities i.e. that they are either able to sell the assets, sell other assets or raise the requisite capital. A sponsor should pre-notify the FSA as to how it will provide capital in the event of possible drawings.

a) If a CP disruption occurs it may result in the sponsor making a large loan or taking a large quantity of assets onto the balance sheet over a short period of time. A sponsor should plan how it will provide capital in the event that this occurs.

8 The FSA considers that it is appropriate for a bank to dissagregate facilities where the following specific conditions are fulfilled:

(a) For an asset repurchase facility, the exposure to the obligor for each underlying asset held by each special purpose vehicle is aggregated for large exposures purposes with the bank's own exposures to that obligor; or

(b) For a liquidity backstop facility, a bank takes reasonable steps to aggregate, for large exposure purposes, exposures to the obligor of the underlying assets, that represents a significant proportion of the pool, with the bank's own exposure to that obligor.

a) A bank should also take into account any originator, sectoral, country or regional concentrations when providing liquidity to an SPV.

See ch LE s9.2.7

b) A bank should not only aggregate the exposure to the obligors of the underlying assets across the SPVs but also any exposures to closely related counterparties across the SPVs.

10.4.3 Bridging Loans

9 A *bridging loan* is a loan made to a vehicle, prior to the issuance of the notes, to cover a mismatch in time between the date of purchase of the underlying assets and the date of issue of the securities.

See s3.2.1

a) A sponsor or repackager should not use the practice in this section to establish a remote origination scheme.

10 The FSA considers that it is acceptable for a sponsor or repackager to provide a bridging loan to an SPV subject to usual capital and large exposures requirements where the following conditions are met:

(a) The loan is provided at market prices with no preference of any kind being shown in the terms and conditions;

(b) The sponsor or repackager has the senior secured status; and

(c) The term of the loan is limited to three months or less.

a) The maturity of the underlying assets should extend considerably beyond this period.

11 A sponsor or repackager providing a bridging loan for greater than three months should treat the assets as on the balance sheet until the transaction is completed.

See s3.2.1

a) Assets that are regarded as being on balance sheet for the purposes of this section will be regarded as originated when securitised.

11 SECONDARY ROLES: DEALING & UNDERWRITING

11.1 Dealing & underwriting by an originator

1 An originator may underwrite the securities issued by the SPV. The assets will not be regarded as being off balance sheet until 90% of the total issue has been sold to a third party.

a) The FSA may vary the minimum level of assets that have to be sold to a third party before off balance sheet treatment is considered appropriate.

See s9.6.1

2 Once the assets have been removed from the balance sheet, any holdings in excess of agreed dealing limits should be deducted from capital. The bank should fully comply with the policy on holding the assets, as detailed above, within one month.

3 An originator should not deal in the securities issued by the SPV unless it has discussed its intention with the FSA. The FSA considers that a bank's deals should be limited. Appropriate limits are likely to represent only a small fraction of the total securities issued.

a) Limit structures should generally be subject to limits specific to individual tiers of securities issued. Limits are likely to be more constraining for trading in securities other than the most senior debt.

See s6.2

b) It is an accepted role of an originating bank to promote an orderly market in the securities issued by the SPV, but not to the extent that that originator is or appears to be able to support the issue, which would be in contravention of the policy above.

See s9 and Ch TI s9

c) The ability to deal in securities is limited to securities deemed to be of investment grade by a relevant rating agency as defined. Securities below investment grade fall within the definition of as credit enhancement as described below.

d) The policy is not intended to restrict the ability of an SPV to buy back securities it has issued at or below par.

11.2 Dealing & underwriting by a sponsor or repackager

See ch TU

4 A sponsor or repackager may act as underwriter for the securities issued by the SPV subject to the policy in chapter TU.

See s9

a) At the end of the underwriting concession period any holdings of sub-investment grade paper will be deemed to constitute credit enhancement unless there is already sufficient enhancement within the scheme.

b) Securities issued that are deemed to be investment grade by relevant rating agencies are deemed not to constitute credit enhancement, provided that there is already sufficient credit enhancement.

5 A sponsor or repackager may act as dealer in the secondary market in the securities issued by the SPV, provided that there is always at least two other third party dealers.

a) This may be waived where a scheme is small and having multiple dealers is not practicable. However, given that in such schemes, there may more reason for concerns as to liquidity, the sponsor should be able to demonstrate that it is creating an orderly market and not supporting the issue. Banks wishing to follow this approach should obtain the prior approval of the FSA.

Interim Prudential Sourcebook for Building Societies

11 Outsourcing

11.1 Introduction

11.1.1 G This chapter contains new guidance for building societies on outsourcing.

11.1.2 G The rest of this chapter consists of the guidance for banks on outsourcing (taken from chapter OS of the IPSB for banks). This guidance applies in its entirety to building societies with the following amendments and exceptions:

(1) all references to "banks" should be read as including building societies;

(2) paragraphs 3(b)(a)(i) and 4 in section 1.1 do not apply to building societies (societies are not currently subject to the RATE process);

(3) the date referred to in paragraph 8 in section 1.2 is changed from 30 June 1999 to 1 September 2000.

OUTSOURCING

1 INTRODUCTION

1.1 Legal sources

1 Principle 3 of the Principles for Businesses states that a firm must organise and control its affairs effectively which includes having adequate systems and controls (see also the high-level rule in SYSC 3.1.1R). The Threshold Conditions ('Suitability') also includes the need to ensure that a firm conducts its affairs 'soundly and prudently'. Relevant to the meeting of these requirements is a bank's outsourcing arrangements. In considering any outsourcing proposal, a bank should consider whether the outsourcing meets the material outsourcing definition below. Where the proposal meets these criteria, the bank should take into account the system and control implications, including adequate anti-money laundering systems, and the degree to which management control of the task will be relinquished to the supplier. The FSA considers that a bank's management is accountable for the adequacy of systems and controls for the outsourced activity.

See Supervision Manual, chapter 2

2 The FSA has powers under section 165 of the Act to require a bank to provide documents to the FSA which it reasonably requires in connection with the exercise of its functions under the Act. Nevertheless additional steps need to be taken to protect the FSA's access to information in relation to outsourced activities.

3 Material outsourcing is the use of third parties to provide services to a bank which are of such importance to the bank that:

(a) a weakness or failure in any of the activities outsourced would cast into serious doubt the bank's continuing compliance with the Principles for Business and Threshold Conditions; and

(b) the outsourcing is by business units which are *significant units*.

a) A *significant unit* is one which is covered by the FSA's risk assessment.

i) The first step in the FSA's RATE approach is to agree with banks exactly which units are significant: this process is described in paragraphs 26 to 30 (UK banks) and 31 to 33 (overseas banks) of the FSA's June 1998 paper "Risk based approach to supervision of banks".

b) The purchase of a standardised service from, for example, Bloombergs or Reuters and the provision of custody arrangements fall outside of the definition of material outsourcing.

4 This definition is solely for the purpose of determining the scope of the policy on outsourcing. It is not intended to restrict discussion with the FSA, nor is it intended to limit the issues that the FSA considers as part of the RATE process. A bank should apply its normal tests in deciding which issues should be raised with the FSA.

5 If in doubt as to whether a function would be considered material the bank should discuss the definition of material outsourcing with the FSA.

6 Although the principles in Section 4 apply to both intra- and extra-group outsourcing, the FSA applies them flexibly where the outsourcing is intra-group or to another regulated entity, particularly where the outsourced activity is a regulated core business function carried out by the supplier for its own purposes, e.g. cheque clearing.

1.2 Application

7 The policy set out in this chapter applies to all banks except EEA banks.

8 A bank which had outsourcing arrangements in place on 30 June 1999 or which was close to completing outsourcing arrangements on or after this date, is exempt from the application of this policy until the existing contracts become due for renewal. At that time the FSA expects a bank to discuss with it how the bank intends to apply this policy to the renewal of its existing arrangements.

1.3 How this chapter is organised

9 Section 2 sets out the basic scope and range of the FSA's approach to outsourcing proposals. Section 3 summarises the main features of the policy.

10 Section 4 details the minimum criteria a bank should adopt when it intends to outsource. These range from its due standard of care, to its relationship with the FSA and to its customers.

11 Section 5 sets out some points for further consideration regarding the structure of a bank's relationship with the supplier of the outsourced function. It stresses particularly the standards the bank should expect a supplier to meet and how the bank should monitor the relationship. This section does not represent additional minimum criteria, but a bank still needs to have considered the issues raised; the FSA may ask the outsourcing bank what procedures have been put in place to address relevant concerns.

12 Section 6 is an appendix setting out the FSA's general approach to *central booking*. It also explains when the FSA regards central booking as a form of material outsourcing for the purposes of sections 2 to 5.

a) *Central booking* is where the business is carried out in one location or legal entity within a group and booked in the accounting records of another. In some cases, the risks arising from such business may be managed in a third location.

2 THE FSA'S APPROACH TO OUTSOURCING

1 Banks frequently decide to outsource aspects of their operations, either to other group companies or to independent third parties. This is sometimes done on grounds of cost, sometimes because the other party can deliver a better service than can be provided in-house, and sometimes a combination of both.

2 The FSA recognises that outsourcing can bring significant benefits to banks and their customers. However, the FSA is concerned that when an important function is performed outside a bank, the bank may lose or have reduced control of the outsourced activity. Furthermore, the FSA's ability to exercise its supervisory powers to gather information or to require changes in the way that the outsourced function is carried out may be affected adversely. In addition, there may be some circumstances in which the FSA will need to assess the suitability of the service provider and its key staff. This policy is designed to address these concerns without impeding unduly banks' ability to use outsourcing to further their business objectives.

3 The FSA recognises that some of this policy will not be appropriate to intra-group outsourcing. Where a particular principle applies only to outsourcing either solely within or alternatively outside the consolidated group this has been clearly stated. Where there is no such statement it should be assumed that the policy applies to both intra- and extra-group outsourcing.

3 THE MAIN FEATURES OF THE POLICY

This section summarises the main features of the policy applying in relation to outsourcing banks. It should be read in conjunction with section 4 below.

3.1 Informing the FSA

See s4.1

1 A bank should make the FSA aware, through its normal supervisory channels, of its intention to outsource a task which, materially, either impacts on its systems and controls or affects its risk profile. This should take place in reasonable time to allow the FSA to consider the proposal and to raise any concerns.

2 During the course of the outsourcing agreement a bank should make the FSA aware of any material problems encountered with the outsourcing supplier.

3.2 Material outsourcing proposals

See s4

3 The FSA expects a bank to be able to analyse the impact outsourcing a particular function will have on its overall risk profile and the bank's internal systems and controls.

See s4.5

4 A bank should ensure that the FSA has access to any information relevant to the outsourced activity reasonably required by the FSA in connection with the exercise of its functions under the Act.

See s4.6

5 A bank should ensure that its internal and external auditors have access to any relevant information they require to fulfil their responsibilities.

3.3 The FSA's consideration of banks' outsourcing proposals

See s4.1

6 The FSA will consider a bank's outsourcing proposal and raise any concerns that it has. The FSA is aware of commercial pressures involved in outsourcing contracts and will agree with the bank a suitable timescale for response.

4 PRINCIPLES OF OUTSOURCING

4.1 General

1 A bank should make the FSA aware of a material outsourcing proposal in reasonable time to allow the FSA to consider the potential impact of the proposal on the bank and to raise any concerns. The FSA is aware of commercial pressures involved in outsourcing contracts and will agree with the bank a suitable timescale for response. Once a bank has notified the FSA of a material outsourcing proposal, the FSA will determine the level of its ongoing scrutiny of the process and ask the bank to provide further information accordingly.

See ch GN s3

2 Regardless of whether the outsourcing supplier is inside or outside the group, the FSA holds the bank's management responsible for ensuring that the outsourced function is carried out to a proper standard and that the integrity of the bank's systems and controls is maintained. The FSA would expect a member of the bank's senior management to take responsibility for each material outsourced function; this person should be an approved person (see 3.3.24G).

3 In some limited circumstances it is possible that a person employed by a supplier may be subject to the approved persons requirements under the Act. Further details are given in the Supervision Manual.

a) The scope and principles of the approved persons requirements are set out in Part V of the Act, the High Level Standards for Business and the Supervision Manual.

b) Applicants apply to the FSA to become approved persons using Form A in chapter 10 of the Supervision Manual.

4.2 Principles governing a bank's relationship with its supplier

See s5.2

4 A bank should monitor and manage on an ongoing basis its relationship with the supplier so as to seek to ensure the integrity of its systems and controls is maintained.

5 The supplier should be a competent, financially sound firm with good relevant knowledge and expertise. The bank should be able to demonstrate that it has taken proper steps to verify this and that it also has procedures for assessing the supplier's performance on a continuous basis. Additionally, the bank should be able to satisfy the FSA that the supplier is committed for the term of the contract to devoting sufficient, competent resources to providing the service.

a) Where the supplier is a member of the same group as the bank, the latter is likely to have a greater pre-existing level of knowledge about the former. The level of assessment may therefore be reduced.

6 The agreement between the bank and the supplier should provide that the bank is informed of any developments which may have a material adverse impact on the supplier's ability to meet its obligations. This includes, for example, relevant material control weaknesses identified by the supplier's internal or external auditors. The supplier's auditors do not have a responsibility to report any concerns to the FSA. Nonetheless, the bank should ensure that there is a clear reporting line between the supplier and itself so that any material problems relating to the outsourced activity can be communicated and to enable it (or the FSA) to make any further enquiries of its own into such problems.

a) Where the supplier operates abroad, the Data Protection Act 1998 sets out legal requirements governing the transfer of data across borders.

7 For outsourcing outside the group there should be a right to terminate the contract in the event that the supplier undergoes a change of ownership or the supplier becomes insolvent or goes into liquidation or receivership.

4.3 Principles covering service level agreements ('SLAs')

See s5.4

8 An *SLA* is a negotiated agreement on the standards of service between the supplier and the end-user (the bank). A bank should always have a written SLA in place with its supplier, where the outsourcing is outside the group. The SLA should also provide for periodic reviews and appropriate remedies should problems arise. Such reviews should allow for the relationship to be amended via the SLA or contract as appropriate, on the basis of performance against specified targets.

(a) Banks may be asked to submit SLAs to their supervisors.

9 Where the outsourcing is intra-group a SLA may not always be appropriate. This is particularly the case where a service is supplied on a group wide basis. In such circumstances the supplier may wish to provide a statement of the standard of service to be provided to the whole group. This statement may be supported by a wide range of other existing relationship management systems. Where these provide a sufficient performance measurement structure a SLA may not be required.

4.4 Principles affecting contingency planning

See s5.5

10 A bank should have and regularly review contingency plans to enable it to set up new arrangements as quickly as possible, with minimum disruption to business, if the contract is suddenly terminated or the supplier fails. The level of detail in such plans may vary. For example, if there are large

numbers of possible alternative suppliers the outsourcer may simply be able to use one of the alternative supplier(s). However, this may still be a complex and time consuming process and a bank should consider how it would deal with the hand-over process. If, on the other hand, the only option is for the bank to resume the activity itself the plan should be far more detailed.

a) As the contract with an intra-group supplier is highly unlikely to be terminated through the actions of the supplier, the only significant risk is that the service will be interrupted by another unrelated event. Such events should be covered by the supplier's business continuity plan and therefore a separate contingency plan for the bank may not be appropriate.

4.5 Principles governing supervisors' access to information

See Supervision Manual, Chapter 5

11 The contract between the bank and the supplier should ensure that the bank can provide the FSA with any information relating to the outsourced activity that the FSA may require in order to carry out effective supervision, whether the outsourcing is within or without the group, for example, through section 166 reports by a person with relevant professional skill.

12 Where the supplier is based outside the UK, the bank should assess the extent to which the local regulator/regulations may restrict access to information about the outsourced activity.

13 The FSA should be informed if any other regulator raises serious concerns with the bank's proposal to outsource.

4.6 The auditor's role

14 A bank should have processes in place to identify and deal with any weaknesses in the supplier's procedures which could have a material adverse impact on the service provided to the bank. This could include access for the bank's internal and external auditors, independent reports on the supplier and/or monitoring of detailed performance statistics.

15 In line with the FSA's approach to other areas of banking supervision, where internal or external audit raises material problems the bank should alert its supervisor. The bank should also ensure that it has the management capacity to assess and respond to any such concerns so raised.

4.7 Outsourcing internal audit

16 All cases of outsourcing internal audit will be considered material.

17 A bank should not outsource its internal audit function to either its skilled persons or its external auditors. A bank should have an internal audit function independent from external audit as this segregation of responsibilities would be compromised if the same firm fulfilled both functions.

See ch AR s3

18 However, the FSA considers that it may be appropriate for certain internal audit services to be provided by the external auditors/skilled persons where the following conditions are met:

(a) the work is carried out under the overall supervision and management of the bank's own internal audit staff;

(b) ultimate responsibility for the adequacy and effectiveness of internal audit lies with the Head of Internal Audit.

(c) the Head of Internal Audit is a senior and experienced individual who is an employee of the bank, or the group of which the bank is a part.

(d) the FSA is satisfied that the Head of Internal Audit has satisfactory reporting lines. These lines would typically involve unfettered access to the audit committee or at a minimum a non-executive director.

19 A bank wishing to use its external auditor/skilled person to perform any part of internal audit's function should notify the FSA of its intention to do so. It need not, however, notify where individual employees of a bank's external auditors/skilled persons are seconded to work within the internal audit function.

20 Where internal audit is outsourced to another firm which is not otherwise involved in the auditing or accounting function of the bank, the independence issue does not arise. Therefore, outsourcing proposals meeting this criterion are assessed in the same way as any other function.

4.8 Principles covering sub-contracting

21 The contract should state that if the outsourcing supplier decides to sub-contract further the original outsourcing supplier continues to be contractually liable and the level of service and systems and controls will not deteriorate.

a) *Sub-contracting* is where the supplier of an outsourced function further contracts out that function to a third party unrelated to the bank or supplier.

5 FURTHER AREAS FOR CONSIDERATION

Banks should have considered the issues raised in this section as the FSA may ask what procedures have been put in place to address these concerns.

5.1 General

1 Any voluntary Codes of Conduct adopted by the bank that would have a direct impact on customers could also be observed by the supplier. This step may help to prevent a deterioration in the service received by its customers.

5.2 A bank's relationship with its supplier

5.2.1 General

See s4.2

2 The bank may wish to be aware of the material risks to which the supplier is exposed in relation to the service provided to the bank by the supplier and the corresponding control procedures in place. There might also be provision for relevant management information so that problems, such as a deterioration in service, are brought to the attention of the appropriate individuals in the bank at an early stage. The bank may wish to take steps to seek to ensure that it is clear who is accountable at the appropriate level in respect of such problems. One such mechanism may be through establishing clear lines of escalation both within the supplier and the bank.

3 It would be prudent for a bank's management to provide adequate resources at appropriately senior levels to ensure that the relationship with the supplier is properly managed and monitored against performance targets.

4 Where the outsourcing supplier is in direct contact with the bank's customers, the bank may wish to establish how its customer relations policies will be reflected by the supplier, for example, answering complaints within a certain time period. Such policies could be measured and factored into any consideration of the supplier's performance. This is important to a bank since any material deterioration in customer relations may adversely affect its reputation. This matter has greater significance if the supplier is external to the group since the supplier might have a different culture.

5.2.2 Termination of contract with the supplier

See s4.2

5 A bank may wish to make provision in the contract to ensure that it does not lose any work or records which are material to the bank's business and has been carried out by the supplier, should the contract be terminated. In

any case it would be sensible for termination clauses to provide adequate notice for the bank to put in place alternative arrangements.

5.3 Confidentiality

6 Confidentiality may not be a significant issue if the outsourcing is within a bank's group. However, the bank may wish to consider whether the confidentiality constraints below need to be fulfilled.

7 Where a supplier deals with a bank's competitors distinct procedures (such as Chinese Walls) may be advantageous in seeking to ensure that there is no breach of client confidentiality. Where the supplier operates abroad, the Data Protection Act sets out legal requirements governing the transfer of data across borders.

5.4 Service level agreements ('SLAs')

See s4.3

8 In order to ensure that there is no confusion over respective duties banks may wish to clearly define what is to be outsourced in their SLA. Additionally the SLA may incorporate the capacity for change (including technological change) or expansion, set out clearly who is responsible for ensuring that work is completed and incorporate details of the reports that the bank might wish to receive from the supplier and their frequency.

9 Where a supplier provides a service for several banks or the bank has peak periods of service, the bank might wish to seek to ensure that a minimum level of resources will be continuously devoted to provide an agreed level of service.

10 For extra-group outsourcing, the contract may provide the option for regular re-tendering. However, for both intra- and extra-group outsourcing, it may be prudent for the relationship to be reviewed, where and when appropriate, but at least annually to take account of all relevant business and environmental changes and the review may also include a financial strength assessment of the supplier.

11 An agreed standard of service between the supplier and the bank might be particularly relevant in the case of extra-group outsourcing. A bank may wish to consider whether the standard of service operated by the supplier needs to be as high as that operated within the bank. Performance targets might be included within the SLA, along with provision for escalation and termination where the targets are not met.

5.5 Contingency planning

See s4.4

12 Daily operations and systems problems, such as temporary disruption/suspension of the service, could be included within a plan although this could be covered in the supplier's own contingency arrangements.

13 A bank might wish to ask the supplier for information about its own contingency plans, in order to assess the level of comfort it can draw from these plans and consider the implications for its own contingency planning. Where sufficient comfort cannot be drawn the bank may wish to make alternative contingency arrangements either in-house or through an alternative supplier as appropriate.

6 APPENDIX – CENTRAL BOOKING

Central booking is where the business is carried out in one location or legal entity within a group and booked in the accounting records of another location or legal entity. This general description covers a range of different scenarios, as explained in the remainder of this section: in all cases, the overriding objective is that, however a bank chooses to organise its activities, it must continue to comply with the Principles for Businesses and Threshold Conditions for Authorisation and with its other legal and supervisory obligations, including those relating to the provision of information to the FSA. The FSA expects banks to discuss significant new central booking proposals with their supervisors, in the same way as for any other significant change in its organisational arrangements.

6.1 Central booking between different locations of the bank

1 Banks often record transactions in a different physical location to that in which the business is undertaken. This will never fall within the definition of material outsourcing (because a bank cannot, by definition, outsource to itself). A bank should nevertheless satisfy itself that, wherever the various functions associated with its business are physically carried out, the bank complies with its legal and regulatory obligations including (but not limited to):

(a) the maintenance of adequate accounting and other records and internal control systems;

(b) the adequacy of provisions, liquidity and capital (where relevant); and

(c) the provision of information to the FSA (including periodic reporting such as prudential returns and the notifications on large exposures, controllers and close links, and ad hoc requests for information).

6.2 Central booking between different legal entities

2 A bank should consider both the legal form and the commercial substance of its arrangements with the other entity in order to establish the true nature of the relationship and therefore the procedures which are appropriate to enable the bank to comply with its obligations. The key consideration is the risks to which the bank is exposed as a result of the transactions undertaken and/or its arrangements with the other party.

3 Material outsourcing issues only arises where the bank records, and bears the risk of, business which is initiated by another legal entity in the group <u>acting in the bank's name</u> (so that clients/counterparties believe that they are dealing with the bank's own staff).

a) In contrast, where another legal entity in the group acts as broker/introducer for example, it provides a discrete service in its own name to both the bank and customers/counterparties.