

The following Compliance articles are for the week ending 23 October 2009.

## COMMENTARY

### FSA TAKES ACTION TO HELP INVESTORS WITH LEHMAN-BACKED STRUCTURED PRODUCTS

The Financial Services Authority (FSA) has today announced tough and wide-ranging action to help investors who received unsuitable advice or misleading promotional material when they bought a Lehman-backed structured product, as well as measures to address issues in the wider structured products market.

This follows an FSA review of the marketing and distribution of structured products, particularly those backed by Lehman Brothers, to achieve the best outcome for all investors who were affected by the insolvency of the firm.

The FSA found significant advice failings on Lehman-backed products in most of the financial advice firms sampled, as well as serious deficiencies in the marketing literature provided by a number of the plan managers selling these products.

As a result, the FSA is taking direct action to address the detriment this has caused for investors with Lehman-backed products and robust steps to ensure all future structured products investors are treated fairly, including:

#### Lehman-backed structured products:

- Following the FSA's review of their promotional material and its subsequent discussions with the firms, three plan managers that packaged and marketed Lehman-backed structured products - NDF Administration (NDFA), Defined Returns Limited (DRL) and Arc Capital and Income plc (ACI) - have gone into administration
- As a result, investors who purchased Lehman-backed structured products through these firms may be entitled to compensation from the Financial Services Compensation Scheme (FSCS) The firms' administrators are contacting investors with information on how this affects them
- Issuing all firms that gave advice to investors on Lehman-backed structured products with a template they should use to deal with customer complaints - it outlines the criteria the FSA expects them to use to assess the advice they gave to ensure investors are treated fairly and consistently
- Writing to all remaining investors that will not be contacted as a result of the plan managers' administration, and publishing guidance, to help investors consider what steps to take, including making a complaint, if they believe they were misled by product literature or received unsuitable advice
- Referring three advice firms to enforcement for giving unsuitable advice, and instructing other advisers it looked at to review past sales of Lehman-backed structured products and pay redress where appropriate
- Providing clear guidance to all firms advising on structured products (both those backed by Lehman Brothers and other firms) on the standards it expects them to meet, including examples of good and poor practice it identified during its review

### Wider structured products market (non Lehman-backed):

- Writing to the largest sellers of other structured products, asking them to examine how they have sold these products in the past against the standards reiterated by the FSA today and, if necessary, to review past sales and provide investor redress where appropriate, as well as change their approach for future advice and sales
- In the course of 2010 the FSA will undertake follow-up assessments to ensure that firms are meeting its advice standards
- Following-up with plan managers where the FSA had concerns about their marketing of non Lehman-backed structured products, to assess whether firms' current literature meets its requirements, and setting out the standards it expects firms to meet when designing and marketing structured products.

Dan Waters, the FSA's Director of Conduct Risk, said: "We are committed to ensuring that retail financial services markets deliver fair outcomes for consumers. The focus of our review has been to achieve the best possible outcome for as many people as possible that invested in structured products backed by Lehman Brothers.

This is a hugely complex area given the number of different firms involved, and there is no one-size-fits-all solution for these investors. However, given the failings we have come across in the marketing and selling of these products, today we are setting out a package of robust measures to help those who have lost money.

We are also taking decisive action to address issues in the wider structured products market to ensure that all future investors will be treated fairly – and we will not hesitate in taking action if firms do not take sufficient steps to respond to our concerns."

**Source: FSA Website**

### FSA SETS OUT REFORMS FOR THE MORTGAGE MARKET

The FSA has set out proposals for the major reforms required in the UK mortgage market to ensure that it works better for consumers and is sustainable for all market participants.

The proposals, published in the mortgage market review discussion paper, reflect the FSA's changed approach to a more intrusive and interventionist style of regulation. The review's key features are:

- Imposing affordability tests for all mortgages and making lenders ultimately responsible for assessing a consumer's ability to pay
- Banning 'self-cert' mortgages through required verification of borrowers' income
- Banning the sale of products which contain certain 'toxic combinations' of characteristics that put borrowers at risk
- Banning arrears charges when a borrower is already repaying and ensuring firms do not profit from people in arrears
- Requiring all mortgage advisers to be personally accountable to the FSA
- Calling for the FSA's scope to cover buy-to-let and all lending secured on a home

Jon Pain, FSA Managing Director of Supervision, said: "The mortgage market has seen extraordinary upheaval over the last 18 months and whilst it has worked well for the vast majority of borrowers, some have suffered great financial distress. We recognise that we need to bring about a step change in regulation and we need to act now to address the issues we have identified.

The paper sets out the main findings of the FSA's comprehensive analysis of the mortgage market. It clearly shows a rapid explosion in mortgage products; the emergence of high risk lending strategies which typically focused on higher risk borrowers; relaxed credit standards; and a mutual assumption by too many borrowers and lenders that the good times could not end.

The FSA needs to ensure that firms only lend to people who can afford to pay the money back. The reforms that we have announced today will ensure that the mortgage market works better for consumers and that it is sustainable for firms."

The review has also identified that the irresponsible lending practices seen in the market until recently will be curtailed by the FSA's existing work on capital and liquidity.

The proposals are designed to tackle the problems identified while maintaining a vibrant and sustainable market but the FSA has not ruled out further change if the initial proposals do not have sufficient effect, including caps on loan-to-value, loan-to-income or debt-to-income. The discussion paper is out for discussion until 30 January 2010 and the FSA will be actively seeking views from consumer groups and industry. A feedback statement will be published in March. Implementation will be phased, with the focus on speed for areas of high detriment, such as arrears.

**Source: FSA Website**

### **SENIOR SUPERVISORS' GROUP PAPERS**

The Senior Supervisors' Group which includes FSA as well as nine other international bodies has published two papers.

One is entitled "Risk Management Lessons from the Global Banking Crisis of 2008" and the other is entitled "Self Assessment Template - A Supplement to Risk Management Lessons from the Global Banking Crisis of 2008."

**Source: FSA Website - SSG Supplement**

### **FSA - PUBLISHES ANALYSIS ON SYSTEMICALLY IMPORTANT BANKS AND CUMULATIVE IMPACT OF CAPITAL AND LIQUIDITY REFORM**

The FSA has issued a Discussion Paper (DP) focusing on policy measures to address the problem of systemically important 'too-big-to-fail' banks.

The paper also examines the trade-offs involved in increasing capital and liquidity requirements, and stresses the need to assess the cumulative impact of multiple reforms.

The paper identifies the dangers posed by those firms that are seen as too-big or too-interconnected-to-fail, or too-big-to-rescue.

It describes the full range of policy options - including the creation of 'narrow banks' - in order to provide the basis for an informed debate, but also outlines the position which the FSA is currently proposing in international fora, namely that:

- There is a strong case for applying some form of capital (and perhaps liquidity) surcharge internationally for systemically important banks; surcharges could be proportional to continuous and increasing measures of systemic importance, avoiding the dangers created by specific thresholds of systemic importance
- A capital surcharge could be combined with an approach to global banking groups which places greater emphasis on the standalone sustainability of national subsidiaries, with overt understanding that home country authorities will not be responsible for the rescue of entire groups. The more that groups are organised on this basis, the less the required surcharge at group level might need to be
- Action should be taken to reduce inter-connectedness in wholesale trading markets, with much Over-The-Counter (OTC) derivative trading moved to Central Counterparties (CCPs), and with effective collateral and margin call arrangements for bilateral trades which reduce the dangers of strongly pro-cyclical margin call effects
- Reform to trading book capital should significantly increase capital requirements and differentiate more strongly between basic market making functions which support customer service and riskier trading activities, with a bias for conservatism in relation to the latter
- Systemically important banks should be required to produce recovery and resolution plans ('living wills') which set out how operations would be resolved in an orderly fashion. If supervision examination of these plans reveals serious obstacles to resolution, then steps will need to be taken to reduce or remove them – this could require restructuring certain parts of the group. Restructuring could include clear separation between retail deposit taking business and businesses involved in proprietary trading activities, with the latter able to fail even if the former were supported in crisis conditions

The DP also stresses the need to assess the possible cumulative impact of multiple reforms to capital and liquidity regimes now being considered by international standard-setting bodies.

It describes the case for significant increases in capital and liquidity requirements to reduce financial instability risks, while recognising the potential implications for lending volumes and the cost of credit intermediation. It considers methodologies which can help inform judgements on the trade-offs involved.

The DP makes clear, however, that the potential trade-off between improved stability and constrained lending does not arise in relation to required changes in trading book capital, nor where capital enhancement can be achieved by moderation of bonus payments.

It therefore reasserts the Financial Stability Board message that the priority use of high investment bank profits must be to enhance capital levels rather than to support excessive bonus payments.

Lord Turner, FSA chairman, said: "The direction of travel is clear: the overall level of capital required in the banking system must be significantly increased over time, while liquidity standards must be significantly tightened.

These changes are required to create a more stable financial system for the long-term: the challenge now is to determine the precise long-term objective and the appropriate transition path.

Meanwhile, the FSA has to reduce the danger that authorities in future will be faced with only one option – using public funds to rescue whole groups with only equity holders suffering loss. And we must also limit the extent to which implicit government guarantees support unnecessary levels of risky proprietary trading. The way to achieve this is likely to be a number of mutually reinforcing policies, not a single silver bullet."

**Source: FSA Website**

#### **ABI RESPONSE TO TURNER REVIEW DISCUSSION PAPER**

Responding to the FSA's Turner Review Conference discussion paper on a new regulatory framework for the banking industry, Peter Montagnon, the Association of British Insurers (ABI) Director of Investment Affairs, said: "While we do not see a formal Glass-Steagall approach as practicable, it might be helpful if market pressures led to banks reorganising themselves into more manageable units, with either a utility or an investment banking focus.

The application of more rigorous capital requirements to the trading book would promote such a market development, which we would broadly support.

We are more sceptical about liquidity and capital surcharges for 'systemically important' banks, not least because 'systemically important' is difficult to define.

"It is vital that that any restructuring of bank capital must be done in an orderly way, so as not to destabilise the market in subordinated bank debt, for example through forced early redemption at a discount, as this market is critical for funding UK pensions."

**Source: ABI Website**

#### **EC REVIEW OF SAVINGS REGULATION VITAL FOR CONSUMERS**

The European Commission (EC) should make sure that investment saving products across the EU are uniformly regulated, says the ABI. Any new rules should prioritise achieving the best outcomes for consumers as a priority.

The ABI has released a Working Document, entitled Packaged Retail Investment Products: New Ways of Thinking, which sets out its initial thoughts.

A hearing into the issue takes place at the European Commission on 22 October 2009. This follows the Commission's Communication on Packaged Retail Investment Products (PRIPs) released in April 2009.

This identified concerns over the lack of a regulatory level playing field for the regulation of retail investment products. The scope of the PRIPs project has yet to be finalised, but it should cover investment savings products, including unit-linked life insurance policies and with-profits funds.

The ABI urges the Commission to:

- Put the needs of consumers first when thinking about any new regulatory framework for PRIPs at a European level
- Recognise the importance of increasing consumers' savings and encouraging a competitive environment between different product types and manufacturers
- Focus on the economic purpose of a product, rather than its legal form – equivalent products should have equivalent regulatory treatment

- Recognise that consumers want, need and deserve a regulatory framework for selling practices that focuses on their needs, treats them fairly, enables them to understand the sales process and ensures that financial advice is not biased by remuneration arrangements with product providers.

**Source: ABI Website**

#### **CML WELCOMES FSA DISCUSSION PAPER ON MORTGAGE LENDING**

The Council of Mortgage Lenders (CML) welcomes the publication of today's Mortgage Market Review discussion paper, and looks forward to working with the FSA as it seeks to refine the system of mortgage regulation for the future.

It is, however, ironic that at the same time as politicians are seeking to encourage lenders to increase their flow of mortgage lending to consumers, they are also keen to take steps to address the perception of "irresponsible lending".

While the FSA's discussion paper is well thought out and logical, some of the wider political rhetoric around lending issues continues to seem more conducive to rabble-rousing than to properly considered debate.

It is interesting to see the FSA note that it believes regulation cannot rely on the notion of borrowers behaving rationally - that is, in their own interests - and that the regulator may instead need to introduce measures to "protect consumers from themselves".

It is important that the principle of consumer responsibility is not lost in such a regulatory environment, as it is a basic tenet upon which transactions of all kinds between firms and consumers rely.

Michael Coogan, CML Director General, said: "We agree with the FSA that regulation in itself cannot resolve the problems of the recent market. However, we also agree that clearly delineated responsibilities, which remove regulatory ambivalence, will help lenders, intermediaries and consumers to know where they stand, and to accept the consequences of their actions.

As always with regulatory change, the devil may be in the detail. But we welcome the consultative approach, and look forward to working with the FSA to ensure that the objective of regulatory fairness between lenders, intermediaries and consumers is achieved in practice."

**Source: CML Website**

#### **CML RESPONDS TO BANK'S LENDING TRENDS REPORT**

Commenting on the "Trends in Lending" report from the Bank of England, CML Director General Michael Coogan said: "As we surmised when we published our September gross lending data, the new report confirms that September saw a continuation of the two-speed mortgage market, with lending for house purchase continuing to increase but remortgaging remaining weak. But, also as we have highlighted, funding conditions remain challenging, despite the encouraging signs of a slight thaw in wholesale funding markets. This report very much confirms our own assessment of market prospects - the most likely scenario is a slow and long-drawn out recovery."

**Source: CML Website**

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