Feedback Statement

09/3

Financial Services Authority

A regulatory response to the global banking crisis

Feedback on The Turner Review and DP09/2

September 2009

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Annex 1: Acronyms

Annex 2: List of non-confidential respondents to DP09/2

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This Feedback Statement reports on the main issues arising from Discussion Paper 09/2: *A regulatory response to the banking crisis*.

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1 Foreword

In March this year the FSA published the Turner Review and an associated Discussion Paper setting out a comprehensive program of reform which we believed was required to create a more stable global financial system. We were very aware, however, that while many of the required changes could already be defined, others merited further thought and analysis before final decisions. We therefore encouraged stakeholders to respond to the proposals made in March. We also stressed the need for UK action wherever possible to fit within the context of global agreements. This Feedback Statement therefore does two things. It sets out our analysis of the responses which we have received; and it reports on progress since March in implementing change and in achieving international agreement.

That progress has already been considerable at both global and European levels. Section 3 of this Feedback Statement describes it. Particularly important has been the emergence of the international Financial Stability Board as a leading forum for global agreement, coordinating the work of the standard setting bodies.

Section 4 of the Feedback Statement summarises points made in the 81 formal comments we have received on the Discussion Paper, and then sets out the FSA's response. Some of the comments received have raised important issues which will influence the detailed design of our final policies.

Alongside the process of formal response to the proposals made in the Turner Review and Discussion Paper, however, wider debate has continued on the overall approach to financial regulation and the FSA's own thinking has continued to evolve. Some proposals which were covered only to a limited extent in our March documents now require more detailed analysis. In addition to this Feedback Statement the FSA will, therefore, towards the end of October issue a new Discussion Paper which will focus on particular issues which merit more detailed debate and consideration. These include:

- The appropriate approach to large systemically important banks, covering the merits of differentiated prudential requirements and the potential role of "living wills".

- The need for a comprehensive analysis of the combined impact of the several changes in the global capital and liquidity regime now already agreed or under discussion.

These issues will form the agenda of the second Turner Review conference which the FSA is holding on November 2nd.

2 Overview

Introduction

2.1 In March 2009 the FSA published *The Turner Review* and its associated Discussion Paper 09/2: *A regulatory response to the global banking crisis* (DP). *The Turner Review* and DP responded to a request from the Chancellor of the Exchequer to review the causes of the crisis – arguably the greatest the financial system has ever faced – and make recommendations on the changes needed in regulation. The crisis has been unique in that it emerged simultaneously in many countries and its impact has been felt throughout the now interconnected world. It follows that the policy solutions that emerge to tackle the cause of the crisis will have to be both deep-rooted and internationally agreed if they are to be effective.

2.2 *The Turner Review* and DP sought to achieve five outcomes:

i) the global banking system is better capitalised and more resilient to liquidity shocks throughout the business cycle;

ii) the regulatory framework in general, and its capital component in particular, are explicitly counter-cyclical;

iii) supervisory, crisis management and resolution arrangements for cross-border financial services groups are effective and reflect the interests of host countries as well as those of the home state;

iv) any material risks to financial stability posed by unregulated activities or firms are identified and controlled to the extent possible; and

v) macro-prudential and other risks to financial stability are identified at both the international and national levels and effective action is taken to mitigate them.

2.3 *The Turner Review* and DP examined the causes of the crisis, highlighted the shortcomings in regulation and supervision that contributed to it, and aimed to stimulate debate on potential regulatory policy responses. The FSA always recognised that the main regulatory issues would be most effectively addressed at the global level and has been greatly encouraged by the degree of alignment internationally on these issues. Although the focus of the FSA's work and those papers is on the regulatory

framework, it is important to remember that the impact of regulatory change, in itself, is limited and that the new framework that will emerge from the process currently underway cannot guarantee crises that will never recur. In particular, monetary and fiscal policies, as well as prudential regulation, have an essential role to play in maintaining financial stability.

2.4 The DP invited feedback on the paper and sets out specific questions on which the FSA wanted views. The comment period for the DP closed on 18 June 2009. The FSA received 81 responses in total from a wide range of respondents, including banks, building societies, trade associations, law firms, insurers, academics and private individuals.

Why is the FSA publishing this Feedback Statement?

2.5 This Feedback Statement (FS) is the response to the consultation that was included in the DP. In this paper the FSA summarises the feedback received and sets out its response, including how the feedback will influence the FSA's approach to the regulatory agenda. This paper also includes an overview of developments since the publication of *The Turner Review* and an updated table of the recommendations and implementation dependencies.

2.6 It is not, however, the end of *The Turner Review* process, as international dialogue and policy work remain ongoing and the FSA will issue further Discussion and Consultation Papers on policy changes as they emerge at international and EU levels, including full cost benefit analyses where applicable. More immediately the FSA will be issuing a further DP in October 2009 to set out its thinking on some key open issues. Further detail on what this DP will cover is set out in Section 5.

Who should read this paper?

2.7 Although the focus of *The Turner Review* and DP is on banking and investment banking activities, elements of the papers are much broader in their potential application and will be of interest to other types of regulated firms, including insurance firms. Therefore this paper should be read by those with a general interest in the financial services industry, as well as policy makers and supervisors in other countries. There is some discussion of the FSA's supervisory approach, which is relevant to all regulated firms. There are implications for the global regulatory framework and global banking system and these in turn have clear implications for consumers.

3 Recent developments

3.1 *The Turner Review* and DP were published on 18 March 2009. Since then there have been several key developments affecting the global, EU and UK regulatory frameworks. This section provides a factual account of these developments. The FSA's views on whether these developments are likely to be sufficient to deal with the issues and concerns set out in *The Turner Review* can be found in the relevant FSA responses set out in Section 4.

G20

3.2 On 2 April 2009 the leaders of the G20 met for the London Summit. The Summit focused on the banking crisis and leaders agreed a broad package of measures relating to regulatory reform. They agreed the need for progress in the following areas:

- international agreement on strengthened capital and liquidity standards, including the need for a more counter-cyclical approach;
- improved arrangements for cross-border crisis management and arrangements for developing supervisory colleges;
- a re-examination of the appropriate scope of supervision and the regulatory perimeter to enable all systemically important firms to be subject to appropriate regulatory oversight;
- the importance of principles covering remuneration;
- improved accounting and financial disclosure standards; and
- registration and the extension of regulatory oversight to credit rating agencies.

3.3 *The Turner Review* formed a key input for the London Summit preparations and the agreements reached there. The actions agreed by G20 heads of state, as set out in the Leaders' Declaration on Strengthening the Financial System, were largely consistent with *The Turner Review* recommendations.[1] This confirmed that the FSA's assessment of the issues, likely sources of risk mitigation and the direction and speed of travel for fundamental regulatory change were part of an emerging international consensus.

1 www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf

However, the recommendations of the London Summit were at the level of broad principle, and since then the key priority for national regulators and the various international bodies has been to translate them into more detailed frameworks that can be applied in practice.

3.4 To this end, the G20 allocated various projects and work streams to international bodies or standard setters, including the Basel Committee on Banking Supervision (BCBS), the membership of which was widened to include the other G20 countries. The task of monitoring the progress of these workstreams, together with developing improved mechanisms for assessing and addressing future vulnerabilities, was assigned to the Financial Stability Forum (FSF). This has been re-established as the Financial Stability Board (FSB) to include all G20 countries as members. The FSA, and other UK authorities, will remain fully engaged in international work to ensure that domestic and international priorities are aligned and mutually reinforcing.

3.5 On 26-27 June 2009, the FSB held its inaugural meeting. This resulted in establishing new internal structures to improve the efficiency with which it can deliver its work programme. This included setting up a Steering Committee (to provide operational guidance) between plenary meetings and three specialist Standing Committees. The three Standing Committees are: (i) Vulnerabilities Assessment, (ii) Supervisory and Regulatory Cooperation and (iii) Standards Implementation. The Standing Committee on Supervisory and Regulatory Cooperation is chaired by the FSA Chairman, Adair Turner.[2]

3.6 At the Pittsburgh Summit (24-25 September), the G20 further endorsed the work programme of the FSB. In doing this, G20 Leaders gave support to the FSB's new Implementation Standards supporting its Principles for Sound Compensation Practices. They also outlined a timetable for certain key work items, recording, for example, the intention to develop internationally-agreed rules to improve the quantity and quality of capital and to discourage excessive leverage by end 2010, with the aim of implementing them by end 2012.[3]

Accounting

3.7 International accounting standard setters are working to address recommendations made by the G20 and at European level. The International Accounting Standards Board (IASB) has published a proposal for a new standard for classifying and measuring financial instruments, that reconsiders which financial instruments are measured at fair value. A final standard is expected before the end of 2009. This is the first part of a fundamental review of accounting for financial instruments being undertaken by the IASB; further exposure drafts on impairment and hedge accounting will be published during 2009, with final standards expected during 2010. Mandatory adoption is expected no earlier than 2012.

3.8 The IASB has also conducted a request for information on the feasibility of an expected loss impairment model, and will consider the responses when preparing its exposure draft on impairment (due in October 2009). This addresses calls from the G20 and FSB to improve standards for loan loss provisioning and incorporate a

2 www.financialstabilityboard.org/press/pr_090627.pdf

3 www.pittsburghsummit.gov/mediacenter/129639.htm

wider range of credit information into impairment judgements, in order to mitigate the procyclicality of loan loss provisions. International supervisory committees (including the BCBS and the FSB) are supportive of further work in this area. However, there remains an active international debate about the extent to which further regulatory tools may be required.

3.9 The Financial Accounting Standards Board (FASB) is also conducting a fundamental review of accounting for financial instruments under US accounting standards. The FASB has initially decided that all financial instruments would be measured at fair value with all changes in fair value recognised in net income (with limited exceptions). In contrast, the IASB's proposal would result in more limited use of fair value, allowing instruments that have basic loan features and that are managed on a contractual yield basis to be measured at amortised cost. The IASB and FASB therefore appear to be moving in different directions. The Boards have agreed that they will jointly deliberate responses to the IASB's consultations before issuing final standards, to consider the scope for achieving convergence. At the Pittsburgh Summit, the G20 leaders called on the international accounting bodies to redouble their efforts to achieve a single set of high quality, global accounting standards.

3.10 The IASB has increased its outreach to stakeholders, including through roundtables held jointly with the FASB and establishing a technical dialogue with the FSB. The BCBS has also published a set of principles for the IASB to bear in mind when undertaking its review, and the G20 Finance Ministers have encouraged the IASB to take these into account.

Capital and liquidity

3.11 One of the key conclusions of *The Turner Review* was that, once recovery was assured, the banking sector needed more and better quality regulatory capital, capital requirements that did not exacerbate the business cycle and stronger liquidity regulation. The main forum for agreeing global capital standards in these areas is the BCBS and, at the London Summit, the G20 tasked the BCBS to work with national authorities to develop a new global framework for liquidity and strengthen prudential requirements.

3.12 The BCBS has made good progress towards delivering on this commitment and on 8-9 July 2009 it held its first meeting in its newly expanded form. Following this, the BCBS announced it would issue a consultation by Q1 2010, which will include proposals to:[4]

i) strengthen the quality of bank capital;

ii) build-up cyclical buffers that can be drawn down in periods of stress; and

iii) introduce a leverage ratio as a backstop to Basel II.

3.13 The July BCBS meeting also agreed measures to strengthen the rules governing trading book capital. These new requirements, building on previous agreements (from January 2009) and taking effect at the beginning of 2011, introduce higher capital requirements to capture the credit risk of complex trading activities and include a stressed value-at-

4 www.bis.org/press/p090713.htm – this followed previous commitments by the BCBS to review the minimum level of capital in 2010, www.bis.org/press/p090312.htm.

risk (VaR) requirement to dampen the cyclicality of capital requirements.[5] The increase in capital requirements as a result of these changes will be greatest for firms that use modelling techniques to capitalise their market risk. Whilst the level of capital increase will differ according to the composition of a firm's trading book and the breadth and nature of its modelling permissions, further analysis based on current positions has shown that the new requirements should deliver a capital charge consistent with that expected in *The Turner Review* (i.e. at least three times the current level for some firms' trading books). The BCBS also announced that it would undertake a fundamental review of the risk-based capital framework for trading activities, as recommended in *The Turner Review*.

3.14 The BCBS's oversight body, the Group of Central Bank Governors and Heads of Supervision met on 6 September to review progress and reached agreement on a number of key measures. These included:

a) agreement to raise the quality, consistency and transparency of the Tier 1 capital base. The predominant form of Tier 1 capital must be common shares and retained earnings. Appropriate principles will be developed for non-joint stock companies to ensure they hold comparable levels of high quality Tier 1 capital. Moreover, deductions and prudential filters will be harmonised internationally and generally applied at the level of common equity or its equivalent in the case of non-joint stock companies. All components of the capital base will be fully disclosed;

b) the introduction of a leverage ratio as a supplementary measure to the Basel II risk-based framework (a Pillar 1 treatment is envisaged based on appropriate review and calibration). To ensure comparability, the details of the leverage ratio will be harmonised internationally, fully adjusting for differences in accounting. The BCBS proposes to conduct impact testing of a leverage ratio as part of a wider impact study in 2010;

c) the introduction of a minimum global standard for funding liquidity that includes a stressed liquidity coverage ratio requirement, underpinned by a longer-term structural liquidity ratio, similar to the core funding ratio proposed in *The Turner Review*; and

d) the introduction of a framework for countercyclical capital buffers above the minimum requirements, including capital conservation measures such as constraints on capital distribution and the promotion of more forward-looking provisions based on expected losses. The BCBS meeting in early October will aim to reach decisions on how these high level agreements may be taken forward in practice.

3.15 Within Europe there have been amendments to the Capital Requirements Directive (CRD) that should help strengthen the regime within the EU. These measures, which have been under consideration for some time, will deliver an improvement in the quality of capital. They include the introduction, as part of the so-called CRD2, of greater harmonisation in the definition of hybrid capital instruments within Tier 1, and additional clarity on the criteria for capital instruments. These represent an

5 www.bis.org/publ/bcbs148.htm – the BCBS has also published the guidelines for computing capital for incremental risk in the trading book, www.bis.org/publ/bcbs149.htm.

important start in terms of improving the quality of regulatory capital at EU level, but the review of the definition of capital by the BCBS will need to go further. The Commission has also issued consultations on implementing the BCBS trading book proposals and 'through-the-cycle' expected loss provisioning (sometimes referred to as dynamic provisioning).[6] In the past, work on the CRD had drawn heavily on the BCBS and the FSA will work to ensure that the global and EU frameworks remain closely aligned.

3.16 The FSA has continued to work with UK banks to develop a cycle-neutral method for calculating capital requirements under the IRB approach. This method, referred to as 'variable scalars', enables firms to estimate capital requirements that do not increase substantially as economic conditions change but continue to reflect changes in portfolio credit quality (for example changes in underwriting criteria). By the end of Q2 2009 the FSA had approved seven portfolios within banks to use a variable scalar approach (an increase of six over the end 2008 position) and is currently working with six firms in developing further approaches.

3.17 There has also been progress in the BCBS on the liquidity issues identified in *The Turner Review*. The BCBS has begun a review of ways to promote greater consistency in the implementation of global liquidity supervision for cross-border banks to enhance the banking system's resilience. Since March 2009, the FSA has also made significant progress on domestic implementation of its reformed liquidity regime. Consistent with commitments to implement the new regime from Q4 2009, the FSA has completed the consultation on its new liquidity framework. This included enhanced systems and controls requirements, updated quantitative requirements, and new granular reporting requirements and detailed transitional rules.[7] The FSA will shortly publish the final policy statement and handbook text.

Macro-prudential approaches and systemically important firms

3.18 In July 2009 HM Treasury published a paper *Reforming financial markets*, which set out its proposals for reforms to banking regulation.[8] The Government announced that it would extend the powers and objectives of the FSA, giving it a formal statutory objective for financial stability, and powers to make rules to protect wider financial stability. It also proposed complementing the FSA's new intensive approach to supervision by enhancing its enforcement powers and enabling it to keep the scope of regulation under review (see below).

3.19 The Government also announced the creation of a Council for Financial Stability, consisting of membership from HM Treasury, the FSA and the Bank of England. This council replaces the Tripartite Standing Committee and will be chaired by the Chancellor of the Exchequer. It aims to formalise and strengthen coordination among the authorities when assessing and acting on risks to financial stability.

6 ec.europa.eu/internal_market/consultations/2009/capital_requirements_directive_en.htm

7 CP08/22, CP09/13, CP09/14

8 www.hm-treasury.gov.uk/reforming_financial_markets.htm

3.20 The cases of Lehman Brothers and AIG highlighted the challenges posed by large, complex financial institutions whose operations span many countries. The Government proposed a number of actions to address these challenges and mitigate the risks presented to consumers and financial stability by the potential failure of such groups and institutions. Included in these proposals were more stringent regulation for systemically important firms, which may take the form of requiring them to hold capital and liquidity at levels which reflect the impact of their failure, and to draw up practical resolution plans for dealing with their own failure.[9] The Government stated it did not believe it would be effective or practical to impose restrictions or formal limits on firm activities through legislation (comparable with the so called Glass-Steagall regulations which were in force in the US for many years).

3.21 Similar approaches have been proposed in other countries since the publication of *The Turner Review*. In June 2009 the US administration published its paper *Financial Regulatory Reform*, which made a number of important proposals on the structure of regulation in the US.[10] If implemented, these will address many of the issues raised by *The Turner Review* and DP. These included the establishment of a Financial Services Oversight Council (FSOC), among whose responsibilities will be monitoring and identifying potential threats to the US financial system (in consultation with the Federal Reserve). There are also proposals to subject systemically important financial institutions (defined as Tier 1 Financial Holding Companies and Designated Financial Market Utilities) to consolidated supervision by the Federal Reserve. Tier 1 financial holding companies will be specifically subject to enhanced regulatory requirements, such as higher capital requirements and required to produce and maintain a credible resolution plan.

3.22 The DP addressed several issues around systemically important firms. It set out the case for the development, in non-crisis times, of firm or group-specific winding-up plans and committed the FSA to exploring higher requirements for systemically important firms (while identifying a number of practical issues).[11] These issues are considered further in Section 4 (specifically in Questions 21 and 22) and will be addressed more fully in the forthcoming FSA DP, as described in Section 5.

Scope of regulation

3.23 *The Turner Review* and DP set out the need for regulators to be able to gather information from outside the regulatory perimeter and, if necessary, to be able to bring some forms of activity into regulation if required. This principle has since become well established domestically and within the international community.

3.24 At the London Summit, G20 leaders committed 'to extend regulation and oversight to all systemically important financial institutions, instruments and markets', including systemically important hedge funds.[12] The Joint Forum, a group that brings together the BCBS, International Organization of Securities Commissions (IOSCO) and the

9 The Treasury Select Committee has also indicated its support for such approaches – for example in www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/767/767.pdf.

10 www.financialstability.gov/docs/regs/FinalReport_web.pdf

11 For example in section 7 and section 9

12 www.g20.org/Documents/final-communique.pdf

International Association of Insurance Supervisors (IAIS), is preparing a report analysing the differences in the nature and scope of regulation and proposing solutions to promote consistency. This will include options to extend regulation and address the challenges presented by the differences. The analysis of this group is focusing on four areas: consolidation and group-wide supervision; hedge funds; consistency of underwriting standards; and risk transfer products including CDS and credit insurance. The FSA is leading the work on consolidation and group-wide supervision. The work is being carried out in conjunction with the development of proposed guidelines for assessing systemically important institutions, markets and instruments by the IMF (with the FSB and BCBS. These guidelines are due to be presented to G20 Finance Ministers and Central Bank Governors in early November 2009. The Joint Forum is expected to provide an update on its work to the G20 in November, with the final report expected to be published in December.

3.25 Following extensive consultation, IOSCO published a set of high-level principles for hedge fund regulation in June 2009.[13] These six principles include requirements for mandatory registration, ongoing regulation, and the provision of information for systemic risk assessments. They also state that regulators should share information to facilitate efficient and effective oversight of globally active hedge funds and their managers. IOSCO will monitor progress in national regulatory regimes for the hedge fund sector and how these align with the IOSCO standards. It will also consider what type of information should be provided by the hedge fund sector (and their counterparties) to allow regulators to assess the systemic importance of individual actors and identify risks to financial stability. IOSCO is liaising with the industry players to agree how the industry best-practice principles can support regulatory aims and will conduct further work – together with the Joint Forum – on what type of prudential requirements (including capital requirements) might be necessary for such players.

3.26 In April, the European Commission proposed the Alternative Investment Fund Managers (AIFM) Directive. This aims to strengthen the regulation of the management and administration of alternative investment funds (including, among others hedge funds, private equity, commodity funds and real-estate funds) by creating a harmonised regulatory and supervisory framework across the EU. The Directive will require all investment fund managers within scope to be authorised and subject to new regulatory standards.

3.27 Since its inception more than ten years ago, the FSA has supervised all investment managers undertaking regulated activities in the UK, including those undertaking these activities in connection with the management or administration of alternative investment funds. The Directive puts forward several proposals to harmonise standards (which the FSA supports in principle), including the creation of a pan-European regime for the private placement of funds, which would improve efficiency and reduce complexity. However, there are considerable doubts about whether the Directive, as currently drafted, is a proportionate or effective response to the regulatory issues posed by hedge funds. This is discussed further in Section 4 (Question 19).

3.28 In order to better identify risks to regulatory objectives and mandates, plans were announced earlier this month for the FSA and the Securities and Exchange Commission

13 www.iosco.org/news/pdf/IOSCONEWS148.pdf

(SEC) to explore together approaches to reporting, and other regulatory requirements, for key market participants such as hedge funds and their advisers.[14] In particular, the FSA and SEC agreed to identify a common, coherent set of data to collect from hedge fund advisers/managers.

3.29 The US Administration's plan for regulatory reform (set out in the US Treasury paper, *Financial Regulatory Reform,* mentioned above) also makes proposals to address issues related to the scope of regulation.[15] The paper proposes that the scope of regulation will include any parent holding company and all subsidiaries, regulated and unregulated, domestic and foreign. The intention is that firms should not escape oversight because of their legal structure and that the FSOC should be given the authority to gather information from any financial firm. Hedge Fund advisers (and advisers to other private pools of capital, including private equity funds and venture capital funds) will be required to report sufficient information on the funds they manage so that the authorities can assess whether any fund poses a threat to financial stability.

3.30 The government has also made commitments about keeping the regulatory perimeter under review and exploring extended information gathering powers (in the HM Treasury paper *Reforming financial markets* referred to above). HM Treasury will ask the FSA to keep it up-to-date on relevant innovations in the financial sector and on areas where the FSA's scope of authority or existing powers are not sufficient for it to fulfil its statutory objectives. In response, the Government will fully consider any legislative changes that may be necessary, including possible expansions to the scope of regulation. The *Reforming financial markets* paper set out various proposals for new primary legislation and the Government has committed to introduce these in a Bill early in the next Parliamentary session.

Reform of EU regulatory architecture developments

3.31 The European Commission set out its proposals for reforming EU regulatory architecture on 27 May 2009. These were broadly endorsed by EU finance ministers on 9 June and by Heads of Government on 18-19 June and the resulting legislative proposals were published on 23 September.[16]

3.32 These proposals include:

- the establishment of an European Systemic Risk Board (ESRB). This will include central bank governors of all Member States, heads of supervisory bodies (in a non-voting capacity), the Commission and the chairs of the three new European Supervisory Authorities (ESAs) set out below. The role of the ESRB will be to issue risk warnings and recommendations based on its macro-prudential analysis; and
- the establishment of three ESAs. These will replace the three existing Level 3 Committees and, although named authorities, will actually have the status of EU

14 www.fsa.gov.uk/pages/Library/Communication/PR/2009/124.shtml

15 www.financialstability.gov/docs/regs/FinalReport_web.pdf

16 ec.europa.eu/internal_market/finances/committees/index_en.htm

agencies. In addition to the existing level 3 responsibilities of advising the Commission and promoting supervisory convergence, it is proposed that the new ESAs be given the following further competences:

- powers to develop binding technical standards for adoption as Commission rules, in areas to be specified and subject to Commission endorsement;
- powers to take binding decisions addressed to national authorities, in order to settle certain disagreements between supervisors;
- powers to take binding decisions addressed to firms in certain specified cases;
- supervisory powers over entities with pan-European reach, including the supervision of credit rating agencies; and
- crisis powers to take decisions binding on national supervisors and firms.

3.33 Heads of Government stressed that decisions made by the ESAs 'should not impinge in any way on the fiscal responsibilities of Member States'.[17]

3.34 *The Turner Review* highlighted that the passporting regime for EEA branches was an area of particular concern. EU single market rules give EEA banks, which are recognised by their home country supervisor as sound, a right to operate in other Member States. As a consequence, the depositors in countries hosting branches, or their governments, can be made vulnerable to the insolvency of the bank in its home country. This means that host countries are potentially vulnerable to shortcomings in supervisory practices or resources in other EEA Member States. The Commission's proposals will make changes in the passporting regime in the following ways:

- amendments to the CRD will give host states of significant branches the right to be a member of a supervisory college and to receive more information than they currently do;
- tougher peer review will be extended to an assessment of supervisors. This should help identify supervisory weaknesses and encourage home states to address them; and
- the proposed new ESA roles in relation to the consistent application of EU rules and/or settlement of disagreements may help where a home state is failing to comply with applicable EU standards.

3.35 The changes being introduced will be of value in addressing supervisory weaknesses. However, the FSA would like to see additional improvements. It believes these are necessary if the concerns set out in *The Turner Review* are to be fully addressed These issues are discussed more fully in Section 4 (Questions 27 and 29).

Credit Rating Agencies (CRAs)

3.36 *The Turner Review* and DP highlighted significant concerns about the role of CRAs. Since the Review was published, IOSCO has formed a new sub-committee to focus solely on CRA issues, particularly facilitating global coordination and consistent

17 www.consilium.europa.eu/ueDocs/cms_Data/docs/pressdata/en/ec/108622.pdf

approach to oversight. The BCBS is also looking at the use of external ratings and the regulatory framework for securitisation.

3.37 A key challenge will be to ensure consistency between global and EU approaches. Since *The Turner Review* was published, there have also been significant developments in Europe. An EU Regulation to deal with CRAs has been approved by both the EU Council and Parliament. This Regulation introduces measures to address conflicts of interest (for example, analyst rotation and corporate governance requirements), increase transparency (particularly of methodologies and rating assumptions) and ensure that ratings and methodologies are monitored appropriately. These were key issues identified in *The Turner Review* and the DP.

3.38 The Regulation is expected to come into force in October 2009. This will mean that all CRAs operating within the EU will need to apply for registration by July 2010 at the latest. Restrictions on the regulatory use of ratings (for example, the use of ratings for capital calculations by banks) will also become binding on firms from October 2010. The Regulation contains specific measures to allow the use of non-EU ratings for regulatory purposes, either through endorsement by an EU office of the CRA group or by an equivalence regime.

3.39 The EU Regulation introduces colleges of supervisors for CRAs with multiple EU offices or whose ratings have a pan-EU impact. These colleges will need to agree unanimously that a CRA meets all the requirements and conditions set out in the Regulation before it can be registered to perform rating activity in the EU and have its ratings used for regulatory purposes. The college will seek to coordinate supervisory and enforcement activity for each CRA across the EU and create a consistent framework for CRA oversight within the EU.

3.40 The de Larosière report recommended that the supervision of CRAs be run by a centralised EU authority.[18] In June, the EU Council agreed that the new European Securities and Markets Authority should carry out this role.

3.41 The US has also issued proposals for the treatment of CRAs. The SEC has announced further proposals for amending their rating agency regulations to bolster existing rules on conflicts of interest and protecting integrity of the ratings process, as well as reviewing the use of ratings in their regulation. These proposals include requirements that are clearly based on provisions in the IOSCO Code, which the EU Regulation also seeks to implement. There are also proposals to combat rating shopping by making issuers reveal any provisional ratings they have obtained from any agency and making issuers share structured finance information with all registered CRAs.

3.42 The US legislation and legislation being introduced in other jurisdictions appear to have the IOSCO Code as their basis. However, rapid developments in this area mean that the legislation being introduced by individual jurisdictions may not be totally consistent with the Code or with other jurisdictions. The FSA considers it important

18 ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

that IOSCO continues to focus on identifying and addressing divergence from the IOSCO Code and assisting the FSB in addressing any global inconsistencies as required by the G20 conclusions.

Remuneration

3.43 The FSA published a Consultation Paper (CP) on *Reforming remuneration practices in financial services* on 18 March in parallel with *The Turner Review*.[19] The CP proposed the rule that a firm's remuneration policies, procedures and practices must promote and be consistent with effective risk management, and the CP outlined a Code for firms to follow in implementing that rule. The Rule and the Code conformed closely to the Principles for Sound Compensation Practices, which the Financial Stability Board (FSB) published in April 2009.[20]

3.44 On 12 August, after extensive consultation with industry, trade associations and regulators in other countries, the FSA published its Policy Statement implementing the Rule and the Code with effect from 1 January 2010. This places the UK in the vanguard of countries implementing the FSB Principles on remuneration.

3.45 To ensure that firms would in fact be in compliance with the Rule and the Code from 1 January 2010, the FSA wrote in early September to the relevant firms requiring them to provide the FSA with a Remuneration Policy Statement outlining how the firm will comply with the Rule and the Code (the deadline for firms to submit the Statement is by 2 November 2009). The FSA will review these statements promptly and provide feedback to the firms by the end of February 2010. While carrying out this review the FSA will be confirming that UK firm's pay policies comply with UK legislation on equality of pay. The FSA plans to publish a statement during Q2/Q3 2010 that will assess the effectiveness of the Code and provide an update on international implementation.

3.46 At the Pittsburgh summit meeting the G20 countries agreed to strengthen adherence to the FSB principles on remuneration with a set of implementation standards.[21] Firms and supervisors are asked to begin the process of implementing these standards immediately and international organisations including the BCBS, IAIS and IOSCO are asked to support them. The implementation standards are closely aligned with the FSA's Code, but also include recommendations regarding the integration of banks' decisions on compensation with the need for banks to rebuild capital. The FSA will work closely with the international bodies and with other regulators on the implementation of the FSB principles and standards.

19 CP09/10

20 www.financialstabilityboard.org/publications/r_0904b.pdf

21 www.financialstabilityboard.org/publications/r_090925c.pdf

4 Analysis of Responses

4.1 The FSA received 81 responses to *The Turner Review* and DP from a wide variety of sources. A full list is set out in Annex 2. Copies of individual responses can be made available upon request (unless a respondent has requested that their response is not made public). The responses were of a high standard and the FSA is grateful to those who took the time to respond. This section summarises the comments that respondents made and sets out the FSA response to them.[22]

International coordination

4.2 The strongest common concern was the need for international coordination and consistency in the formulation and implementation of the regulatory policy response to the crisis. A number of respondents felt that, as the crisis developed, responses were predominantly national and did not take the global nature of the crisis and banking into account. One respondent noted that, in its view, protectionism had exacerbated the problems.[23] Some respondents also commented on the need for consistency between EU and global approaches. Concern centred on ensuring that London's position as a global financial centre is maintained; for example one respondent stated that London's health as a competitive market place rests on prudent regulation and market innovation.[24]

FSA response

The FSA made it clear in *The Turner Review* and DP that many of these issues identified, particularly relating to capital, were best tackled on a global basis and many of the recommendations in *The Turner Review* were directed at the FSB and BCBS. Since publishing *The Turner Review*, the FSA has continued to be very active in the relevant international groups to add and agree detail on the general principles that were set out in *The Turner Review*.

There are some issues on which the FSA will, in future, be prepared to proceed ahead of international agreement. One of these is liquidity, where the FSA will introduce a new

22 Some of the questions quoted in this FS have been slightly altered from how they appeared in the DP. This is so that they can be understood when read outside the context of the DP.

23 HSBC

24 London Investment Banking Association

quantitative framework ahead of full international agreement. That said, the FSA's approach is fully consistent with the guidelines CEBS and BCBS have produced.

The FSA also agrees that London's reputation as a financial centre will be enhanced by a strong and effective regulatory framework, implemented robustly by FSA supervisors. Some have argued that the FSA should be very sensitive to the impact of any new regulatory proposals on London's attractiveness as an international financial centre. While the FSA is certainly required (and will continue) to have regard to 'the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom', this is only one of a number of considerations that the FSA is required to take into account.[25] More importantly, the FSA's overriding concern is to achieve its statutory objectives, in particular maintaining market confidence and protecting consumers. An effective regulatory regime that delivers those objectives is the FSA's highest priority.

The impact of the package of regulatory reforms

4.3 Another key concern was about the overall impact of the new regulatory regime. A number of respondents were concerned whether the interaction of the different measures proposed would be sufficiently taken into account when assessments of the costs took place (as opposed to individual measures being subject to cost benefit analysis in isolation as each was agreed). There was also concern, particularly among the major banks, that strict new measures would have a serious and detrimental impact on innovation and growth in the real economy.

FSA response

The FSA is aware of the significance of the interactions between the different measures and the need to analyse the overall impact of whatever new regulatory regime emerges. The FSA has undertaken analysis and commissioned National Institute of Economic and Social Research (NIESR) research on the methodology that might be used to develop a clearer understanding of the impacts the overall package of improvements to the regulatory framework may have on the UK economy. The results of this analysis will be explored in the forthcoming DP, as described in Section 5.

The vast majority of proposed changes to the regulatory framework outlined by *The Turner Review* are currently being discussed at international level and therefore the exact outcome remains uncertain. In 2010 the BCBS will carry out a quantitative assessment on the overall impact of the proposed changes to the framework for firms' capital levels. A key challenge will be to understand the cumulative effects of a range of policy changes, including the definition of eligible capital resources, strengthened risk-based capital requirements and supplementary measures such as the leverage ratio. Both the BCBS and the FSA's domestic analyses will be essential components of the work to ensure that the new international regulatory framework is appropriately calibrated.

25 Section 2, Financial Services and Markets Act 2000

Supervisory approach

4.4 The DP contained a section looking at the new FSA's supervisory approach and delivering effective supervision, on which it received a number of comments. Many respondents welcomed the FSA's realignment of its supervisory approach and the aims of the Supervisory Enhancement Programme (SEP). Almost all respondents agreed that there was a need for more intrusive supervision but not to the extent that it affected competitiveness and innovation. They emphasised the need to be flexible enough to take into account international issues and not put UK firms at a competitive disadvantage. Respondents felt that a 'bank examiner' approach was not appropriate and should be avoided. Instead respondents generally favoured the approach outlined in the DP of more focus on outcomes, rather than systems and controls, and credible deterrence. One respondent asked for more clarity on the difference between outcome-based and principles-based regulation.[26] Respondents also favoured the FSA being given increased resources, both in terms of quality and quantity.

4.5 Respondents agreed that the FSA's approach should continue to be risk-based in nature, with one respondent stating that the FSA's risk appetite should be lowered with regard to deposit takers.[27] Two respondents suggested that peer comparisons (taking into account individual firm circumstances) be used more to identify outlier business models.[28] Several respondents were concerned that the system should be adaptable and not rigid and that challenge between the FSA and firms needed to be two way.

4.6 Some concerns from respondents were wider in nature and not actually directly related to supervision. For example, concerns were raised about whether the FSA could attract and retain staff with appropriate levels of knowledge and expertise. Data issues were also raised, including by a number who were concerned about onerous requirements and the need for good quality global data.

4.7 Feedback was also received from the Financial Services Consumer Panel, an independent panel that represents the interests of consumers to the FSA. It was clear that the FSA should strengthen its supervision, including its interrogation of business models and enforcement. It also highlighted that the FSA should not dilute its focus on conduct regulation.

FSA response

As part of the SEP, the FSA is seeking to address these concerns and ensure that a better, more efficient model is in place to deliver effective supervision. As well as the FSA being open to challenge, there will be opportunities for senior management of firms to engage in discussion with the FSA. The FSA is working towards ensuring there is consistency across its regulatory approach and will work with firms in achieving its regulatory objectives.

26 Royal Bank of Scotland

27 Building Societies Association

28 JP Morgan, British Bankers Association

Principles-based regulation and outcomes-based regulation are complementary rather than alternative approaches. Principles-based regulation means, wherever possible, moving away from prescriptive rules towards a higher-level articulation of what the FSA expects firms to do. It therefore concerns how requirements are expressed. Outcomes-based regulation involves a focus on the results of the actions of regulated firms. The emphasis is therefore on judging the effects of the outcomes achieved by the firms and individuals the FSA supervises.

The FSA is continuing to develop a more intensive and intrusive approach to prudential supervision of systemically important banks. This is taking place within the context of the existing Advanced Risk-Responsive Operating frameWork (ARROW) and the SEP. It involves embedding a severe level of capital stress testing into the FSA's assessment of the amount of capital a firm should hold; continuing to increase the emphasis on liquidity; assessing in a more structured way the sustainability of business models; and reviewing in greater depth the effectiveness of governance and risk management.

Wider issues remain important, and improving the quality of the FSA's staff is a key priority. The SEP includes a major training programme for existing supervisors. The FSA accepts that it will always be difficult to compete in the recruitment market. However it will continue to strive to make the FSA an attractive work place. Over the last year the FSA has recruited 517 new members of staff.[29]

The FSA also agrees that the focus on conduct regulation should not be lost as prudential supervision becomes more intensive. The FSA continues to believe that the unitary authority model remains the best way for supervisors to be able to understand all the risks firms face and has benefits for firms in understanding everything that is required from them by supervisors.

Causes of the crisis

4.8 *The Turner Review* set out the FSA's analysis of the causes of the banking crisis. The FSA felt it was essential that international debate on regulatory reform was informed by, and focused on, the causes of the banking crisis (although it was also important to anticipate future problems, such as when considering the scope of regulation). The FSA's analysis highlighted three areas:

a) the global story: macro-imbalances meet financial innovation;

b) the UK specific story: rapid credit growth, significant wholesale and overseas funding dependency; and

c) global finance without global government: fault lines in the regulation of cross-border banks.

4.9 Not all respondents commented on the section dealing with the causes of the crisis. However, overall the responses reflected general support for the FSA's analysis, agreeing that it was both thorough and conclusive. Clearly, some respondents were inclined to give more weight to particular factors than to others. For example, one

29 September 2008 to August 2009

particular respondent stressed the market failure aspects, while another focused on risk management systems, excessive borrowing and financial innovation.[30]

4.10 As noted above, agreement was not unanimous and some respondents were critical of the FSA's analysis. A small number of respondents believed the analysis in *The Turner Review* did not go far enough in acknowledging the failure of passporting firms, excessive balance sheet leverage, quality of capital and over-reliance on models. One respondent felt the paper did not explicitly pinpoint the role of lax budgetary and monetary policy, particularly in the US.[31] Others were more critical of the FSA's own role. One respondent was particularly critical of the quality of the FSA, which it felt helped enable players in the City of London and other financial centres to put their own interests ahead of their clients' and depositors'.[32] Another respondent claimed the financial crisis was rooted in a failure of supervision and the FSA's refusal to recognise that it was itself responsible compromised its ability to draw lessons for the future.[33] This respondent was also critical of *The Turner Review* because it did not include an analysis of the FSA's own performance.

FSA response

The FSA welcomes the fact that the majority of respondents agreed with the FSA's analysis of the causes of the crisis. This included recognition of the fact that the causes of the crisis were varied and global. On the narrow question of the FSA's effectiveness that a few respondents highlighted, the FSA has previously acknowledged that its historic supervisory approach was inadequate in two key respects. First, its supervisory philosophy was essentially reactive and primarily focused on ensuring firms had adequate systems and controls. Critically it did not sufficiently focus on analysing the risks inherent in firms' business models. Second, its supervisory area was understaffed and in many cases the staff lacked the necessary skills to make forward looking judgements. These failings were made public through the publication of the FSA's Internal Audit Report on the supervision of Northern Rock.

The FSA has, in the last two years, radically reformed its supervisory model. As a supervisor, the key lesson learned is that the FSA must be proactive and not reactive to the management of risks. This is primarily a matter of judgement and events have shown that the best judgements are made by focusing on a single, integrated view of firms' risks. The goal of delivering effective integrated supervision in an intensive manner has required radical change at the FSA. The FSA has, for the first time, introduced a genuinely integrated supervisory approach that effectively addresses both prudential and conduct issues. To deliver on this model, referred to as 'intensive supervision', there have been significant increases in both the number and quality of staff. A fuller description of the FSA's new intensive supervisory approach can be found in the FSA chief executive's speech of 23 July 2009.[34]

30 For example Association of Corporate Treasurers, Grant Thornton LLP

31 French Banking Federation

32 Tony Shearer

33 Adam Smith Institute

34 www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0723_hs.shtml

It should, however, be noted that the FSA, does not believe that the new supervisory approach would, in itself, have averted the crisis, not least because the FSA believes the most significant causes of the crisis were inadequate international capital and liquidity regulatory regimes.

Liquidity regime

4.11 Concerns were expressed about the FSA's work to introduce a new liquidity regime. A number of respondents felt that it would be more onerous than that applied to other global banks and therefore put the UK banks at a competitive disadvantage. One respondent felt that, although there might be some short-term gains to the UK's approach, tit-for-tat responses would be sure to follow, leading to trapped pools of liquidity and all countries being worse off.[35]

FSA response

Liquidity work streams are underway in CEBS and BCBS, covering definitions of liquid assets, common stress testing metrics and structural balance sheet measures. The FSA strongly supports such international initiatives and is participating fully in them.

However, it may be some time before international agreement on specific proposals works its way into national legislation. Therefore, given the public commitment to reforming the UK's liquidity regime (as reconfirmed in *The Turner Review*), the FSA does not judge it sensible to wait further for an international outcome before acting. The structure of the FSA's new regime is sufficiently flexible to allow it to be amended through time to reflect new international standards, subject to consultation.

The FSA fully appreciates that, in seeking to protect their national interests, other supervisors may also require entities in their jurisdictions to increase their local liquidity holdings. Where this is the case, the FSA expect the calibration of any local liquidity requirements to be risk-based and non-discriminatory, as is the case with the UK requirements. However, regulators are generally tightening liquidity standards and this is likely to affect some firms more than others. Many firms have successfully operated liquidity models that will not be materially impacted by these proposals and so the FSA does not believe that such an outcome risks leading to a fragmentation of the global economy.

Loan to Value and Loan to Income restrictions

4.12 Many respondents commented on potential Loan to Value and Loan to Income restrictions. In October, the FSA will publish its review of the mortgage market, where these issues will be set out for further, more detailed, consideration.

35 British Bankers Association

Responses to DP questions

Capital and Liquidity

Q1: Are there shortcomings in the international prudential framework not already identified in the DP that are relevant to the analysis?

4.1.1 *The Turner Review* and DP highlighted shortcomings in the current international prudential framework that allowed the build up of systemic risk, including too little capital (in terms of both quantity and quality), insufficient liquidity standards and inadequate mitigation of procyclicality.

4.1.2 On the whole respondents agreed that the FSA had identified the right issues, although individually they emphasised different aspects (for example excessive balance sheet leverage, quality of capital and over-reliance on models). Respondents also highlighted problems in international cooperation, which led to inconsistencies across jurisdictions, and a sense of national protectionism had contributed to the detriment in the system. They agreed on the need for an international approach to be adopted in the implementation of any new prudential framework and for the creation of a resolution process for cross-border financial institutions.

4.1.3 Many respondents echoed the need for a proportionate and evidence-based response that would consider the many changes introduced recently by the FSA and other institutions (e.g. central banks), as well as the cost that would be imposed as a result of these changes. Some respondents did not believe that a step increase in capital and liquidity would capture all risks and that further analysis was needed. Respondents also highlighted that other drivers and risks should be considered and, where these were not captured by modelling, provisions and add-ons must be made. In addition to this, one respondent believed that a more comprehensive capital framework, which closely followed how a firm managed its risk, would dampen procyclicality.[36] Another respondent believed that focus on regulatory capital alone could not support confidence and much wider considerations about the role of financial services were needed to ensure that the sector was robust and competitive.[37]

4.1.4 There were a variety of other comments (including some general comments about the causes of the crisis and the FSA's role which are included above). Some respondents considered that the FSA should have paid more attention to risk management by firms, Pillar 2 and stress testing. Many respondents wanted to see more analysis to determine extent to which Pillar 2 supervisory reviews had effectively addressed weaknesses in Pillar 1. In addition to this, one respondent acknowledged that, although the development of Pillar 3 was in its very early stages, an analysis of the level of disclosure and the benefits achieved in the market was needed.[38]

36 Goldman Sachs

37 Confederation of British Industry

38 The Institute of Chartered Accountants in England and Wales

4.1.5 One respondent believed that a more robust approach must be adopted for the interaction of regulation and accounting practices.[39] It believed that this could be achieved through the alignment of working practices and closer dialogue between accounting firms and the FSA. Another stated that the move towards complexity of the capital framework disadvantaged small firms, and was perceived to be counter-productive. It suggested that the framework be simplified as many of the shortcomings identified related to the bigger, internationally active banks.[40]

FSA response

The FSA agrees that international coordination is needed to address shortcomings in the regulatory framework and that the global response should be proportionate and evidence-based. Both the BCBS and the FSA will need to undertake a thorough impact analysis to ensure that the new global prudential framework is properly calibrated. These issues will be considered further in the forthcoming DP, as described in Section 5.

The FSA accepts that tougher capital and liquidity standards will not address all the causes of the current crisis, although it continues to believe that they are the most important components of the global regulatory response. Consistent with this, the FSA remains committed to pursuing the other, complementary measures set out in *The Turner Review*. Pillar 2 and stress testing remain essential parts of the regulatory framework. The SEP will better equip supervisors to engage with firms and strengthen Pillar 2 assessments including the setting of idiosyncratic capital planning reserves. In Q4 2009 the FSA will publish a Policy Statement on stress testing which will reinforce its role, both in firms' own governance and risk management.

The FSA is currently recruiting to increase its accounting expertise to support its more intensive and intrusive approach to supervision. This will enable the FSA to scrutinise key accounting judgements more closely. As part of this more intrusive approach the FSA is also committed to a closer dialogue with the auditors of high impact firms.

The BCBS capital framework will undoubtedly become more complex, but this will affect the advanced approaches of the calculation of capital requirements more than the standardised approach. Since most smaller firms use the standardised approach, they will be less affected. In addition, the introduction of a leverage ratio will introduce a simpler, backstop measure.

Q2: What are the measures supervisors should take to mitigate the risks to depositors and other unsecured senior creditors of secured funding, taking account the benefits of such funding where used to an appropriate degree?

4.2.1 Most respondents highlighted the central role secured financing plays and the benefits it delivers through enhancing liquidity and reducing the cost of funds. Respondents also highlighted the role regulation has played in encouraging secured funding and actively discouraging unsecured exposures through the large exposures regime and recognition of risk mitigation.

39 KPMG LLP

40 Building Societies Association

4.2.2 Many respondents called for increased transparency to enable creditors and the FSA to assess effectively the risks of encumbrance. One respondent fully supported the development of a comprehensive policy on encumbrance.[41] However, the majority of respondents did not consider additional measures on encumbrance necessary. In their view, the FSCS was available to depositors and unsecured creditors should monitor levels of encumbrance of counterparties and the likelihood of encumbrance increasing in a downturn.

4.2.3 There was also concern that any formalised approach to asset encumbrance could constrain a bank's ability to operate flexibly and to optimise its access to liquidity, particularly in times of stress. A few respondents highlighted the need to distinguish between different forms of asset encumbrance in any policy response. Most respondents viewed Pillar 2 as the appropriate mechanism to deal with any concerns on encumbrance and cited the FSA's approach to covered bonds as an example of how this has worked effectively in practice.

4.2.4 Respondents supported the FSA seeking international agreement to prevent fragmented approaches, although one respondent viewed this to be desirable but ambitious given other jurisdictions view asset encumbrance more benignly.[42]

FSA response

The FSA recognises the benefits that secured financing brings. It agrees that unsecured creditors should factor levels of encumbrance into their analysis and fully supports increased transparency to assist with this. However, the FSA is concerned that the responses to the DP underestimate the risks posed by encumbrance and does not believe that the existence of the FSCS obviates the need to deal with this particular risk. Regulators should ensure the regulatory capital framework captures significant risks, including those posed by different forms of asset encumbrance and seek to implement the most appropriate policy response.

The FSA acknowledges respondents' concerns in relation to the implications of a hard-wired policy response and will factor this into its analysis.

Although the FSA agrees that an international approach to encumbrance is the ideal, it is less clear that implementing a comprehensive encumbrance policy domestically will create a more fragmented approach. This is because such policies already exist across many different jurisdictions. For example, Australia has a prohibition on the issuance of covered bonds while the US does not allow qualifying covered bonds to exceed 4% of a bank's total liabilities and Canada limits the issuance of covered bonds to 4% of total assets.[43]

Micro-prudential measures

Q3: Do you agree with the proposals to redefine what counts as capital with a stronger emphasis on going concern loss absorbency?

41 Building Societies Association

42 Building Societies Association

43 For covered bonds that meet certain conditions, the Federal Deposit Insurance Corporation provides assurance of their treatment in the event of receivership.

4.3.1 The DP highlighted that, as they are most clearly capable of absorbing loss, ordinary shares and retained earnings should represent the positive components of Core Tier 1 capital.[44] The majority of respondents agreed with this concept and that capital needed to be redefined, with a greater emphasis placed on absorbing losses in a going concern. They also agreed this redefinition needs to be undertaken internationally through the BCBS and FSB. While respondents recognised that in the future there would be a greater focus on Core Tier 1 capital, they were also concerned that the transition should not be disruptive.

4.3.2 Some respondents argued that forms of capital other than common stock could also be included as Core Tier 1, if they had the capacity to absorb losses and were permanent, non-cumulative and provided issuer flexibility as to payment. A small number of respondents supported the use of contingent capital, although they stated that further work was required in this area.

4.3.3 Although they recognised that hybrid capital instruments provided less loss absorbency than Core Tier 1, some respondents said that such instruments provided some support on a going concern basis through payment deferral and provided protection in a gone-concern situation. It was also noted that recent liability management exercises, in which UK banks bought back or exchanged their non-core instruments with a consequent increase in core capital (capitalising on depressed secondary market values) had demonstrated that non-Core Tier 1 capital instruments did provide loss absorbency.

4.3.4 There was a general consensus among respondents that dated subordinated debt still had a part to play for systemic firms and not just for small deposit-takers as suggested in the DP. Respondents were concerned that lower tiers of capital would be given insufficient weight. One respondent stated that the loss of subordinated instruments would also remove a potential market signal on the health of banks and highlighted academic work on the role of subordinated debt as a means of disciplining risk-taking by banks.[45]

4.3.5 Some respondents argued that, as banks were reliant on subordinated debt as a means of accessing alternative capital markets while maintaining returns to shareholders (and, inter alia, their credit ratings), there was an important role for subordinated debt capital in all institutions. Therefore, they argued, hybrid capital instruments and lower tiers of capital should still have a role in providing a less expensive form of capital, meeting demand for various levels of subordination and thereby providing protection for depositors and reducing the taxpayer cost in the event of a bank failure. One respondent stated, while Core Tier 1 should be the bedrock of the capital structure, too much focus on it could create too much reliance on the equity markets and thus increase the vulnerability of the industry.[46]

4.3.6 Another respondent believed that the amount of loss-absorbing capital held at the subsidiary level can be less than that held at ultimate parent level, provided that the additional capital making up the minimum requirement in dated subordinated debt

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44 The negative items of Core Tier 1 comprise certain deductions and filters such as goodwill.

45 Royal Bank of Scotland

46 Standard Chartered Bank

was from the parent. The respondent argued that the parent itself would still need to be well capitalised with loss absorbing capital and be subject to group supervision and felt in these circumstances subordinated debt was as good as equity capital.[47]

4.3.7 Several other issues were identified. Responses from mutuals suggested that further work was required on the definition of Core Tier 1 capital for those entities which cannot issue ordinary shares. A small number of responses questioned the permanence of ordinary shares due to the ease with which firms can buy back shares and highlighted the fact that reserves cannot absorb losses where dividends continue to be paid.[48] The limited number of comments from respondents on deductions and prudential filters agreed that it was appropriate to review which deductions and filters should make up the negative adjustments to core capital (and under what circumstances any adjustments could alternatively be made from non-core capital).

4.3.8 Responses were mixed on the proposal that any new definition of capital should be used to meet all types of risk, including market risk. Some respondents agreed with the overarching concept that any new definition of capital should be used to meet all types of risk. Firms which argued against the proposal wanted a continuation of the current regime whereby market risk requirements can be met largely with lower quality capital. Some institutions suggested that shorter term subordinated debt subscribed by a parent to a subsidiary to support market risk should continue to be acceptable.

FSA response

The FSA will use the responses received to inform work on the definition of capital in the BCBS and in the EU. Engagement with market participants and other stakeholders will continue to support policy development and negotiations. Work on core capital for mutuals is in progress.

Any new definitions of capital will be based on international agreement and *The Turner Review* makes it clear that the FSA will work to ensure the timing of the introduction of a new long-term capital regime will take into account the health of the macro-economy and the recovery of banking profitability.

In the nearer term the FSA will focus attention on the ongoing discussions in BCBS on the definition of capital and the EU in relation to the CRD amendments on hybrid capital instruments. The FSA intends to consult on these amendments later in 2009. The amendments are required to be transposed into Member States' national law by 31 October 2010 and will be implemented from 31 December 2010.

The September statement by the Group of Central Bank Governors and Heads of Supervision said that 'deductions and prudential filters will be harmonised internationally and generally applied at the level of common equity or its equivalent in the case of non-joint stock companies'.[49]

For the reasons set out in the DP (paragraph 3.3 onwards), the FSA does not agree with the responses that suggest that non-Core Tier 1 capital instruments provide the same

47 Goldman Sachs

48 Building Societies Association

49 www.bis.org/press/p090907.htm

degree of loss absorbency as common equity and reserves. During the crisis, mechanisms such as the capability to cancel and defer coupons were not used on a timely basis. Liability management transactions are dependent on external factors such as market prices and take-up by investors and are not sufficiently certain to act as an acceptable loss absorbing mechanism. Further, firms may not be able to derive the Core Tier 1 benefit when needed if falls in secondary market prices do not occur at an early stage. The FSA's view is that hybrid capital instruments must be capable of supporting Core Tier 1 by means of a conversion or write-down mechanism at an appropriate trigger. Instruments with these characteristics could be seen as a form of contingent Core Tier 1 capital.

The FSA continues to believe that events of the banking crisis have highlighted the inadequacy of market discipline. The FSA does not agree that dated subordinated debt should be used to support risks in more systemically important firms. Dated subordinated debt would not directly help a firm to continue as a going concern at a time of extreme stress. Recapitalisation during the current crisis has of necessity been in the form of capital of higher quality than dated subordinated debt and in many instances Core Tier 1 capital. The FSA does not agree that access to alternative capital markets, maintaining returns to shareholders and lower cost are sufficient reasons for continuing the current policy on dated subordinated debt.

The FSA also does not agree with the suggestion that subsidiaries should be able to use a higher proportion of subordinated debt to meet their capital requirements where the group is adequately capitalised with Core Tier 1 capital. This would undermine the FSA general approach to solo supervision which requires that all regulated entities have the same quality of capital. This is to ensure that capital is allocated properly within the group. It also demonstrates a commitment by the parent to capitalise the subsidiary adequately.

On the use of capital to meet market risk, the FSA does not agree with industry comments. The FSA continues to hold the view that firms with large market risk exposures face the same risk of large unexpected losses as firms with predominantly credit risk. This has been amply demonstrated in the recent crisis where a major contributor to losses was trading book positions. As such the FSA continues to believe there is no clear rationale why market risk requirements should be met with a lower proportion of 'going concern' capital.

The FSA notes industry support for the potential role for contingent capital that is capable of supporting core capital at an early enough trigger. Further work is required in this area which will be taken forward in discussions in international fora.

Q4: Should IRB banks be required to use a system such as variable scalars, or equivalent, whose effect is to limit the potential for procyclicality in capital requirements to a level that would be produced by a through the cycle (TTC) ratings system?

4.4.1 Overall respondents supported the objective of achieving less cyclical capital requirements and of using variable scalars as one possible means of doing this, although most respondents did not want the FSA to oblige firms to make use of

variable scalars or a similar method.[50] Most respondents supported making more use of TTC approaches, although there were some general issues around flexibility, including that the timescale and detailed development of TTC methodologies should be at the discretion of the firm. Some respondents thought that the framework already included sufficient dampeners or that dampening of procyclicality was achieved within their own rating system and so a regulatory requirement for a counter-cyclical approach would unfairly compound their own conservatism.

4.4.2 Another issue respondents raised was the relationship between the use of variable scalars and the 'use test'. Several respondents pointed out that banks are likely to wish to retain Point in Time (PiT) ratings to inform their risk-management processes. Others were clear that banks should not be required to use TTC methodologies for pricing purposes. Further, a number of respondents noted that the variable scalar approach only applies to some aspects of procyclicality in the capital requirements, but not all (for example, it would not address the cyclicality in VaR-based methodologies for assessing market risk).

4.4.3 A small number of respondents were not convinced of the methodology of variable scalars. However, they did not present any alternative approach. One respondent stated that the Basel II framework already contained TTC rating methodologies.[51]

FSA response

The need to address cyclicality in capital requirements is a key element of *The Turner Review* and DP. The FSA expects banks with strongly PiT models for large portfolios to adopt variable scalar approaches or to take some alternative steps to move these closer to TTC where this is feasible. This emphasis should address the concerns about applying a variable scalar or similar approach where this is not necessary as it concentrates on the rating systems that are known to have the greatest cyclicality. Although the FSA does not believe that the variable scalar approach has any inherent tendency to result in double counting within its calibration, it will nevertheless assess the potential for unwarranted conservatism against the specific details in the individual proposals put forward.

The FSA does not agree with the suggestion that the existence of TTC rating methodologies in the Basel II framework is sufficient. This is because, in practice, the implementation of the Basel II framework and, notably the CRD, does not require such methodologies.

The FSA will continue to work to improve the use of TTC approaches and variable scalars. In addition, substantive proposals to mitigate and counter the procyclicality of capital requirements are being debated by the BCBS. These should lead to an internationally consistent approach. It acknowledges that the approach does not cover cyclicality in non-Internal Ratings Based (IRB) capital requirements. Other mechanisms are being used to address this situation, such as the proposed move towards a stressed-VaR approach in market risk.

50 For example the Confederation of British Industry response commented: 'To some extent pro-cyclicality is part of human nature; arguably it will simply happen generally in banking. Therefore proposing efforts which aim to minimise the impact that the level and nature of regulatory capital has on exacerbating that human nature is logical. This should help to mitigate against the impact that pro-cyclical effects can have on the capacity to provide finance to the wider economy'.

51 French Banking Federation

As regards the 'use test', the FSA agrees that variable scalar or equivalent measures need not be used for all purposes. This is already covered by the principle within the IRB approach that allows for reasonable differences between estimates used for regulatory capital and internal purposes.

Q5: Are there any other key issues that the review of trading book capital should cover?

4.5.1 *The Turner Review* and DP explained that the FSA believes a fundamental review of the Basel II capital regime for trading activities is necessary. It highlighted three key issues that the review should consider:

i) the trading book / banking book boundary;

ii) the role of the VaR modelling framework in setting regulatory capital in the trading book; and

iii) the capital requirements for structured finance positions.

4.5.2 Respondents were uniformly supportive of a fundamental review of trading book capital, with many acknowledging that the trading book had been a source of substantial losses in the recent crisis. Many respondents agreed that the banking book / trading book boundary would be the right starting point for a fundamental review of trading book capital, noting that:

i) they felt a review of the trading book / banking book boundary should avoid introducing a prescriptive list of positions that must either be included, or excluded, from the trading book, regardless of the rationale for holding them. Respondents felt this would open any new regime up to arbitrage;

ii) any regulatory rules or adjustments to the trading book / banking book boundary would not achieve their desired outcome unless there was stronger internal and regulatory policing of the trading book / banking book boundary; and

iii) any review of the banking book / trading book boundary must also consider the interaction between accounting standards, and regulatory classifications for capital requirements. Some respondents felt that accounting standards and regulatory classifications should be better aligned.

4.5.3 All respondents accepted that there were some markets, including some structured products markets, in which the size of losses experienced were far in excess of the size of losses predicted by VaR models. However, many respondents stressed that VaR models should only be part of the toolkit used in setting trading book capital.

4.5.4 Respondents felt that rather than a failure of the models per se, there had been a failure amongst banks, and to some degree regulators, in their use of models. Respondents felt this had manifested itself in a failure to understand fully models' limitations, so insufficient consideration had been given to the techniques required to augment the use of market risk models. In particular some respondents noted that firms should be required to supplement their market risk models with additional capital buffers that capture some of the risks that VaR models are, by design, incapable of capturing.

4.5.5 In addition to the comments that relate directly to the key issues highlighted in *The Turner Review*, respondents also raised the following issues that they felt should be included in a fundamental review of trading book capital:

i) a number of respondents cautioned regulators against treating capital as a 'panacea' to mitigate all trading book risks. They felt that risk management and governance oversight in the trading book should be of sufficient quality to give regulators as much comfort as additional capital held against traded assets; and

ii) a number of respondents were keen to ensure that the development of regulatory trading book policy gave full consideration to the interaction of market, credit, liquidity and other risks. Some respondents expressed concern that recent regulatory communications regarding the trading book had focused on the interaction of credit and market risk without giving sufficient weight to liquidity and other risks.

FSA response

The FSA remains fully committed to a fundamental review of the prudential regime for trading activities. Since the DP, the FSA has been working closely with other BCBS members to obtain international consensus for what the fundamental review of the trading book should cover. International agreement has now been reached on the scope of the review.

The FSA agrees that there will need to be adequate consideration of the interaction between the regulatory regime for trading activities and the accounting framework. However at this stage the FSA has not reached any conclusions regarding what the appropriate level of alignment should be. The IASB has recently proposed changes to IFRS that would reduce the number of potential accounting classifications, a simplification with which the FSA agrees in principle. The FSA will follow closely the changes to IFRS proposed by the IASB.

The FSA also agrees that the review should include an assessment of a range of modelling techniques. It is extremely important that such a review not only sets out what risks can be captured by modelling techniques, but also what risks cannot be captured, and how those risk measures compare with objectives for regulatory capital. Alternative risk capture methodologies will need to be devised for those risks that cannot be reliably modelled.

The FSA agrees with respondents that good risk management and governance can mitigate trading risks. However, improvements in these areas should be in addition to, rather than instead of, a more robust capital framework.

With regard to the interaction between market risk and other risks, the FSA agrees that all sources of risk, and the interaction between them, should be considered. The fundamental review should not be limited to a narrow set of risks.

The FSA has started the fundamental review process by initiating an exercise to understand the material sources of loss in firms' trading activities over the past two years. This is not limited only to the trading book but covers all activities that would be considered 'investment banking'. The FSA anticipates that this will provide evidence to focus attention on areas where the current regime has been shown to be most deficient.

The FSA intends to publish a DP in Q1 2010 that will explore in more detail the key policy issues the FSA thinks need to be considered as part a fundamental review of the prudential regime for trading activities. This DP will set out the FSA's initial view on these policy issues and seek to engage relevant stakeholders.

In addition to the fundamental review the FSA is currently working on implementing the 'CRD 3' amendments package (the European implementation of the trading book amendments agreed at the 8-9 July BCBS meeting). This package seeks to address some of the deficiencies in the current regime. In particular it introduces higher capital requirements to capture the credit risk of complex trading activities and includes a stressed VaR requirement to dampen cyclicality of capital requirements. These were significant weaknesses of the Basel II framework identified several years ago.

The CRD 3 amendments package will be implemented on 1 January 2011 and, based on firms' current trading portfolios, will deliver a market risk capital charge three times the current level for firms that use market risk models to calculate their capital requirement on a wide range of products.[52] This is consistent with the increase expected in *The Turner Review*.

Q6: How should the leverage ratio capture (i) off-balance sheet exposures and (ii) derivatives?

4.6.1 There was general support for a leverage ratio, provided it was appropriately structured and calibrated and operated alongside the risk-based framework of Basel II. In addition a large number of respondents highlighted that a leverage ratio should be agreed at international level and applied consistently across jurisdictions.

4.6.2 No respondent made the case for excluding off-balance sheet exposures in their entirety, nor derivatives. Indeed a significant number of respondents pointed out that, in order to have a meaningful measure of leverage, such exposures had to be captured. Respondents set out a range of options for measuring the exposure value of a derivative for the leverage ratio. These ranged from fair value through to the options under the Basel II framework for counterparty credit risk which would seek to reflect potential future exposure and the possibility of using a notional measure of potential loss.

4.6.3 Several respondents commented on the different approaches to netting adopted under IFRS, US Generally Accepted Accounting Principles (GAAP) and the Basel II framework. The main emphasis was on consistency across jurisdictions however most respondents supported a wider scope of netting than is permitted by IFRS.

4.6.4 The issue of differences in accounting treatment was also raised in respect of the consolidation or exclusion of Special Purpose Vehicles (SPVs). One respondent pointed out that the IASB was consulting on the approach to derecognition of assets, which would have implications for the treatment of repo (sale and repurchase) transactions.[53]

4.6.5 One respondent suggested that a leverage ratio should be introduced as a relative restriction, meaning that a firm's leverage should not be allowed to become significantly out of line with its peers or leverage should not be allowed to increase

52 It should be noted that instead of holding higher capital requirements firms may choose to reduce their level of risk, thus the absolute level of trading book capital may rise by less than two-three times.

53 Ernst & Young

very sharply over a short period of time.[54] Further, a number of respondents proposed that the leverage ratio should be introduced as a Pillar 2 measure.

FSA response

There is clear evidence that major banks in several jurisdictions, including some in the UK in particular, became highly leveraged in the years running up to 2007. This creates a strong prima facie case for a leverage ratio. However, as the DP recognised, a leverage ratio is not a panacea and the FSA agrees with the consensus among respondents that such a ratio should be imposed alongside the risk-based capital requirement of Basel II. The FSA also agrees that in general it would be undesirable for the leverage ratio to be the binding capital requirement, although of course this must occur in some economic conditions for some banks in order for the requirement to have effect. So the risk-based capital requirement will continue to be the primary measure, which a leverage ratio will supplement.

The FSA believes there are considerable risks in constraining leverage only on a relative basis, particularly that over time the leverage of the banking sector as a whole could increase substantially, as seen in the years running up to mid 2007 (as shown in Chart 3.5 in the DP). Therefore the FSA believes such an approach could undermine the effectiveness of the leverage ratio as a regulatory tool. Indeed, one of the arguments presented in the DP in favour of a leverage ratio is that it provides a back-stop to reliance on an individual bank's modelling and to the risk of dilution of capital standards over time.

The FSA has considered whether a leverage ratio should be implemented as a Pillar 2 measure. Pillar 2 implementation could lead to different approaches to implementation across jurisdictions which would conflict with a common view among many respondents, namely that a leverage ratio should be agreed at international level and applied consistently across jurisdictions. However, it is important that a leverage ratio does not exacerbate any future period of financial instability by forcing rapid deleveraging, therefore there should be scope for a temporary exemption in the event of severe financial uncertainty.

Work on the design of a leverage ratio is underway in the BCBS and the European Commission has also been developing its own proposals for a leverage ratio.

Q7: Should the numerator of the leverage ratio be Core Tier 1 capital or should a broader measure of capital be used?

4.7.1 There was a range of views on the appropriate definition of capital measure. A number of respondents supported the use of Core Tier 1 or another similar measure of high quality capital. Reasons provided included that this was the capital measure the market focused on, that it provides simplicity and that it is available to absorb losses on a going-concern basis.[55]

54 Royal Bank of Scotland

55 For example Ernst & Young stated: 'We believe it should be Core Tier 1 capital in its strictest sense; in other words, equity and reserves. We say this because this definition matches the definition used by the market in calculating whether or not an institution might fail. We see no reason for the regulatory definition to be different'. Other respondents who supported Core Tier 1 as the eligible capital in a leverage ratio included: PriceWaterHouse Coopers LLP and the Institute of Chartered Accountants in England and Wales (in their view Core Tier 1 should be used for large banks but not necessarily for other banks).

4.7.2 By contrast, some respondents believed that the measure of capital should be wider and include instruments such as preference shares (which may count currently as either non-Core Tier 1 capital or upper Tier 2 capital) and, in the case of building societies, Permanent Interest Bearing Shares.

4.7.3 Many respondents emphasised the need for international consistency in the measures of capital and that the definition of capital and the calibration of the leverage ratio need to be considered together.

FSA response

The FSA continues to develop its thinking on how the definition of capital for the leverage ratio could support its regulatory objectives. It agrees with the large number of respondents who emphasised that the approach to the leverage ratio should be consistent internationally.

The FSA's broad approach is that capital that would be eligible to contribute should have going concern loss absorbency. Therefore the capital component of a leverage ratio would be expected to be composed of core capital and possibly other Tier 1 capital elements. The FSA also believes that the leverage ratio should adopt capital definitions which are aligned with those agreed by the BCBS for the Basel II framework, rather than develop an entirely separate set of concepts of capital solely for the leverage ratio.

Finally, it is clear that the definition of capital will have an impact on the appropriate calibration of the leverage ratio.

Macro-prudential policy

Q8: Should reforms, including an asset-based leverage ratio, counter-cyclical capital buffers, a framework for discretionary macro-prudential policy and a stronger, more robust Pillar 2 process, be applied to smaller and domestic banks, building societies and investment firms? If so, how can this be achieved in a proportionate manner?

4.8.1 *The Turner Review* noted that recent experience had made it clear that the current prudential framework was far too focused on the micro-prudential objective of ensuring that each individual bank was adequately capitalised and managed its risk effectively, and failed to address the systemic risk that had accumulated across the financial system as a whole. To address this failure, the FSA set out its view that incorporating macro-prudential regulation within the current system would be necessary to achieve financial stability. In particular, reforms that have a macro-prudential role, such as the introduction of counter-cyclical capital buffers and a core funding ratio, might reasonably not be applied to small institutions or might be applied or calibrated differently for such institutions. In addition, the DP noted that there may be a role for 'gone concern' capital, such as dated subordinated debt, for smaller deposit-taking institutions but not for the largest internationally active banks.[56]

56 See DP paragraphs 1.16 and 4.7

4.8.2 Most respondents felt these reforms should be applied to smaller and domestic banks and building societies, albeit in a proportionate manner (this overall view was broadly consistent with the views of respondents to Question 16, which relates to the scope of application of the core funding ratio). A number of respondents argued against the application of these reforms across the board for certain categories of investment and investment management firms.

4.8.3 Those in favour of applying these reforms to smaller banks, domestic banks and building societies, were particularly concerned about avoiding a two-tier regulatory system. There was also concern that, in some situations, the failure of some smaller institutions (or a group of them) could have systemic consequences and regulators should try to develop a measure of systemic risk rather than directly equating size or geographic spread with systemic importance in all cases.

FSA response

The FSA agrees that there are advantages and disadvantages to applying the new prudential framework that will emerge from the current international discussions to the broadest range of firms. The FSA's current view is that, on balance, the advantages outweigh the disadvantages, provided that there is scope (as a number of respondents noted) to apply the new framework in a proportionate manner. But this overall view requires further debate, at least for some particular classes of firms (for example, the relevance of applying macro-prudential tools to smaller investment firms appears limited). However, ultimately the scope of application is likely to be determined by the European directives that will implement the new framework and the FSA will return to this question in that context.

There is a case for a differentiated approach for systemically important firms and the development of the FSA's views on this topic will be set out in the forthcoming DP, as described in Section 5.

Q9: Do you agree with the FSA's reasons for favouring a range of policy measures, including an asset-based leverage ratio and a core funding ratio, to deal with macro-prudential policy issues rather than adjusting the Basel II risk-based capital requirement?

4.9.1 Respondents broadly agreed with the FSA's desire to introduce a range of macro-prudential policy measures to deliver against a wider financial stability objective. It was felt that a broad set of complementary policy tools would be superior to a single macro-factor adjustment in capturing system-wide risks. There was a general consensus that a single risk-based metric, in isolation, would not be capable of producing a comprehensive capital requirement that could deliver against the FSA's objectives.

4.9.2 The primary caveat, made by a number of respondents, was that supplementary macro-prudential measures would aid in strengthening the regulatory framework only where they were properly designed, proportionate and correctly calibrated. There remains a general concern that while individual measures may appear to achieve their intended objective in isolation, the cumulative effect of multiple measures, and their

interaction with the risk-based Basel II requirement, may result in unintended and adverse consequences. Respondents were clear that any macro-prudential measures would need to be evidence-based and substantiated by robust analysis.

4.9.3 Many respondents were keen to stress the relative infancy of the Basel II framework and felt that risk-based capital must continue to have a core role in future. However, consideration would need to be given to the interaction of risk-based requirements and the supplementary measures, now and in light of future revisions to the Basel framework. For example, some respondents were concerned about how macro-prudential measures would affect those banks whose model methodologies already incorporate cyclical adjustments into the risk-based requirement. Others were less convinced that even the introduction of multiple macro-prudential measures would be sufficient to capture the cyclical characteristics of different bank portfolios, advocating instead individual Pillar 2 adjustments.

4.9.4 The DP explained that it was the FSA's preference that the proposed supplementary measures be adopted at an international level. Many respondents reiterated the importance of securing international agreement on supplementary measures, citing risks to the UK's international competitiveness should the FSA progress without the support of its European and US counterparts. Others felt that the FSA was not necessarily best placed to oversee multiple macro-prudential measures and an international central body would be better placed to identify system-wide risks, given the global nature of financial markets.

FSA response

A significant programme of work to identify the components of a global macro-prudential framework is currently underway. The FSA believes that the respondents have raised some important concerns and will take them into account in the development of the macro-prudential framework. It is working closely with the Bank of England, HM Treasury and international partners in this area.

Q10: What should be the focus of the FSA's initiatives on valuation and disclosure in UK banks' accounts so as to maximise their impact on market confidence?

4.10.1 The DP outlined how the publication by banks of reliable financial information (of sufficient granularity) was an important factor in fostering market confidence in individual banks and the banking system.[57] In particular, the FSA identified that for certain complex asset classes, valuation procedures and assumptions differ quite significantly between UK banks. The FSA therefore proposed to engage in an intensive dialogue on this subject with UK banks and their auditors. Additionally, the FSA considered making enhanced disclosures mandatory for UK banks. These disclosures would be based around leading practice disclosures as published by the Senior Supervisors Group in 2008 and fully in line with international best practice.[58]

57 DP Box 5.1

58 Leading Practice Disclosures for Selected Exposures. Senior Supervisors Group Report to the Financial Stability Forum, 11 April 2008.

4.10.2 The vast majority of the responses received to this question supported the FSA's proposals to engage in an intensive dialogue with UK banks and their auditors. However, some concerns were expressed including the potential blurring of the respective responsibilities of directors, auditors and the FSA. For instance, one respondent called for reinforcing the message that 'directors remain clearly responsible for the preparation of accounts in compliance with accounting standards, and the auditors remain clearly responsible for the independent verification of the judgements made.[59] Some respondents further cautioned that the FSA should be careful not to become an 'interpretive body' on accounting issues. Another area of concern was uniformity, where some respondents indicated that, to the extent that differences in valuation techniques are the result of underlying differences in economic circumstances, they did not regard the pursuit of uniformity as a useful goal.

4.10.3 Of the respondents who commented, the majority opposed the imposition of mandatory disclosures, although a substantial minority did indicate general support for improved disclosures with certain caveats. Concerns focused around having a 'one size fits all' approach to disclosures which, it was felt, would not be particularly useful. In addition, some respondents viewed any further mandatory disclosure as better coming from the international standard setters and global groups, such as the FSB, and stated that the FSA should avoid taking unilateral action. Others questioned the practicality of imposing more disclosures at a time when major revisions to the international standard for financial instruments (IAS39) are planned by the IASB.

4.10.4 A number of respondents supported the need for better principle-based disclosure for reasons that included the need for disclosure to be 'sufficiently transparent' and focus on 'simplification'. One respondent further added that transparency was always welcomed by investors.[60] Another who was against mandatory disclosures stated it would prefer establishing 'clear principles of transparent disclosure'.[61] In particular, one respondent encouraged the development of a 'best-practice framework for disclosure, to include the clear articulation of the major assumptions underlying key judgements, principles for disclosure and consistent definitions to promote comparability'.[62] However, some respondents believed that, to deliver benefits to a wider geography, the overall adequacy of disclosures is best looked at in the context of Pillar 3 requirements.

FSA response

The FSA agrees on the need to be mindful of the respective roles and responsibilities of directors of UK banks and their auditors (as indicated in Box 5.1 of the DP). The FSA also appreciates the need to be careful not to become an 'interpretive body' on accounting issues. In addition, uniformity in valuation is not necessarily the desired goal; a more pressing aim is to understand why the range of dispersion exists. Furthermore, as auditors have an important role in independently assessing valuation assumptions and techniques used by directors, it is essential to include them in the dialogue and not rely solely on

59 British Bankers Association

60 Genworth Financial

61 HSBC

62 Royal Bank of Scotland

directors. Nonetheless, the FSA will continue to work closely with all relevant stakeholders, including the accounting standard setters, to promote the right outcome on valuation and disclosure issues. Moreover, given the harmful effect on confidence regarding uncertainty about valuations at critical points in the crisis, it is appropriate that the FSA become more involved in comparing, contrasting and challenging differences in valuation assumptions and judgements in relation to comparable assets.

The FSA notes the strong opposition to mandatory disclosures by a number of respondents and accepts some of the concerns, including about adopting a 'one size fits all' approach and the challenges of framing such disclosures so that they are appropriate for banks with different business models. The FSA also notes the view that mandatory disclosure should be determined by international standard setters, and concerns about practicality at a time when major revisions of IAS 39 are planned by the IASB. However, a number of respondents supported the need for better principles-based disclosure and the FSA continues to believe that enhanced disclosures for UK banks that are fully in line with international best practice and measures which enhance the ability to compare banks' results will aid market confidence.

There remains a high level of interest in UK banks' disclosures, as evidenced by recent statements from a number of bodies. The Treasury Committee of the House of Commons criticised the length and complexity of banks' annual reports and recommended that the FSA consult on ways in which financial reporting can be improved to provide information in a more accessible way.[63] The Bank of England has called for banks' disclosures to be more standardised to allow a greater level of comparability across firms,[64] and the IMF has expressed a similar view.[65]

Given the high level of ongoing interest in banks' disclosures, the FSA has decided to publish a DP on UK banks' disclosures in Q4 2009. This DP will enable further exploration of the issues around, and elicit more detailed responses on how to enhance, the ability to compare UK banks' disclosures, for example through a code of good disclosure practice, or possibly specific templates.

Q11: Do you agree with the FSA's analysis of the implications of accounting standards for procyclicality?

4.11.1 In the DP, the FSA argued that the mixed attribute model of accounting, together with current application of 'cost less impairment' accounting, was likely to be procyclical, and may have contributed to the financial crisis. However, the mixed attribute model, including fair value measurement, should continue to be used where it provides the most relevant information to users of published accounts. Procyclical accounting effects could be mitigated by greater use of prudential filters or introducing additional reserves into bank accounting.

4.11.2 Several respondents asked whether there was evidence which established a relationship between accounting standards and the economic cycle. However, most agreed that accounting results were a factor which influenced the cycle. Some respondents argued for a change to accounting standards to reduce procyclicality and questioned the

63 Banking Crisis: reforming corporate governance and pay in the City. Published May 2009 by the House of Commons.

64 Financial Stability Report Issue No. 25. Published June 2009 by the Bank of England.

65 United Kingdom: 2009 Article IV Consultation – Staff Report. Published July 2009 by the IMF.

appropriateness of market prices in certain circumstances (for example, for illiquid instruments and those held for the long term). However, most felt that procyclicality was a matter for regulators, which should be addressed by regulatory tools. Many respondents argued that accounts are procyclical by nature, since they reflect an entity's performance, which reflects (in part) underlying market cycles. In order for accounts to display a true and fair view, some procyclicality in measured financial performance and condition of firms is inevitable, and this should not be a cause for concern. These respondents felt that any mechanism to smooth results to reduce procyclicality would not be appropriate within general purpose financial reporting.

4.11.3 Some respondents noted that fair value helped early identification of problems, by writing down declines in value earlier than would be expected under other measurement approaches.[66] However, only one respondent appeared to support an increase in the use of fair value, noting increased certainty and comparability compared to cost-based accounting, which in turn increases market confidence.[67] There was also a question about whether financial reporting was immediate enough to affect short term trading decisions.[68]

4.11.4 Respondents also expressed views on potential tools that could mitigate procyclicality through the prudential framework, rather than by adjusting published accounts. Several respondents (particularly from the insurance sector) urged that accounting and prudential frameworks should be as consistent as possible, while recognising that they have different objectives. Some respondents supported the use of prudential filters to adjust accounts where they did not provide relevant information for regulators. A number of respondents also supported additional regulatory reserves or buffers to reduce procyclicality. The feedback and analysis of responses to Question 12 considers these issues further.

4.11.5 Some participants suggested that disclosures would be necessary for users to understand the relationship between accounting and regulatory frameworks. Suggestions included a reconciliation between accounting and regulatory capital and transparency on any additional regulatory reserves/buffers, although there was some concern about disclosure of buffers agreed bilaterally with the regulator for individual firms.

4.11.6 Several respondents mentioned (and supported) the IASB's current review of accounting for financial instruments, although one respondent noted that this did not have an explicit aim to reduce procyclicality and another cautioned against any changes on this basis without more substantial evidence to support the link between accounts and procyclicality.[69]

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66 To support this, several respondents referred to the Securities and Exchange Commission's (SEC) Study on Mark-to-Market Accounting (published in December 2008), which concluded, 'Bank failures in the US appeared to be the result of growing probable credit losses, concerns about asset quality, and, in certain cases, eroding lender and investor confidence. For the failed banks that did recognise sizable fair value losses, it does not appear that the reporting of these losses was the reason the bank failed'.

67 Goldman Sachs

68 International Swaps and Derivatives Association

69 Deloitte LLP, The Institute of Chartered Accountants in England and Wales

FSA response

The FSA continues to believe that a mixed attribute model provides users of accounts with information on the performance of financial instruments that is useful for investors' decisions. The FSA notes the comments from respondents that fair value measurement helped early identification of problems by writing down declines in value earlier than would be expected under other measurement approaches. However, both fair value measurement and judgements within impairment estimates should be accompanied by robust disclosures to enable users to assess potential risks and uncertainties.

The FSA also notes the arguments made by some respondents for a change in accounting standards to reduce procyclicality. However, the FSA shares the views of many respondents who believed that it was not appropriate to seek to eliminate procyclicality from published accounts. Accounts aim to reflect an entity's performance, which will often have cyclical aspects. Therefore, accounts should mirror this behaviour.

The FSA is closely monitoring developments in the IASB's review of accounting for financial instruments, and is actively engaging with the IASB as part of its increased dialogue with the international regulatory community. Although, as mentioned by some respondents, the IASB's review does not explicitly intend to reduce procyclicality, the FSA believes that improvements can be made which will provide some mitigating effects, as well as greatly simplifying current accounting standards.

In particular, the FSA can see merits in the arguments for introducing more forward-looking provisioning for bank loan losses, and specifically an expected loss model, which would help to ensure that some expected future losses are anticipated and set against current income. However, any revisions to the impairment model should not be at the cost of losing the information currently available on actual credit quality deterioration already experienced; nor should such a significant change be implemented without an assessment of the quantitative impact.

Although it may help to reduce procyclicality, the FSA does not believe that an expected loss impairment model will in itself be sufficient to eliminate it. This is because, in some respects, the approach under consideration remains procyclical. Therefore, even following possible future changes to accounting standards, the FSA believes, as did several respondents, that additional regulatory tools will be required to reduce procyclicality, and that this is necessary to enhance financial stability.

Although the FSA agrees with many respondents that this is better dealt with through the prudential framework supported by robust disclosure, rather than through significant changes to published accounting figures, both the BCBS and CEBS believe that this cannot be considered in depth until the IASB's proposals are published. The FSA believes it is important to continue to have an open discussion about the various ways in which earlier accumulation of buffers for loan losses could be achieved, and is mindful of the need to join up various aspects of the debate to ensure a coherent set of measures within both the accounting and prudential frameworks.

Noting concerns about the cumulative effect of various changes under consideration (in both capital and accounting), the FSA intends to carry out a full assessment of the overall impact of the changes being proposed. This will be considered in further detail in the forthcoming DP, as described in Section 5.

Q12: How best should prudential regulators address the problem of procyclicality through counter-cyclical reserves/buffers?

4.12.1 Responses on this question were divided between those who saw it as a discussion of the respective merits of various dynamic provisioning approaches versus an economic cycle reserve, and those who commented upon counter-cyclical buffers more generally.

4.12.2 On the former, the majority of respondents preferred an economic cycle reserve as an appropriation of capital to a dynamic provision within the income statement, which only a small number supported. However, other respondents were opposed to the concept of dynamic provisioning in principle as, in their view, it would allow accounting manipulation and would be a step back towards hidden reserves.[70] One respondent thought the existing Pillar 2 approach was sufficient.[71]

4.12.3 Specific comments included the need for a study on whether a buffer would have had the desired effect, and also whether there should be communication with the users of accounts on whether they would find disclosure useful. Two important and related aspects of such an approach were i) whether the buffer should be based on standardised supervisory estimates of loss rates for exposure types as opposed to firms' own estimates; and ii) whether the results of this calculation should be automatically applied as a buffer, or there should be an element of discretion. Both issues concern the appropriateness of the buffer to the circumstances of a particular firm. Two respondents were concerned that an extreme formulaic approach, based on standardised estimates with no discretion, would not take sufficient account of firm-specific differences.[72]

4.12.4 One respondent called for a combination of a formula-based approach and discretion, including management judgement, and expressed concern about the equity amongst firms of a non-distributable reserve approach (for example if there had been a recent bonus issue of shares which had already converted distributable reserves into non-distributable capital)[73]. The same respondent wanted clarification on how the approach would apply at both group and subsidiary levels, and also raised the consequences of the move away from the incurred loss model of provisioning and towards an expected loss approach. On the last point, another respondent expressed concern that an expected loss approach would prove procyclical in a serious recession.[74]

4.12.5 There was a range of comments made on the more general issues around counter-cyclical buffering. A number of respondents highlighted the need to avoid double-counting between various different mechanisms and to ensure it should be possible to draw down the buffer in a downturn to avoid it becoming a new minimum (i.e. that neither market reaction nor reluctant supervisors would prevent this happening).

4.12.6 One respondent suggested a buffering approach would require regulators being prepared to call the top of the cycle and that experience showed they would be

70 Goldman Sachs, Adam Smith Institute

71 Goldman Sachs

72 HSBC, Goldman Sachs

73 British Bankers Association

74 Building Societies Association

unwilling to do so.[75] In addition some respondents noted the issue that internationally active banks will face a range of different economic cycles in the different geographies where they operate.

FSA response

The FSA is working in the Basel process on a 'three pronged' approach to address:

a) the cyclicality in minimum capital requirements;

b) the cyclicality in regulatory capital arising from the volatility in lending losses, as argued for in *The Turner Review* and DP; and

c) a buffer to cover unanticipated losses and support lending in a recession.

The FSA has identified several key design issues in this work, including the potential use of methodologies covering volatility in IRB capital requirements,[76] developed by CEBS and included in its July position paper on countercyclical capital buffers.[77] Developmental work on the various prongs should address the specific points upon which respondents have commented on countercyclical buffers more generally.

Since publication of *The Turner Review*, the European Commission has consulted upon a dynamic provisioning approach, similar in many respects to what had been proposed by the FSA in *The Turner Review* and the DP. Further, the IASB has begun consulting on modifying the accounting treatment of impairment. This would constitute a move away from the existing incurred loss model towards an "expected loss" model. While the definition of expected loss is not clear at this stage, it will differ from the definition of expected loss used in the IRB approach.

In principle the FSA supports the approach put forward by the Commission to address the cyclicality of loan-loss provisions, as it substantially aligns with the FSA's own proposals. However, significant further development work is needed and, in particular, the FSA is not convinced that the Commission's proposal will be allowable under the current (or likely revised) accounting framework.

Conceptually the right approach is for regulators to determine the appropriate philosophical method to reflect the regulatory treatment of financial assets, to assess how the emerging accounting standards will be applied to such assets, and to bridge any remaining gap, possibly using a system such as economic cycle reserves which are deducted from regulatory capital.

As a prudential regulator, the FSA is indifferent to whether adjustments to create buffers covering the cyclicality of lending losses should be by way of a provisioning methodology, or outside of the provisioning approach. However, as noted above, any change will need to have regard to the accounting framework. The detailed policy questions, such as how to estimate an expected loss across the cycle, are the same in any event.

75 London Investment Banking Association

76 The volatility of the Pillar 1 minimum is not limited to IRB capital requirements.

77 www.c-ebs.org/getdoc/715bc0f9-7af9-47d9-98a8-778a4d20a880/CEBS-position-paper-on-a-countercyclical-capital-b.aspx

The FSA urges the international regulatory community to pursue an approach both to cyclicality of lending losses and to countercyclical buffers more generally by adopting the 'three-pronged approach' set out above.

As regards some of the specific comments made in the responses:

- the FSA does not agree that either of the approaches constitutes a step back towards hidden reserves provided that, as the FSA has argued, appropriate disclosure is an important element of the mechanism;
- Pillar 2 does not build up a system-wide precautionary buffer in the way envisaged by these approaches. The idiosyncratic capital planning buffer currently identified under Pillar 2 is a necessary but not sufficient tool to achieve the outcomes of the FSA's prudential regime. Moreover, there is a risk that a Pillar 2 system-wide buffer may deliver inconsistent outcomes across national jurisdictions depending on their different applications of Pillar 2, which is undesirable; and
- the FSA is clear that it is intended that such an approach, along with other aspects of the regulatory capital regime, would apply on the basis of both group and solo entities.

Q13: Do you agree that serious consideration needs to be given to establishing some form of global supervisory architecture for international audit firms?

4.13.1 The DP noted that reliable financial reporting is not only of public interest but a critical factor in underpinning market confidence.[78] It identified two gaps in the current regulatory architecture for the independent regulation of audit services by major accountancy firms. First, that the major accountancy firms operate globally but audit regulation is conducted nationally and, secondly, that there is no regulation of non-audit services. Consequently, the FSA proposed that serious consideration be given to establishing some form of global supervisory architecture for international audit firms.

4.13.2 The majority of responses acknowledged the gap and agreed that serious consideration needs to be given to establishing global oversight. For instance, one respondent stated that a robust framework of international audit firms was a pre-requisite for a robust financial services industry.[79] Another respondent mentioned that this was 'very important in terms of both banks and all other large scale companies'.[80]

4.13.3 However, some respondents expressed reservations and questioned whether this was the most urgent issue for the FSA. They noted that there may be other risks which would lead to one of the 'Big 4' audit firms exiting the market, such as unlimited auditor liability in certain jurisdictions. Reservations about focusing on this area also referred to the nature of any international oversight and the need to ensure an 'appropriate split' was found between international and national oversight, to ensure a level playing field and avoid a 'rush to the bottom' in the interests of harmonisation. Others noted, in relation to the firms' provision of non-audit services, that there was some local supervision of this through firms' membership of

78 DP Box 5.3

79 Confederation of British Industry

80 Leicester University

professional bodies, and that in the UK the Auditing Practices Board's ethical standards restricted what non-audit services could be provided to audit clients by auditors. Some respondents noted that the Institute of Chartered Accountants in England and Wales (ICAEW), on behalf of the Financial Reporting Council, was developing a code of governance for multi-disciplinary accountancy firms that audit public interest entities.

4.13.4 All respondents that addressed this question agreed with the FSA on the challenge posed by the major accountancy firms being primarily networks. On the best way forward, the majority supported strengthening the role of the International Forum of International Audit Regulators (IFIAR). However, respondents did express some concerns. For instance, one respondent cautioned that it may take too long to deliver and dialogue between auditors and financial regulators from the main jurisdictions would be a better alternative if the objective was to achieve a more immediate impact.[81] Another respondent called for 'global high-level recommendations or principles' driven by global regulatory convergence combined with effective oversight by the IFIAR.[82] In addition, one respondent added that global oversight should help to ensure a set of common principles but not bind every country into an identical system.[83]

FSA response

The FSA acknowledges that there is some local monitoring of non-audit services and that potentially useful work is taking place on a draft Code for audit firm governance. This is being consulted upon by the ICAEW on behalf of the FRC.[84] However the FSA continues to believe that serious consideration also needs to be given to addressing gaps in the global regulatory architecture for major accountancy firms, although it agrees that others, such as the FRC and IFIAR, are likely to be best placed to carry this work forward. The FSA will continue to engage with the FRC on this matter.

Q14: What macro-prudential policy tools should be considered other than those mentioned in this DP?

4.14.1 There was a range of responses to this question. A large number of respondents noted that the prudential policy tools advocated in the DP were either appropriate or at least comprehensive. These were, (i) a counter-cyclical approach to regulatory capital (ii) a gross leverage ratio and a core funding ratio and (iii) the possibility of employing caps on Loan to Value or Loan to Income in the mortgage market.

4.14.2 A small minority of respondents made the case against the development of macro-prudential policy tools. Their argument was based on the sufficiency of monetary and tax policy tools to address, for example, asset bubbles and/or excessive credit growth; some respondents argued that the monetary policy framework should be re-cast to include an explicit focus on asset bubbles. Further, the Pillar 2 process was cited as a means for financial supervisors to address emerging prudential concerns more effectively.

81 Building Societies Association

82 JP Morgan

83 KPMG LLP

84 The Institute of Chartered Accountants in England and Wales paper on behalf of FRC – Audit Firm Governance, Second Consultation Paper, July 2009.

4.14.3 Two respondents argued that there was insufficient emphasis on the issue of the interconnectedness of the banking system in the DP, and related the macro-prudential issue to the large exposures regime.[85] Others noted the risk of mistakenly identifying a shift in the 'operating paradigm' of the market as a bubble, and thereby stifling valid innovation.[86]

FSA response

The FSA agrees that the Pillar 2 regime can be used more intensively than has been the case and is already planning this, in particular in the area of stress-testing. The FSA will publish a Policy Statement on its approach to stress testing in Q4 2009.

Nevertheless, the FSA agrees with the implied view that explicit macro-prudential tools are required which go beyond those available to monetary and fiscal authorities and those which are now regarded as instruments of micro-prudential policy. It will continue to work to develop a macro-prudential framework and consider, with the Bank of England, HM Treasury, and internationally, what tools could be developed and how they should be used.

Since the publication of *The Turner Review* and the DP the Government has published a White Paper 'Reforming Financial Markets' in which it sets out its view on the macro-prudential system (which is discussed in Section 3).[87]

The FSA agrees that the issue of inter-connectedness is an important one, particularly in respect of systemically important firms. This will be explored more in detail in the forthcoming DP, as described in Section 5.

Q15: What are your views on the effectiveness of a core-funding ratio as a measure to constrain excessive asset growth?

4.15.1 Respondents generally agreed that an appropriately calibrated core funding ratio, as a component of a liquidity risk framework, could be an effective macro-prudential tool to ensure sustainable funding of balance sheet growth. In fact, a number of firms said they already had such measures in place before the current crisis.

4.15.2 The most common concern was the effect that the adoption of a blunt one-size-fits-all approach of a common ratio might have on different business models, particularly in the absence of an international standard. Respondents also voiced concern about the possibility for regulatory arbitrage if the ratio were not to be applied simultaneously to all relevant firms, domestically and internationally, which would potentially increase the amount of assets moving to non-banks, off balance sheet and abroad.

4.15.3 Firms active in the wholesale markets, and in particular the repo markets, wanted to ensure that the ratio took account of the liquidity of certain asset classes that, in their view, did not need to be funded by stable funding sources. Some firms felt that applying the ratio could dramatically increase the competition for, and hence the cost of, retail deposits, and that this might also lead to retail deposits being used to fund wholesale banking activities.

85 PriceWaterHouse Coopers LLP, The Institute of Chartered Accountants in England and Wales

86 British Bankers Association

87 www.hm-treasury.gov.uk/d/reforming_financial_markets080709.pdf

4.15.4 Building societies that responded highlighted that they already had a measure comparable to a core funding ratio and therefore did not see the need for an additional measure to apply to the sector. Further, some firms were uncertain as to how a core funding ratio would interact with the proposed leverage ratio.

4.15.5 One respondent suggested it was important to differentiate between unsecured and secured funding; pointing out that secured funding encumbers assets. The respondent also suggested further refinements, including the effects of currency mix and off-balance sheet items.

FSA response

The FSA believes that a structural liquidity measure – such as the core funding ratio proposed in the DP – should be a key macro-prudential element in liquidity policy, ensuring that a proportion of balance sheet growth is sustainably funded. This measure should reduce the risk that incremental asset growth is financed by funding of deteriorating quality or that high quality funding is substituted over time.

The FSA therefore welcomes the September 2009 announcement by The Group of Central Bank Governors and Heads of Supervision (the oversight body of the BCBS) that key measures to strengthen the regulation of the banking sector should include a longer-term structural liquidity ratio.[88] The FSA is contributing actively to this work and supports continued work within international fora, including the BCBS and EU bodies.

Within the international debate, a number of key policy questions have arisen. These include the extent to which simplicity of the measure should be a key objective (at the expense of the complexity inherent in more comprehensive measures), the possible use of multiple time-horizons or other approaches to avoid 'cliff' effects, and the relative incentives such a measure would introduce for the balance between secured and unsecured funding. A limit focusing on a single time-period can lead to a 'cliff' effect whereby banks manage to the limit (both individually and potentially in aggregate), with a significant portion of liabilities maturing just over the time-horizon. In a period of stress where it can be difficult to re-finance liabilities, this can lead to structural balance-sheet weakness. The FSA believes a better approach is to focus on a number of time-horizons to ensure a smoother and more stable funding profile.

From a macro-prudential perspective, the key issue is the extent to which it is appropriate to include the quality and stability of the assets within a structural funding measure (i.e. to concentrate on the 'net stable funding' position as opposed to the structure of the liabilities only). The arguments in favour of inclusion are that this type of approach better reflects the asset liability match of the balance sheet. The arguments against are:

- that any attempt to include the asset-side of the balance sheet more broadly necessarily requires ex-ante assumptions about the ability of firms to liquidate their assets in stressed conditions – as the FSA has seen in the current crisis, many assets which were regarded as liquid were illiquid under stress conditions; and
- even if the assets do remain liquid in stressed times, it seems undesirable to have a policy which depends on large-scale and possibly simultaneous liquidation by firms of a

88 www.bis.org/press/p090907.htm

wide set of assets in order to meet liabilities where the market values of these assets would very likely deteriorate significantly. This is especially a concern where trading or other mark-to-market activities are being financed on a short-term secured basis.

The FSA sees a structural measure (such as core funding) as a complementary measure alongside (and in some cases as a backstop to) more firm-specific measures tailored to firms' individual risks. As such, whilst there are good arguments to seek to refine the 'core funding ratio', the FSA also believes there is a risk of creating un-necessary complexity which could undermine the macro-prudential function of such a measure.

In the near term, the FSA intends to reflect its view of individual firms' structural funding position within the Individual Liquidity Guidance (ILG) issued under the FSA's new liquidity policy.

The FSA recognises that there is a diversity of business models with different liability structures but continues to believe that all business models should be sustainably funded, and that a suitably designed structural measure can contribute to this outcome. Subject to this constraint, it is expected that firms will continue to be able to exercise choice over how best to fund their balance sheet. The FSA does not expect that all firms will choose to be predominantly retail-funded.

The FSA notes feedback that building societies are already subject to statutory structural balance sheet limits on the proportion of non-retail funding they may have and acknowledges the need to consider carefully how any additional measure would interact with the existing statutory legislation in this case.

Q16: What types of institutions should be exempt from such a core funding ratio? How would any exemptions limit the effectiveness of the measure?

4.16.1 Those respondents that addressed this question put forward a number of different points of view regarding the scope of application of a core funding ratio. Some felt it should only apply to systemically important firms, or those that took retail deposits, others felt that to ensure a level playing field it should apply across the board.

4.16.2 The exception to this were building societies, who explained that current legislation effectively imposes a form of a core funding ratio, by requiring building societies to ensure that at least 50% of their funding is from member retail deposits,[89] although they noted that longer-term wholesale funding was not counted for these purposes. Therefore, the application to building societies of a core funding ratio of a lower level would be superfluous to the current legislation and where this is the case they should be exempt.[90]

FSA response

As stated in the FSA's response to Question 15, the FSA is aware of the position of building societies and acknowledges the need to consider carefully how any additional measure would interact with the existing statutory legislation.

89 Section 7 of the Building Societies Act 1986

90 Building Societies Association

As a macro-prudential 'backstop' to firm-specific liquidity measures, the FSA's starting point is that any core funding measure should apply to those firms to which the new quantitative liquidity risk standards will apply.

There are additional arguments in favour of higher standards for systemic institutions which could include higher requirements for core funding; the general arguments in favour of higher prudential standards for systemic institutions will be discussed further in the forthcoming DP, as described in Section 5.

Q17: To what extent would market discipline and the convergence of supervisory practices be improved by the disclosure of information relating to Pillar 2 assessment? What information would be most useful?

4.17.1 Respondents to question 17 expressed some caution about the potential benefits of disclosing the outcomes of Pillar 2 assessments and Individual Capital Guidance (ICG). Their main concern was that the outcomes of Pillar 2 assessments might be misinterpreted as a supervisory rating, which they are not, with the potential to undermine market confidence. Some respondents did suggest that the publication of the FSA's risk methodologies used in Pillar 2 assessments would improve transparency and market understanding. Respondents also suggested that the publication of aggregate Pillar 2 information would be useful for benchmarking purposes. In addition, the benefits of sharing of ICG in colleges of supervisors were noted.

FSA response

The FSA understands respondents' concerns that the general publication of individual Pillar 2 assessments may not be well understood by market participants at present. However, the FSA also noted respondents' requests for greater transparency in the methodologies that the FSA uses to assess Pillar 2 risks.

The first step that the FSA will take to address these requests will be to publish and, where appropriate, consult on methodologies used in Pillar 2 assessments. So, in late 2009, the FSA will consult on its approach to setting capital planning buffers and in 2010 will identify specific risk areas, such as the FSA's approach to assessing interest rate risk in the banking book, for publication.

The FSA will also assess the potential for publishing aggregate benchmarks related to ICG. At a later date, the FSA will assess whether greater transparency in the approach to Pillar 2 assessments would facilitate selected publication of ICGs.

The FSA agrees with respondents that effective information sharing in colleges is important and that this should include capital issues. As colleges are international in nature, the FSA is working with other regulators through the FSB and the BCBS to identify the types of information that could be usefully shared in colleges. In these discussions the FSA will pursue the merits of sharing the outcomes of Pillar 2 assessments, at least amongst colleges' core membership where this information is most relevant.

Scope of Regulation

Q18: Are there other considerations that are relevant to the assessment of the issues and risks posed by the boundary question?

4.18.1 There was clear agreement that the boundary issue was a tricky one, and respondents gave broad support to the approach presented by the FSA, particularly for the principle of regulation on economic substance and not legal form. Many respondents stressed that the FSA's approach to any extension of regulatory scope should be necessary, proportionate and as far as possible global, with costs and benefits clearly spelled out. Several felt that further clarification was needed as to how any scope changes would work in practice, and how further information, if gathered, would be used. In their view, the current powers already go a long way and these should be used to their full effect before any extension was considered.

FSA response

The FSA agrees that any approach should be proportionate, global and focused on financial stability. The Government, in its White Paper 'Reforming financial markets' has stated that it will work with the FSA to look carefully at existing powers and duties to assess whether it is necessary for the FSA to have any additional or extended information gathering powers.[91] The Government has also stated that it will give full consideration to any legislative changes that may be necessary in light of future developments in financial innovation, which mean the scope of authority or existing powers of the FSA are not sufficient for it to fulfil its statutory objectives.

The FSA is committed to ensuring that any extended information gathering powers are proportionate, and is exploring appropriate safeguards and limitations that could be associated with them. The power to collect data should be driven by impact, not by type of firm. A broadly drafted power is key to ensuring future flexibility to respond to a constantly evolving profile of risks to financial stability. A narrow power is unlikely to be future-proof, in the sense that it would be unlikely to capture business models which may emerge years from now as a potential threat to financial stability; could create opportunities for regulatory arbitrage, by encouraging firms to design business models which do not quite fit within the scope of the information gathering power; and would present significant drafting challenges, such as a need to describe certain entities in statutory language.

The FSA is not currently intending to recommend an extension of the perimeter, but will put in place a process for continually reviewing perimeter issues. It will use this to update HM Treasury regularly on relevant innovations in the financial sector and areas where the FSA's scope of authority or existing powers are not sufficient for it to fulfil its statutory objectives.

Whilst it is beyond the FSA's control to ensure that scope extensions are initiated globally, it is fully committed to international coordination in this area and will work through the various international bodies and fora to support appropriate international responses to the challenge of the regulatory perimeter.

91 www.hm-treasury.gov.uk/reforming_financial_markets.htm

Question 18 was an open question, but many responses merged the narrower answer to Question 19 with wider considerations more pertinent to Question 18. Therefore the response to Question 19 picks up many of the wider issues posed by Question 18.

Q19: Is the escalating response set out here the right way to deal with the threats to financial stability and consumer protection posed by unregulated financial activities and institutions? Or should the FSA, along with other regulators, develop an alternative approach?

4.19.1 The DP proposed a three step escalating approach to dealing with risks from outside the regulated boundary. First, regulators should be able to have access to information about the regulated sector's exposure to the unregulated sectors. Second, they should then be able to gather information on systemic risks posed by the unregulated sector. Finally, mechanisms are needed to move the boundary of regulation should risks that need mitigation be identified.[92]

4.19.2 Overall, the responses reflected general support for this approach. At least one respondent, which included acting as a hedge fund service provider in its activities, said it would be supportive of providing additional information to supplement an already positive dialogue with the FSA.[93] There was unanimous agreement that any changes to the regulatory boundary need international or global coordination to be effective and avoid regulatory arbitrage or other unintended consequences.

4.19.3 The process for amending the boundary (defining policy, engaging in consultations, run-in periods and transitional periods), which aims to ensure fair treatment of institutions, was recognised as time-consuming and inappropriate for reacting to emergencies. Therefore the escalation approach was supported, albeit with certain triggers such as those suggested in the DP (for example the scale of activities undertaken, potential market or real economy impact of a disorderly unwind, or potential consumer detriment).[94] Many respondents recognised that defining triggers ex-ante was very difficult and so would need constant review. There was also concern that regulation should not be imposed on activities unless there is clear justification for that course of action.

4.19.4 However, there were some concerns voiced about the escalation process and the need for extra powers. There was a broad view that the FSA already had sufficient power to gather what information it needs to carry out the early steps of escalation (information gathering, monitoring and evaluation) and the ability to conduct 'indirect regulation'. The powers, of HM Treasury to modify the Regulated Activities Order (RAO) and its exceptions, or the power of the FSA to lay down new rules, were also seen as quite extensive.

4.19.5 Some respondents suggested further examination of the limitations of an indirect approach before devising ways of gathering large amounts of information from unregulated firms.[95] There were various voices in industry that did not see a need for

92 DP Section 6

93 Goldman Sachs

94 See Paragraph 6.23 of the DP

95 For example Addleshaw Goddard LLP

further regulation of hedge funds or groups as both come under the scope of regulation in some form. These included hedge funds in the UK, where the FSA already has a prime broker survey and regulates hedge fund managers.

4.19.6 Many respondents believed that direct regulation, or bringing activities into the boundary, should be seen as a last resort, and that the FSA should seek to use its current powers to their full extent.[96] Some respondents felt that, as a matter of practice, the FSA should try to avert the need to pass legislation through cooperation with any unregulated bodies that pose the systemic risk.[97]

4.19.7 A number of respondents believed the FSA already had the ability to gain an understanding of the totality of risks a group faced, and could deal with these through consolidated supervision and the integrated groups' regime. Other respondents suggested that investor due diligence was more comprehensive than the FSA's ARROW assessment, and others noted that effective counterparty and credit risk management is the responsibility of banks and prime brokers. There was also caution about the regulator's ability to understand the universe of risks, and the possible unintended impacts of it trying to do so.

4.19.8 Various respondents gave support for scope proposals concerning offshore centres or UK-based entities, but raised reservations concerning the costs and benefits, as well as how scope extensions would work in practice. They requested further clarification on various aspects of proposed scope changes, including how the FSA will use any new data it gathers.

FSA response

The FSA recognises that it currently has extensive powers to access information from regulated group entities, as well as UK-based hedge fund managers and prime brokers providing services to hedge funds. The FSA is committed to issuing its current information gathering powers to their full extent. However, the purpose of a new information gathering power will be to assist with the identification of newly developing threats to financial stability, most likely from new types of unregulated entities or activities.

As noted in the response to Question 18, a broadly drafted power is needed (as it is impossible to know which unregulated activities or entities will develop in the future to become a threat to financial stability) and the FSA will put in place a process for continually reviewing perimeter issues.

The question over how the FSA would use data is simple to answer conceptually – it would use it to identify and assess systemic risk – but in practice decisions on when to intervene would be extremely difficult. The size, substitutability and interconnectedness of the institution, market or instrument need to be considered in order to determine the negative impact of failure and hence the systemic importance. The guidelines currently being prepared by the IMF to help countries determine whether a firm, market or instrument is systemically important will be valuable in this respect. Information obtained through an extended power could also assist in determining whether increased capital requirements or other arrangements should be put in place to protect regulated firms in their dealings with

96 For example British Bankers Association

97 For example Addleshaw Goddard LLP

unregulated sectors of the market. It would also assist the FSA to provide HM Treasury with well informed advice about potential extensions to the perimeter. It would ensure that extensions are only made when justified by the circumstances.

The question of how extraterritorial powers would work in practice is a valid one. The FSA accepts that there will be practical limitations to the use of extended information powers where the relevant information is only held by overseas entities.

The FSA is fully committed to international coordination in this area, and will work through the various fora to support appropriate international responses to the challenge of the regulatory perimeter. The FSA fully supports the IOSCO work set out in Section 3 and believes the agreement on its high-level principles (as set out in 3.25) is a major step forward towards achieving a comprehensive and coherent regulatory response globally to the risks posed by the hedge fund.

Within the EU, the AIFM Directive (as set out in Section 3) seeks to strengthen the regulation of the management and administration of alternative investment funds (including hedge funds) across the EU. One of the Commission's stated objectives for the Directive is to capture those investment funds which pose significant risks to financial stability and market efficiency. The FSA does not believe that the present thresholds in the Directive strike the correct balance between imposing additional costs on funds and ultimately investors and delivering commensurate benefits to regulators in the assessment and mitigation of systemic risks. The Directive also creates an unlevel playing field for other sectors of the market such as private equity which do not appear to pose systemic risks to the financial system and whose natural competitors (e.g. family offices and sovereign wealth funds) do not appear to have been captured.

The FSA has been developing a Hedge Fund Manager survey so that it can better identify potential sources of systemic risk that hedge funds may pose, either individually or collectively. Some firms have already been contacted, but the FSA will be looking to conduct a survey with a larger number of firms Q4 2009. This is in parallel to a separate Hedge Fund as Counterparty survey (previously know as the Prime Broker survey) that is run every April and October. This survey considers the exposures of the major banks in London to hedge fund counterparties. Together with the survey of hedge fund managers, this should enable the FSA to better assess and, if need be, act on systemic risks posed by hedge funds. Work is also currently underway to explore the FSA's ability to gather information on, and supervise, complex group entities, including holding companies and on complex intra-group relationships.

On other issues, the FSA believes that investor due diligence and risk management are necessary, but are not always sufficient (for example in capturing system-wide risks). The FSA is also aware that the current crisis shows evidence that some aspects of investor due diligence have been very weak. Industry concerns about regulators' ability to understand risk points to the need for comprehensive cost-benefit analysis as well as evolving and effective risk management within the FSA. The FSA is constantly reviewing and strengthening its ability to manage risk and views ARROW as a comprehensive and proportionate approach to supervision and risk management

Q20: What are the implications of subjecting parent holding companies for financial services groups to direct powers to comply with the requirements of the prudential framework?

4.20.1 The feedback the FSA received was mixed, with many respondents suggesting that the proposals were not detailed enough for them to assess the implications and requesting more clarification. Respondents did feel strongly that any developments in this area should be aligned with global and EU developments and that the UK should avoid 'gold plating' or moving ahead of other jurisdictions. A small number of respondents stated they were in favour of direct regulation of holding companies (although these were mainly from firms whose legal structures mean that changes in this area would not affect them).

4.20.2 A number of respondents supported the general principles but had serious concerns and placed strong caveats on their responses. In total about a third of those who responded to this question overtly supported the principle either that holding companies should be subject to direct regulation or that FSA should be able to look at financial resilience and probity at a group-wide level.

4.20.3 Just over a quarter of respondents were strongly against direct regulation of holding companies with most of the strong disagreement coming from the banking sector. Those that disagreed thought that the FSA's indirect powers of consolidated supervision (for example under the Financial Conglomerates Directive), senior management approval, systems and control regime, capital requirements and powers to act against unsupervisable structures were sufficient. They did not see any benefit in solo supervision of a holding company and were not convinced that the FSA needed additional powers to achieve its objectives.

4.20.4 Nearly all respondents raised concerns about the potential harm that a unilateral or overly burdensome regime could produce. Many were concerned about the increase in costs and regulatory burden that direct regulation of holding companies could bring. This was considered to have the potential of influencing a firm's choice of domicile and drive business from the UK. Respondents felt that any burden should be proportionate to the risks the group poses and concerns were also raised about the extra complexity for those whose parent holding companies were outside the EEA.[98] Respondents were also concerned about the potential for restriction of fungibility between group entities, and felt that there is a need to recognise the benefits being part of a wider, diverse group can bring.

4.20.5 A number of respondents raised the concern that the parent would be subject to direct supervision by the regulators of each of its subsidiaries. Concerns were also raised that new powers could lead to undesirable conflict between different regulators, both cross-border and across sectors (particularly non-financial regulators of other parts of the group).

4.20.6 Many respondents commented on various aspects of the scope of the proposals. One thought that the FSA should focus on the banking sector as that was where the main problems had been generated, and should not read across to other sectors. Others thought that the FSA should be able to decide the most appropriate level to apply

98 National Australia Group

provisions to and that any direct powers should not go beyond the level of the immediate holding company and should not capture non-financial businesses.

4.20.7 Some respondents also felt that imposing any extra burden was not justified where the parent only has a limited role and influence and that any new powers should be restricted to entities that present a clear risk to financial stability or consumers. One respondent thought that the application of direct powers was unnecessary in the case where the group board is the same as the subsidiary board.[99] A number of respondents, particularly those who disagreed with the proposals, thought that the regulatory perimeter is in right place. Others thought that such large regulatory perimeter issues should be coordinated at an international level.

4.20.8 A number of respondents, again mostly those who disagreed with the idea, thought that the FSA should further explore using its current powers more fully before seeking additional powers. Several respondents though that senior management should be aware of all risks and report anything to FSA that it would reasonably expect to have notice of. One respondent queried whether FSA would have the resources or expertise to review the significant amount of additional information that would be required to analyse and monitor any holding company level requirements.[100]

FSA response

The FSA recognises the concerns that have been raised by this issue, particularly those around the risk of regulatory arbitrage and the need for international agreement and co-operation.

Parent holding companies play a key role in the governance and strategy of a group. It is important that the scope and power of regulation can be applied consistently to the activities undertaken by a group irrespective of group structure. In terms of FSA powers, existing measures such as the strengthened Approved Persons regime and the various consolidation provisions in European Directives are helpful in identifying and reducing group risk and in achieving FSA objectives. However, the issue identified is that parent holding companies are not subject to the same incentives or oversight when considering the regulatory implications of their strategy and actions compared with regulated firms that are either head of or part of a group.

This subject is being considered in the Joint Forum work on the differentiated nature and scope of regulation and in the Joint Committee on Financial Conglomerates as part of the review of the Financial Conglomerates Directive. The FSA is actively participating in this work.

The FSA is also considering options to address this issue. This work will be influenced by work being conducted on intra-group relationships (see responses to Q23 and Q24) and on resolution.

99 The Institute of Chartered Accountants in England and Wales

100 The Institute of Chartered Accountants in England and Wales

Systemically Important Firms

> Q21: Are there other issues which regulators should take into account when assessing their response to the evidence from the current crisis that some financial institutions have been deemed too big to fail fully?
> If so, what are they?

4.21.1 *The Turner Review* and DP included some discussion of how any future regulatory framework should treat systemically important firms, including the question of whether or not they should be subject to tougher prudential standards, for both capital and liquidity. The DP identified both advantages and disadvantages to such an approach, concluding that the case for such differentiation had not at that time been decisively made, and that further consideration needed to be given to this subject.

4.21.2 Respondents provided mixed views and comments on the systemically important firms issue. A number of larger firms opposed the idea of increased capital requirements for systemically important firms (although they were open to more intensive supervision). However, their view contrasted with other respondents, who were more in favour of tougher requirements, which were felt to be needed to guard against failure.

4.21.3 Generally respondents were not in favour of the separation of commercial and investment banking activities (often referred to as the 'Glass-Steagall' approach), which they felt would counterproductive. Many respondents agreed with the FSA's analysis on narrow and bulk banks approach and the impracticalities in adopting such a system. Many also felt that the narrow bank approach carries inherent risks itself and diversity of activities would be important for weathering crises in the future.

4.21.4 However, a number of respondents felt that institutions deemed too big to fail create an unacceptable degree of moral hazard and thus should be avoided, although many of these respondents also conceded that there will always be some firms that are of some systemic importance. One respondent believed that customers would be attracted, particularly in times of crisis, towards institutions which are perceived to be government backed (and that this creates competition issues).[101] Similar concerns were also echoed for investors.[102]

4.21.5 Respondents also identified that systemic importance was about more than just size and that small firms could cause systemic risks in times of stress. One respondent stated that the FSA should identify what constitutes systemically important activities that, in the event of a crisis, would need to be protected. Supervisors should identify in which firms these activities were taking place and draw up credible plans that would protect these activities in the event of the firm's failure.[103]

4.21.6 Some respondents were in favour of breaking up institutions that were deemed too big to fail. One respondent stated that such a break up could be beneficial for consumers as it would encourage greater competition. Another respondent suggested

101 Aegon UK

102 For example by Confederation of British Industry & Association of British Insurers

103 Barclays

that systemic risk reduction could be achieved by reducing the dependency on intra-group trading and borrowing thereby limiting intra-group risks.[103]

4.21.7 One respondent from the insurance sector voiced concerns about the risks they faced from the failure of large banks since the introduction of cross-sector funding for the FSCS. This meant action was needed to ensure banks did not become too big to fail.[104]

FSA response

The Turner Review and DP included some discussion of the treatment of systemically important firms. Since the papers were published, there has been a great deal of debate on how to deal with the particular risks posed to such firms. This has included various calls for higher prudential requirements for such firms, including by the G20. The FSA intends to address these wider issues, including those raised by the respondents, in its forthcoming DP, as described in Section 5.

Q22: What are your views on the balance between varying the intensity of supervision according to the impact and risk that an individual firm poses, and having policy frameworks and approaches that differentiate across-the-board according to a firm's systemic significance?

4.22.1 Many respondents agreed that large systemically important firms should be more closely supervised and that the level of this supervision should be based on the risk posed by the firm. However, there was universal agreement to have a common policy framework that was clear and focused, and some respondents felt that the current principles and risk-based approach remained appropriate.

4.22.2 Many stated overwhelmingly that the FSA should vary the intensity of supervision based on the risk posed by firms while ensuring a single policy framework across the board as opposed to having specific policies for firms perceived to be systemically important. It was suggested the FSA should base its judgement of systemic relevance on activities undertaken or the particular business models applied in the circumstances.[105]

4.22.3 Most respondents agreed that policy frameworks which explicitly differentiated between banks would raise boundary issues and distort competition between systemically important and 'nearly' systemically important banks. Additionally this may impose a burden on the FSA as it would have to monitor more intensively banks that were on the boundary.[106] One respondent argued that it was not clear to what extent the FSA viewed systemic risk as a concept arising only from banking, and its related activities, or whether it believed the insurance sector could also be systemic.[107]

4.22.4 Another respondent argued that the FSA paid relatively little attention to smaller firms. It was suggested that this 'lighter supervision' sometimes leads to lower

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103 Ernst & Young

104 Royal Sun Alliance

105 Barclays

106 British Bankers Association

107 Lloyd's General Counsel Division

regulatory standards in these organisations. The respondent felt this lack of challenge could lead to institutions taking on more risk than they can support.[108]

FSA response

The FSA operates a risk-based approach to supervision, in order to determine where it should focus its finite resources. It follows from this that firms whose business models, size, etc mean that they pose less risk to the FSA's objectives attract less direct supervisory resource. This is a conscious choice on the FSA's part. However, the FSA does monitor these lower risk firms using a range of techniques and makes supervisory interventions and takes enforcement action where it is appropriate to do so. The FSA also undertakes significant amounts of education and communication with these firms, to promote good standards of compliance and the fair treatment of customers. It does not accept that this constitutes 'lighter' supervision, or that it necessarily means standards are lower in these firms.

As stated in the response to Question 21, the forthcoming DP described in Section 5 will include further discussion of systemically important firms. The response to Question 37 explains the FSA's thinking on the circumstances in which insurance firms may be considered to be systemic.

Groups and Intra-groups Exposure

Q23: Are there other aspects of group structures that the FSA should be taking into account?

4.23.1 Respondents felt that the DP identified key issues in respect of group structures and the aspects that should be taken into account. A respondent noted that there must be a proper understanding by supervisors of the risks and interdependencies between retail deposit-taking and trading activities of banking groups.[109] A number of respondents stated that regulators needed to understand and be provided with information on group structure and intra-group relationships.

FSA response

The FSA is undertaking an internal project looking at intra-group relationships. This project is being conducted in conjunction with the policy development work on liquidity and the large exposures work that is being discussed in relation to the CRD amendments. The FSA anticipates disclosing the findings and conclusions of this project and consulting on any proposed developments in the course of the next twelve months. As part of this work, the FSA is involved in the work of the Joint Forum considering the differences in the nature and scope of global regulation which is analysing the supervision and treatment of intra-group transactions and exposures.

Q24: Is the increased focus on group structures and intra-group relationships and increased supervisory cooperation the right way to deal with the threats to financial stability and consumer protection posed by large, international group structures? In what circumstances would a greater focus on individual legal entities be warranted?

108 KPMG LLP

109 Barclays

4.24.1 Respondents were generally supportive of an approach with increased focus on group structures and intra-group relationships and increased supervisory cooperation. One respondent noted that this should not include approving or requesting changes to structures by regulators, which could potentially lead to contradictory positions between regulators, unforeseen legal and taxation consequences and unnecessary commercial implications.[110]

4.24.2 A number of respondents highlighted that this approach should not result in the imposition of simpler structures but greater focus by regulators, with the assistance of groups themselves, on mitigating the risks that complex groups bring. Respondents suggested that this could be best achieved by improving regulatory relationships between a group's supervisors (within the context of supervisory colleges and led by a consolidated supervisor) and through greater focus on international convergence and harmonisation across regulation (so that all companies within a group would be subject to comparable regulatory standards).

4.24.3 Respondents were broadly supportive of the view that there needed to be a balance between the FSA's focus on groups and on individual legal entities. A number of respondents noted that this was important to ensure the college benefitted from local knowledge of supervisors. Some respondents cautioned that any increased focus on individual legal entities should not raise unnecessary barriers which might unduly increase costs or reduce the ability of a group to react in times of crisis.

FSA response

In developing its policy, the FSA will consider the potential options for regulations that mitigate the risks of complex structure and encourage the development of group structures that can be wound down in an orderly manner in a crisis.

In some cases, this may require changes to be made to group structure. The forthcoming DP described in Section 5 will out the FSA latest thinking in relation to the development of resolution plans, which will be relevant to the issue of complex group structures.

International Architecture

Q25: How can the international architecture be arranged to provide the most effective early warning of threats to financial stability and challenge to national authorities and in an apolitical way?

4.25.1 Respondents agreed that an early warning system should be established and there should be some international coordination of macro-prudential oversight. There was broad support for the re-establishment of the FSF as the FSB and proposals to enhance the coordination of international standard setters.

110 The Alternative Investment Management Association Limited

4.25.2 Respondents were also supportive, and saw the need for, additional macro-prudential supervision, on an EU level and a national level.[111] Respondents however highlighted four main potential issues with these additional levels of macro-prudential supervision:[112]

i) potential duplication in activities;

ii) potential lack of co-ordination among macro-prudential authorities[113];

iii) quality and sharing of data; and

iv) the potential for political intrusion into supervisory actions.

4.25.3 Some respondents suggested these issues could be partially addressed by giving the FSB responsibility for coordinating the work of the various authorities involved in macro-prudential supervision[114]. Some respondents also suggested that macro-prudential authorities, specifically the IMF, should report the results of any macro-prudential analysis to the FSB. Furthermore, the IMF should also incorporate conclusions reached by the FSB into its surveillance work.[115]

4.25.4 One respondent specifically suggested a role for the FSB/IMF in setting standards for macro-prudential data collection.[116] Other respondents suggested that all macro-prudential authorities should be required to share information and require disclosure in a consistent format.[117] It was argued that this would also facilitate the macro-prudential authorities' ability to understand and more readily assess cross-sector risks.

4.25.5 Some respondents argued that any risks identified by macro-prudential authorities should be publicly communicated as this would create an expectation that national authorities, financial institutions and markets would respond.[118] Any communication should also highlight the potential weakness and limitations of macro-prudential monitoring.[119] This would contribute to preserving the credibility of a macro-prudential approach, by seeking to manage expectations regarding what can be realistically achieved.[120]

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111 For example Addleshaw Goddard LLP, ABI, The Alternative Investment Fund Management Association, Barclays, the British Bankers Association, HSBC, JP Morgan, RSA Insurance Group, The Institute of Chartered Accountants and RBS.

112 For example Aviva Plc

113 For example Aegon, Barclays and Standard Chartered Bank

114 For example the British Bankers Association and The Investment Management Association

115 For example the British Bankers Association

116 Standard Chartered Bank

117 For example the Investment Management Association, JP Morgan in its response on International and EU Colleges – 'supervisors leveraging other supervisors', KPMG LLP, the London Investment Banking Association and Standard Chartered Bank

118 For example the British Bankers Association, the Confederation of British Industry and Ernst and Young

119 For example the London Investment Banking Association

120 For example Barclays

FSA response

The responses indicate high levels of support for the idea that a stronger international regulatory architecture is needed, capable of identifying and acting on potential risks and coordinating regulatory standard setting activities. The FSA agrees fully that this needs to be achieved in an efficient and non-duplicative way.

The FSB is central to this. It brings together regulators, central banks and finance ministries from a number of major jurisdictions as well as the regulatory standard setters (e.g. the BCBS) and international bodies (e.g. the IMF and the Bank for International Settlements). It is the main global forum for discussing financial stability questions and identifying ways of making the international financial system more resilient. The FSB was asked by the G20 following the London Summit in April to play a leading role in coordinating international regulatory reform, although much of the detailed policy work on new initiatives (e.g. revised international capital and liquidity standards for banks) remains with the sector standard setters.

The FSA is continuing to engage with the FSB at the most senior levels as well as working closely with the Bank of England and HM Treasury, which are also FSB members. Lord Turner represents the FSA at FSB Plenary meetings. He also chairs the FSB's new Standing Committee on Supervisory and Regulatory Cooperation. The Standing Committee will address coordination issues that arise among supervisors and regulators, examine the need for policy development in this area, advise on best practice, and present recommendations to the FSB Plenary.

The responses raise a number of important issues of which the FSA is very aware. *The Turner Review* and DP highlight the need to ensure that risks to financial stability are identified and addressed in a coherent and timely way. The FSA is supporting collaboration between relevant national, regional and international authorities to ensure duplication is minimised and that bodies responsible for macro-prudential oversight draw on one another's work to the maximum extent possible. The FSB (in collaboration with the IMF) will be the key to this as it includes representatives from major EU bodies (e.g. the European Commission and the ECB).

Discussions within the FSB will help identify whether there are areas where the FSA should work with other authorities to develop its approach to data collection or usage. The FSA also considers that any data which firms or financial institutions supply to international organisations responsible for macro-prudential analysis should also be provided to the relevant national supervisor.

Q26: Is this the most effective way of organising colleges on the one hand and crisis management groups on the other?

4.26.1 Respondents agreed that colleges of supervisors have an important role to play in improving the effectiveness of the global regulatory architecture. Many supported differentiated involvement in colleges based on the distinction between a core group of supervisors, and other, more extended, groupings of supervisors with a legitimate interest in the operations of an international group. Many respondents also acknowledged the distinction between crisis management and supervisory colleges. Respondents' main concerns however, were about duplication and how different

college arrangements could be reconciled.[121] For example, how would information be exchanged between FSB colleges and those established as a result of the CRD and Solvency II?

4.26.2 There was also concern about the lack of clarity on how any disputes that arose between the global and EU colleges would be reconciled. Some respondents argued that the distinction between global and EU colleges seemed artificial, and proposed that global and EU colleges would operate more effectively if they were integrated.

FSA response

The FSA continues to work to improve the effectiveness of international cooperation. The FSA shares many of the concerns expressed by the respondents. This is particularly true for the interaction between EU and global colleges. The FSA has long argued that global and EU arrangements need to complement each other (through a single college where possible) and that parallel running should be minimised, not least because of the scope for this to undermine the effectiveness of individual colleges.

In reality, however, legal and practical constraints are such that the goal of having single, all encompassing colleges for the major firms may not be realised. Host states in the EU have few rights over EEA firms operating branches in their jurisdiction. Because of this, they will inevitably wish to have greater involvement in EU colleges than might be appropriate for a global college focused solely on the key supervisors of a group. Furthermore, colleges are legally mandated in the EU, and the new EU Authorities will have a responsibility to ensure consistency of approach. The FSA will however continue to press for colleges to operate in the most effective way and to avoid outcomes in which the existence of parallel structures undermines the effective supervision of global financial groups.

Q27: Do these options set out in the DP represent the right approach to the problems posed by EEA branching?

4.27.1 *The Turner Review* and DP drew attention to a number of shortcomings in the EU's branching regime, and in particular the absence of requirements for host supervisors to be provided with full and timely information about problems with parent entities and the absence of pre-emptive powers to limit the risks to depositors (and potentially taxpayers) in their jurisdiction. The current arrangements were described as 'inadequate and unsustainable' in their current form. Although it did not advocate them, *The Turner Review* also suggested that it would be worth exploring whether EU-wide frameworks, such as a deposit guarantee scheme (DGS) could underpin the passporting system.

4.27.2 There was acceptance amongst the respondents that the EU rules on 'passporting' of bank branches should be reviewed. However, there was little support for any form of pre-funded EU wide DGS or for more direct powers for host supervisors over branches.

121 For example the British Bankers Association, Confederation of British Industry, HSBC, JP Morgan, and Royal Bank of Scotland

4.27.3 Some respondents suggested the passporting issue could be addressed by using existing powers more effectively. Many respondents suggested the issue would be addressed, to a great extent, by proposed EU reforms (including CRD revisions and reforms of the EU's regulatory architecture).[122] Some respondents also suggested any reforms here should also form part of the further harmonisation of EU prudential requirements and of cross-border insolvency law.[123] The importance of recognising the differences between wholesale and retail business and between bank branches and insurance branches in any reforms, as the risks were fundamentally different, was also a concern to some respondents.[124]

FSA response

The financial crisis demonstrated that the EU's branching regime was inadequate and unsustainable. Since then Europe has embarked on a process of reform, as set out in Section 3. The changes already announced (colleges, peer review and binding mediation) will improve information sharing, raise standards and provide a way of addressing significant supervisory weaknesses. However the FSA believes that further action is needed in the EU to provide additional safeguards for depositors and taxpayers in host countries. The FSA considers that these groups would be better protected, without losing the single market benefits of branching, by two further reforms. These are:

- a clearer right for the host state to receive all relevant prudential information about a firm (including the group) when required; and
- the right of the host state to take proportionate and measured steps to restrict the activities of a branch in response to manifest prudential weaknesses which, in opinion of the host supervisor, have not been adequately addressed by the firm or its home supervisor (this would be subject to binding mediation where the home state did not agree).

Without these improvements depositors and, potentially, taxpayers in host states continue to be potentially at risk from deficiencies in supervision in home states and for this reason the FSA will continue to press hard for a strengthening of host state powers.

The FSA agrees that the risks of branching vary from one sector to another. Since branching is given effect by the sectoral directives, EU regulation is already structured to provide for a differentiated approach, where such differences are appropriate.

Q28: Are the functions of rule-making capability and supervisory oversight the right ones to be given to a European institution that has the characteristics described here?

4.28.1 Although respondents generally agreed with a key principle of *The Turner Review* that there should be alignment of supervisory responsibility with fiscal responsibility, many submissions did not respond to the specific question asked. Instead they stated their view on the EU regulatory reform proposals, which emerged after the publication of *The Turner Review*. For example, some respondents were in favour of

122 For example, The Alternative Investment Management Association, AVIVA, Barclays, Confederation of British Industry, JP Morgan, Royal Sun Alliance Group and Royal Bank of Scotland

123 For example the British Bankers Association

124 For example the Association of British Insurers and Legal and General

binding mediation and binding technical standards, although there was no overall consensus. There was also some support for the proposals that ESAs should participate in EU supervisory colleges.[125] It was also worth noting a general preference for a sectoral rule making approach, which would preserve the distinction between banking, insurance and securities, as opposed to a single rule-making body.[126] In general, respondents were also keen to see a harmonised supervisory process and EU rule book.

FSA response

The Turner Review set out the FSA's position that it would support a single EU body to oversee regulation at EU level. Since the publication of the Review, the EU Commission and Council have agreed the broad outline for reform of the EU's regulatory architecture. This does not include a single EU body. Instead the existing Level 3 advisory committees will each be transformed into EU agencies called European Supervisory Authorities (ESAs). In addition to the existing Level 3 responsibilities of advising the Commission and promoting supervisory convergence, the new ESAs are likely to be given the following further competences:

- powers to develop binding technical standards for adoption as Commission rules, in areas to be specified and subject to Commission endorsement;
- supervisory powers over entities with pan-European reach, initially confined to including CRAs;
- powers to take binding decisions addressed to national authorities, in order to settle certain disagreements between supervisors;
- powers to take binding decisions addressed to firms where the requirements are directly applicable and the national supervisor is failing to apply them; and
- crisis powers to take decisions binding on national supervisors and firms.

Importantly, it was also agreed that the exercise of these powers should not impinge in any way on the fiscal responsibilities of Member States. Further details of the EU Council's Decision are set out in Section 3. While the EU's proposed arrangements are different in a number of significant respects from those put forward by the UK, the FSA is committed to making the arrangements agreed on in the EU work well, and will continue to work closely with HM Treasury to promote an EU regulatory architecture which will help in the key task of identifying and mitigating risks to consumers and financial stability.

Market Issues

Q29: Does the DP highlight the correct issues concerning the role of CRAs and the use of their ratings?

4.29.1 *The Turner Review* and DP identified three policy objectives for CRAs. Broadly, these were to review the use of ratings in regulation; the introduction of regulatory oversight (to address concerns over conduct of business, conflicts of interest, and transparency); and to monitor the use of ratings by investors.

125 For example The British Bankers Association

126 For example Aviva

4.29.2 Generally respondents agreed that the DP highlighted the correct issues, although one respondent commented that the FSA's analysis was 'superficial'.[127] One area that the DP was seen as not addressing was the CRAs' severe reaction to the widespread criticism they received, in particular the sharp downgrades of some securities and significant modifications to their methodologies. Some respondents believed CRAs may have overreacted and the downgrades may ultimately prove too aggressive. A number of respondents raised concerns about barriers to entry and lack of competition within this market.

4.29.3 Respondents noted that some firms' own risk assessments were not sufficiently robust to replace external ratings and so external corporate ratings should continue as an independent measure of risk within a risk-based capital framework. Others recognised that the securitisation framework needed to adapt but believed that currently there was no better alternative to external ratings. Another noted that a move away from the use of external ratings for securitisations would imply a greater acceptance of credit modelling than the FSA (as well as the BCBS and EU) had previously been prepared to consider.[128] One joint industry response highlighted that its members would prefer not to use external ratings as obtaining and maintaining a credit rating to calculate regulatory capital requirements involves significant time and cost (although it also noted that it was not always practical for its members to carry out their own due diligence and risk assessments, which implies some reliance on ratings).

4.29.4 The majority of respondents agreed that the FSA had identified the correct issues in respect of the operation and performance of CRAs. This particularly included the importance of focusing on conduct of business and transparency, rather than specific ratings or methodologies.

4.29.5 However, a small minority of respondents highlighted that simply managing conflicts of interest would not be sufficient and that alternatives to 'issuer pays' business models should be encouraged (although other respondents recognised the difficulties of the alternatives). A number of respondents indicated that simply increasing transparency around ratings would not be enough regarding securitised products and more underlying information would need to be made available to investors. Respondents also generally agreed with the need to ensure appropriate levels of ongoing monitoring of ratings, with some calling for CRAs to indicate when ratings are amended and whether this is due to a change in underlying methodology or due to a change in the performance of the rating against expectations.

4.29.6 Generally respondents agreed that over-reliance on ratings was an important issue to be addressed, particularly with regard to understanding the impact of rating triggers in certain products. However, it was also highlighted that many smaller investors did not have the capacity to carry out full independent credit risk assessment and this must be kept in mind when formulating policy. This also meant that increased transparency around ratings and structured finance product characteristics more generally also was important.

127 Adam Smith Institute

128 Barclays

FSA response

The FSA welcomes these views and acknowledges that the analysis in the DP presents only an overview of the key issues associated with CRAs. If CRAs have over-reacted in their downgrading of certain securities (and the FSA is not aware of any evidence of this), it can be taken into account when monitoring CRAs' default and transition data for prudential purposes. The FSA also shares concerns about market entry in the CRA sector and supports ongoing work in IOSCO to assess the consistency of various regulatory regimes with the relevant IOSCO Principles for CRAs, which aim (among other things) to promote competition in the rating industry.

The issues raised by respondents, including the need for more detailed analysis, will be addressed by the ratings-securitisation workstream of the BCBS Policy Development Group (PDG). This group will conclude in 2010 and the FSA will play an active role in it.

The FSA also recognises that there are additional costs associated with using credit ratings to calculate capital requirements. However, it notes the lack of alternatives, except a return to a non-risk based framework, as was used under Basel I, which the FSA does not believe to be practical.

In relation to oversight and supervision of CRAs, the international landscape has altered considerably since the publication of *The Turner Review*. The response to feedback received to Question 30 indicates how developments fit the issues identified in *The Turner Review* and many of the concerns of respondents highlighted above.

Q30: Are the approaches outlined in the DP to address the issues around CRAs and the use of their ratings appropriate and proportionate?

4.30.1 Generally respondents believed the approaches outlined in the DP to CRAs are appropriate and proportionate. As noted above, most respondents felt that there are currently no valid alternative to external ratings, but some industry participants expressed different views. There were some concerns that the regulatory use of ratings encouraged greater reliance on CRAs. The alternative of removing external ratings from the capital regime was also suggested.[129] Another noted that an agency set up by the BCBS, funded by financial institutions, could issue ratings for regulatory purposes.[130]

4.30.2 The DP highlighted that implicit government support was reflected in firms' capital requirements but that a stable financial system should not rely on contingent government support under 'normal' conditions. A joint industry response noted that the 0.03% probability of default (PD) floor applied protects against implicit support.[131] Another respondent noted that its approach to rating exposures to institutions took into account government support through a floor (i.e. the rating assigned to the exposure will not fall below a given level). In 'normal' market conditions the stand alone rating was above the floor but in times of stress it would

129 Standard Chartered Bank

130 Actuaries Association

131 London Investment Banking Association

likely move below, so the floor acted to prevent capital requirements from rising sharply in a downturn.[132]

4.30.3 In addition, there remains the issue of IRB firms' indirect use of external ratings to estimate PDs. The DP suggested that the FSA would examine the possibility of prescribing rating-linked calibrations for IRB wholesale portfolios where external ratings were a significant input to the firms' PD estimates and where the capital requirement was considerably less than that under the standardised approach. A joint industry response raised concern about this proposal.[133] In particular, the response noted that prescribed rating-linked calibrations ran counter to the principle of the IRB approach (where capital requirements were based on firms' own assessment of credit risk) and would like to discuss this further with the FSA.

4.30.4 Generally, respondents supported the FSA's proposed approach to oversight of CRAs, particularly the focus on increasing transparency and the oversight of the conduct of business (rather than specific ratings and methodologies) through working within the EU and internationally to develop a consistent approach. A number of concerns were also raised about how the EU supervisory structure would operate, including how the EU regulation would treat non-EU ratings, the possible international inconsistency, and the potential for political interference with ratings.

FSA response

The FSA recognises the merits in removing external structured finance ratings from the capital framework but believes that the risk assessments of a significant number of firms are not sufficiently robust to replace external ratings. Further, the provision of external ratings by an agency established through the BCBS would have its own moral hazard and independence issues.

The FSA also continues to believe that the capital requirement regime should not assume a level of government support when its purpose is to prevent the likelihood of bank failure and therefore avoid government support. The floor approach implemented by one firm has some merit, but it still assumes a degree of government support.

The FSA is willing to discuss the indirect use of ratings by IRB firms with the industry and expects the forthcoming hypothetical portfolio exercise to shed some further light on this topic.[134]

Since *The Turner Review* was published the EU Regulation of CRAs has been approved by both the EU Council and Parliament (as set out in Section 3). The EU Regulation contains requirements that focus on addressing the issues raised by the DP and many of the more specific issues that were raised by respondents, for example disclosing the reasons for rating changes. The FSA will also work to ensure firms are prepared for the potential impacts of CRA regulation and monitor the impact of its implementation.

132 JP Morgan

133 London Investment Banking Association

134 The FSA is carrying out a second bank, sovereign and large corporate hypothetical portfolio exercise on PD ratings. The small amount of internal default data for banks, sovereigns and large corporates often makes robust statistical validation of the risk parameters difficult. The aim of the excercise is to shed light on the level and spread of PDs among the different participants across various credit qualities, allowing for meaningful comparisons to be made.

The key to the success of the EU Regulation will be a sensible, efficient and coherent application across the EU and an appropriate integration of non-EU ratings. Inconsistencies with international standards, either in the actual legislation or in the approach to oversight, have the potential to create negative market impacts. The FSA's current policy focus is, therefore, on developing appropriate consistency of approach at an EU and international level by working within CESR and IOSCO.

The FSA considers that the new IOSCO sub-committee on CRA issues should focus initially on analysing the various regulatory initiatives to identify any inconsistencies and reach an understanding of their potential impact. The FSA strongly supports IOSCO as the appropriate body for setting international standards for CRAs and, in the event IOSCO identifies material inconsistencies between national or regional regulations and IOSCO standards, they should be addressed through the FSB in line with G20 conclusions.

The CRA Regulation will require the EU Commission to include in a report to the European Parliament and Council, an evaluation of the appropriateness of the remuneration of CRAs by the rated entity. This report will be produced to assess the impact of CRA Regulation and whether further action is necessary. The FSA is fully prepared to contribute to this debate as is appropriate.

The FSA will also monitor the development of market practice with regard to the reliance on ratings in light of the additional transparency that the new EU Regulation will bring and also the work carried out by various market bodies and IOSCO. If market participants are continuing to place too great a reliance on ratings, the FSA will consider further action.

The use of ratings for prudential purposes will form part of the BCBS's broader programme to strengthen the regulatory capital framework

Q31: What options should a review of the use of structured finance ratings in the regulatory framework consider?

4.31.1 Generally, respondents agreed with the deficiencies identified in the use of ratings in the securitisation framework and the over-reliance placed on ratings by investors. Most respondents suggested adjustments to the current framework rather than replacing the use of ratings across the board, highlighting the drawbacks of other approaches. Some called for the recalibration and mapping of the securitisation framework as the initial calibration was based on rating and price data predating the crisis. They stated that the recalibration should be based on current data, and take into account the changes that CRAs are making to their rating systems for structured credit products.

4.31.2 Some respondents suggested that the Supervisory Formula approach (SFA) could be used provided improvements in transparency enabled firms to apply the approach (the SFA is based on the formula used to estimate capital required under the IRB Approach for credit risk coupled with key parameters of the securitisation structure). However, one respondent was highly critical of this approach, stating that it was too simplistic and took insufficient account of many risks and factors which rating agencies do consider.[135] Some respondents suggested wider consideration of the use of the Internal Assessment Approach (IAA), according to which banks apply

135 The Royal Bank of Scotland

an approach which is comparable to that used by the CRAs themselves. However, it was noted that this may be difficult due to the level of information needed.

4.31.3 Most respondents called for improvements to the roles and responsibilities of CRAs through increased transparency and investor education, which some commented were only available at a cost. Respondents also considered that CRAs should ensure wider dissemination of transaction level information as well as communicating the nature, remit, limitations, characteristics, volatility and factors that may trigger changes to ratings.

4.31.4 Respondents did not think that investors' risk assessments were robust enough to replace ratings altogether and most called for greater risk assessment by investors to complement a ratings-based approach. Investors needed to determine suitability of their investments, including consideration of what risks ratings address and the limitations of ratings. One respondent noted that ratings are not homogenous; they cover many different asset classes and structures and demonstrate divergent characteristics and performance.[136] Therefore, appropriate consideration of these ratings should involve a granular analysis of different sectors rather than adopting a uniform approach to all structured finance ratings.

FSA response

The FSA remains concerned with the performance of structured finance ratings and reliance on ratings for capital requirements purposes and believes that alternatives should be explored. As a result the FSA continues to believe that a fundamental review of the Basel II securitisation framework is necessary and is pursuing this objective within the BCBS.

Alternatives to the current Basel II approach (which prioritises the use of CRA ratings in capital requirements) should include requiring firms to make an assessment of the risk in securitisation positions independent of an external rating. The feasible approaches may depend in part on whether the firm is acting as originator/service provider or as investor. At least where the firm is the originator the SFA is one possibility.

The FSA agrees that investors' own risk assessments may not be adequate to replace ratings entirely; at a minimum investors need to improve their risk assessment to complement a ratings-based approach. The FSA notes that significant work has already progressed in this respect and supports the new amendments to the CRD with regard to increased due diligence and monitoring requirements.

Should ratings continue to form part of the securitisation framework, the FSA agrees with respondents that recalibration and mapping of the securitisation framework is necessary.

The FSA agrees with respondents that the roles and responsibilities of CRAs could be improved and disclosure of methodologies enhanced. The FSA believes that the relevant elements of the IOSCO code of conduct for CRAs should be incorporated into the Basel II framework.

Extending the use of the SFA should be explored within the BCBS and the FSA agrees with respondents that this is only a viable option if there are significant improvements in transparency and the formula is improved to address its current inadequacies as outlined in the DP.

136 Moodys

Extending the use of the IAA should also be explored with the BCBS and the FSA will consider the level of information needed in considering the viability of this option.

Q32: Is the framework set out in the DP the most appropriate framework for post-trade transparency, or are there other aspects that should be considered?

4.32.1 Respondents agreed that markets should be transparent and generally considered that the framework for post-trade transparency set out in the DP was appropriate. Some respondents considered that there were no difficulties with the current position and so changes were not required. Respondents noted that, in considering how post-trade transparency should operate in any market, the specific characteristics of that market needed to be considered and the MiFID regime for equity transparency should not simply be applied more widely. Respondents described the potential disadvantages of increased post-trade transparency, particularly the risk that liquidity may be reduced as a result (and mitigating measures, for example using aggregated data, were also suggested). A number of respondents noted that post-trade transparency was only one aspect of the way financial markets operate.

4.32.2 More specifically, many respondents supported an examination of what transparency currently exists and how the market could provide additional transparency by using data vendors and other existing infrastructure. Some respondents cautioned against the use of post-trade transparency for valuation purposes because the last traded price may not be a good indication. A small number of respondents pointed out that, even for rarely traded or structured finance products which are hard to value, additional transparency can bring benefits.

FSA response

The FSA agrees with many of the comments made by respondents. Specifically it is of the view that it is essential that any post-trade transparency is calibrated (for example in terms of size thresholds and timing delays) so as to minimise any adverse impact on liquidity. As noted above the use of aggregated data may be helpful, although it is the FSA's view that this is only likely to be the case in less liquid markets, such as asset backed securities. For more liquid markets, trade-by-trade information is likely to be more useful in terms of price formation.

The FSA agrees with respondents that a direct copy-out of the MiFID transparency regime for equities is unlikely to be appropriate given the very different characteristics of the assets and market participants in question. In the FSA's view, the framework it set out in the DP clearly takes into consideration those differences. The FSA also agrees that any post-trade transparency regime should look to build on existing infrastructure wherever possible and will continue to take those points into consideration as regulatory action in this area develops.

Some respondents have suggested that there are no difficulties with the current position. The FSA does not agree and considers that the financial crisis highlighted weaknesses in the availability of post-trade information. Therefore, in its view, maintaining the status quo is not an option.

Since the publication of the DP, the FSA has continued its participation in the CESR working group considering the need for enhancing post-trade transparency for corporate bonds, structured finance products and credit derivatives. In its recommendations CESR reinforces the points made above and notes that any regime should be calibrated in order to minimise any adverse impact on liquidity.

CESR published its conclusions in July 2009 with the recommendation that the European Commission consider the adoption of a mandatory trade transparency regime for these instruments in the context of the forthcoming MiFID review. In terms of scope, CESR recommends that any post-trade transparency regime should cover all corporate bonds admitted to trading on a regulated market or on a multilateral trading facility; asset-backed securities and collateralised debt obligations which are considered standardised; and credit default swaps which are eligible for clearing by a central clearing counterparty. There should be a phased approach to the introduction of greater transparency.

In September 2009 IOSCO set out its recommendations that member jurisdictions consider enhancing post-trade transparency for structured finance products. Again the recommendations reflect some of the points raised by respondents and the framework which the FSA set out in the DP, notably that the individual characteristics of the market in question need to be taken into consideration when designing a post-trade transparency regime.

The European Commission's consultation on over the counter (OTC) derivatives which closed at the end of August, as described in more detail in the FSA response under Q34, also covers trade transparency for OTC derivatives. The European Commission is expected to address trade transparency for instruments other than those covered in the CESR recommendations as a part of its review of MiFID review.

The FSA will continue to work with the European Commission and its European counterparts in this area, along with its coordinated efforts with other regulators and liaising with industry where appropriate.

Q33: Are there other measures to improve transparency which the FSA should be considering or promoting in international fora?

4.33.1 Respondents encouraged the FSA to pursue international regulatory efforts in a markets context, especially in those areas of particular importance to the UK. They particularly highlighted the need to have international coordination to promote the innovative nature of financial markets, to advocate flexibility in approaches, and to take account of industry efforts.

4.33.2 For the continuing efforts to deal with the disclosure of information on underlying assets in capital markets products (RMBS as an example), respondents made specific proposals, including the standardisation and simplification of disclosures on, and the quality of loans, in the asset pool for structured products. For additional internationally coordinated measures they made proposals which included:

i) a consolidated European 'tape' of equity transactions or other methods of making information across many markets available;

ii) a database of terms for all European debt securities issues; and

iii) consistency in disclosure requirements for short-selling, contracts for differences and major shareholdings.

FSA response

The FSA has been, and will continue to be, actively involved in CESR discussions in a wide range of areas, including the impact of MiFID on equity markets, short selling and disclosure of cash-settled derivatives. The FSA is also actively participating in IOSCO discussions on disclosure principles for asset-backed securities and for other structured products.

Q34: What other considerations should the FSA take into account with respect to OTC derivatives infrastructure?

4.34.1 Respondents were generally supportive of initiatives to use a central counterparty (CCP) for standardised credit default swaps (CDS) and other standardised OTC derivative transactions. Some respondents commented on the importance of risk management by CCPs. Concern was expressed by some respondents as to the timing set for targets to clear OTC derivatives and any further regulatory steps to incentivise the use of CCPs for OTC derivatives. Specific proposals for default protection for the benefit of investors were put forward by one respondent which relate also to the matters described in Question 35.[137] Of the respondents which considered the location of a clearing house, more expressed neutrality as to the location of a CCP than otherwise.

4.34.2 Nevertheless, many respondents clearly wanted to preserve the ability to use bespoke or tailored OTC derivatives to manage particular risks. Concerns were raised by some respondents about compelling standardisation. Methods of reducing risks of OTC derivatives (other than the use of CCPs) were noted, including the use of electronic confirmation matching and multi-lateral netting (compression). A number of respondents also gave views on the valuation of OTC derivatives noting that this was an area that should be further explored given the characteristics of some OTC markets. Respondents noted that the FSA already receives considerable information through transaction reports.

FSA response

A number of developments have occurred since the publication of the DP. In July the European Commission published a Consultation Paper on possible initiatives to enhance the resilience of OTC derivatives markets to which the FSA and HM Treasury have jointly responded.[138] The UK authorities agree with the broad aims of the Commission's proposals. The authorities consider that the principal objectives of regulatory reform of the OTC derivatives markets should be designed to reduce systemic risk and to improve overall transparency and, to achieve those objectives, the following four key issues need to be addressed:

- further standardisation of contract and economic terms;
- greater use of CCP clearing in OTC derivatives markets for 'clearing-eligible' products;

137 Investment Management Association

138 www.fsa.gov.uk/pages/Library/Other_publications/EU/eu_docs/index.shtml

- strengthened risk management for bilateral collateralisation arrangements for non-CCP-cleared products; and
- increased trade transparency to the market and position transparency to the market and to regulators.

The UK authorities believe that continued international coordination and consistency are also vital to ensure consistency of approach in these global markets.

The joint response (referred to above) sets out the UK authorities' views in more detail, including on some matters covered by the responses. In particular, it puts forward their view that bespoke derivatives products have an important role to play in hedging risks that individual market participants face and as such have a role to play in today's global financial markets.

Also since the publication of the DP, the FSA has been working closely with counterpart regulators both in Europe and the US to progress central counterparty clearing for CDS. Initial services have been launched in Europe for European Index CDS products and for single name CDS contracts on a limited number of European entities. The FSA expects an expansion of those offerings over time.

The FSA agrees with the respondents' view that risk management in CCPs is of paramount concern to avoid creating a new centre of systemic risk. For FSA-recognised CCPs, this is achieved by requiring them to satisfy the applicale legislative and other provisions set out in the relevant section of the FSA Handbook.

Currently clearing is not a harmonised activity and therefore there are no Europe-wide standards. The FSA is keen to engender regulatory cooperation and to agree common standards and arrangements for CCPs to ensure consistently high standards for all CCPs irrespective of location. At the European level, the ESCB-CESR recommendations for CCPs have been updated and published to include provisions for OTC derivatives. Along with HM Treasury, the FSA supports work on the development of a Clearing and Settlement Directive and its priorities should be to establish uniform standards building on those efforts and to enshrine fair and open cross-border access for, and competition between, clearing houses. At the international level, work has now begun on updating the CPSS-IOSCO recommendations for CCPs clearing OTC derivatives, as outlined in the DP.[139]

The FSA shares the broad regulatory and political support for the use of targets agreed for operational improvements amongst regulatory (and other) authorities and market participants, as outlined in the DP.[140] They have proved effective at improving post-trade operational changes, including the use of clearing. Engagement between regulators and market participants on operational targets continues. In addition, substantial international work is being undertaken to reassess risk-proportionate capital requirements. Such capital levels should naturally incentivise the use of clearing. However the FSA notes that, in some instances, those changes may not create sufficient incentive for market participants and so further regulatory intervention may still be needed to bring about the desired increased use of clearing. The FSA recognises the concerns

139 DP 10.67

140 DP 10.68, 10.72

expressed by some respondents to the use of targets and this potential regulatory intervention and will take them into account in relation to any initiatives.

Counterparty risk for products which remain outside of a CCP will continue to be managed on a bilateral basis, including, in many cases, by way of collateral posting mechanisms. The FSA supports the significant work already undertaken by the industry to increase the frequency of portfolio reconciliations and enhance valuation dispute processes. The FSA is also conducting the thematic review on current collateral management practices outlined in the DP.[141] Furthermore, the FSA has initiated an industry-led review of collateral practices for bilaterally managed transactions to investigate where further enhancements may be beneficial (which will be under the auspices of the OTC derivatives supervisors group – an international group of supervisors who coordinate on topics associated with OTC derivatives). This is expected to be completed in Q1 2010.

While the FSA agrees that considerable information is already provided via transaction reports, it still believes that there is a need for increased position transparency to both regulators and the market with regard to OTC derivatives. A group of international regulators, including the FSA, is working together to coordinate the sharing of information routinely made available to regulators or to the public on OTC derivatives by CCPs and trade data repositories.

The FSA agrees with respondents that other tools also play an important role. These include the use of compression services to reduce counterparty risk and electronic confirmation to reduce operational risk.

In relation to the specific views made by respondents on the valuation of OTC derivatives, the FSA will consider them as a part of its ongoing work.

The FSA continues to work with the European Commission, other regulators, central banks and market participants on a range of initiatives designed to strengthen the infrastructure for OTC derivatives.

Q35: Are any (other) changes to clearing arrangements needed? If so, what should they be?

4.35.1 The Lehman Brothers default highlighted difficulties in how client positions and margin may be held at the clearing house level. The DP described a number of options for account structures. How client money, including margin, should be segregated and held with third parties will be the subject of an FSA Consultation Paper due to be published in December.

4.35.2 The responses provided confirmation of the results of the FSA's initial discussions. They suggested that there was support amongst market participants for a choice of account structures at the clearing house level for client business, although there was also support in the responses for the proposal that client business should be segregated and for maintenance of the status quo. Respondents generally did not favour requiring the use of designated segregated accounts for client business. They noted that this could result in significant costs (including the loss of netting) which may adversely affect the UK's competitive position. Many respondents described

141 DP 10.70

how important it was that disclosure was made to clients of the consequences of the use of particular accounts. Particular clearing issues were raised in the responses, principally in relation to European coordination. For example, one respondent commented on the need for a greater level of convergence in standards and more transparency and sharing of information between clearing entities.[142] Another respondent suggested that a legislative initiative on access provisions may be appropriate at the EU level.[143]

FSA response

The FSA agrees with the broad consensus conveyed by clearing houses, clearing entities and representatives of clients that clearing houses should offer a choice to their members over the type of clearing house account in which a member can hold its client business. The FSA does not consider that mandating the segregation of client business to be appropriate. This is because the benefits of segregation can largely be addressed by providing a choice of accounts. The FSA will be mindful of any arrangements which could artificially restrict choice and, for example, would expect that accounts could be operated at a reasonable commercial cost. The FSA agrees with respondents that disclosure to clients about account segregation is important. The FSA will consider whether any resulting changes should be made to the relevant section of the FSA Handbook.

The FSA will continue to consider how client positions and margin held at the clearing house level by a clearing member are treated on a default of the clearing member. This includes considering whether the arrangements should be made more robust, particularly whether, and under what circumstances, those positions and margin could be transferred to other clearing members.

In May 2009, HM Treasury published a paper on *Developing effective resolution arrangements for investment banks* with input from its specialist Advisory Panel, including the FSA.[144] Account structures at the clearing house level and the default of a clearing member are considered in the HM Treasury paper. The FSA will continue to work with HM Treasury and the other members of the Panel and participate in European and other international coordination efforts. In particular, the FSA plans to coordinate any steps to amend the UK regimes in these areas with HM Treasury.

EU and international efforts towards the harmonisation of clearing standards and arrangements are described in the FSA's response to Question 34.

Q36: Are any changes to settlement arrangements needed? If so, what should they be?

4.36.1 The FSA put forward in the DP ways to improve the arrangements for dealing with the default of a market participant, particularly for OTC transactions. Respondents were generally supportive of:

142 Ernst & Young

143 British Bankers Association

144 www.hm-treasury.gov.uk/consult_investment_banks.htm

a) any market-led initiative to establish contractual provisions to deal with how OTC transactions are settled in a default situation; and

b) changes which could be introduced by Euroclear UK and Ireland to give more certainty as to how transactions with a defaulter would be treated within its settlement system.

However, there was more limited specific support in the responses for legislative change to introduce a new OTC default regime.

4.36.2 There was also support in the responses for continued or further FSA work to discuss with market participants ways to record correctly transactions as OTC or on exchange, to consider (with HM Treasury) whether MTFs should be brought into the scope of Part VII of the Companies Act 1989, and to encourage market efforts to reduce the current settlement cycle (T+3 days).

FSA response

The FSA supports efforts leading towards improvements in arrangements applicable to OTC transactions in the situation where a market participant defaults. It also supports the work underway to achieve better recording of transactions as OTC or on exchange. The FSA will continue to discuss those matters with HM Treasury, HM Treasury's Advisory Panel, market participants and other stakeholders, and coordinate any further action with HM Treasury.

The FSA does not consider that reduction of the current T+3 trading cycle for UK equities is a priority for regulatory action, a position that appears to be supported by the majority of market participants and other stakeholders in the market.

The FSA has not been convinced that, apart from dealing with specific difficulties, including those described in the DP, wholesale change is required or desirable. However, this subject comes within the HM Treasury Paper 'Developing effective resolution arrangements for investment banks'[145], and so the FSA will continue to work on it with HM Treasury's Advisory Panel.

Any legislative change whether consequential on the matters described above or otherwise, would be led by HM Treasury. In particular, the FSA is in consultation with HM Treasury and the Advisory Panel on whether further changes to the scope and provisions of Part VII would be beneficial

Implications for other Regulated Sectors

Q37: Which of the issues set out for discussion in this DP are most relevant to other regulated sectors?

4.37.1 Responses to this question (and relevant responses to other questions) focused largely on the potential implications for the insurance sector and were concerned that there should not be an automatic read across of the recommendations in the DP to the insurance sector. The main argument was that the insurance sector is very different in terms of systemic issues, capital function and liquidity risk. These responses also

145 www.hm-treasury.gov.uk/consult_investment_banks.htm

recommended that, to the extent that there was any read across, any new rule changes proposed should take into account the changes envisaged under Solvency II.

4.37.2 Some respondents did not believe the insurance sector, nor any individual UK based insurance company, posed a systemic risk to the economy at any level (national, European or international). Most respondents also preferred an approach where all insurers fit within a single policy framework (as opposed to a two-stream approach to systemically important firms that has been discussed in various fora) with the supervision of the more significant firms being more intense.

4.37.3 Some respondents also noted that UK insurers are major investors in the banking industry. They tend to be long-term investors in bank debt and hold these assets against long term liabilities such as annuities. These respondents urged the FSA to consider any changes to the quality of bank capital rules carefully as they could significantly change banks' preference for having particularly types of capital outstanding and insurers' preference to own these instruments on their balance sheet. If any changes are implemented, a sufficiently long transition period was recommended to prevent lasting damage to the banking sector's ability to raise capital.

4.37.4 A number of respondents opposed any change in approach to the operation of branches in Europe and passporting arrangements. The sentiment is that changing this system could damage the competitiveness of UK insurers. One respondent commented that the setting up and harmonisation of insurance guarantee schemes across Europe presents the most appropriate response to the FSA's concerns.[146]

FSA response

The FSA notes the concerns raised and agrees that a policy solution developed for the banking sector should not be applied to the insurance sector without careful consideration. Nevertheless there remains the potential for macro-prudential risk to crystallise in the insurance sector. The FSA will consider the wider lessons learned from *The Turner Review* and how they may be applied to insurance policy in future.

The future policy framework for insurance firms will largely be determined by the outcome of Solvency II which is due to be implemented on 31 October 2012. The FSA recognises concerns about *The Turner Review* proposals in areas such as quality of capital and continues to work for an outcome that delivers the appropriate degree of consumer protection and financial stability, while at the same time providing a workable regime for the sector. CEIOPS, of which the FSA is a member, is currently working on its technical advice to the European Commission on the Level 2 implementing measures needed to operationalise Solvency II; and it will provide final advice to the European Commission on most issues by the end of the year. In contributing to and negotiating on this advice, the FSA will continue to take into account both the direction of travel in the banking sector and any features of the insurance sector that might suggest that a different, insurance-specific approach is preferable.

The FSA believes that there is the potential for insurance firms to have systemic impact on the real economy (for example, in terms of their funding role in the financial system) and/or other sectors in the financial markets. However, the FSA notes that the systemic

146 Lloyd's General Council Division

relevance of insurance firms will be more limited than in the banking sector and more likely to be situation-specific.

The insurance and banking sectors show increasing inter-linkages. This is most visible in conglomerates and bancassurances, but also materialises in the fact that insurers increasingly engage as major counterparties to, and investors in, the banking industry. The FSA acknowledges the interdependencies between these financial sectors and the potential implications that regulatory changes imposed on one sector may have on the other. This can be either a direct result of the proposed regulation or indirect following the changes in market behaviour of banks. A cost benefit analysis of the impact of regulatory change will be considered in the forthcoming DP described in Section 5.

The FSA notes the resistance to giving more direct powers to host supervisors of EEA branches and the feeling that this would breach the terms of relevant EU Treaties. Please also see the relevant section in Question 27.

Q38: Are there any lessons which have been learned in other sectors which could be applied to banking?

4.38.1 A number of respondents highlighted that the Solvency II Directive provides a useful model for other sectors in a number of areas such as developing effective group supervision and better alignment of supervision with the way business is managed.

4.38.2 A number of respondents also suggested that insurers' approach to risk management including a high number of stress tests, assessing the real cost of the risk and the effects of extreme circumstances could usefully be applied to other sectors.

4.38.3 Under implications for other regulated sectors, some respondents commented on equalisation reserves. One respondent highlighted the fact that the equalisation reserve (currently a provision within the Solvency I regime) is built up in profitable years and serves as a cushion against periods with worse than average claims experience. There was also support for these to be presented as a reserve rather than a provision in the future.

4.38.4 One respondent wrote to highlight its belief that credit agencies could play a greater role in financial services regulation and supervision and improve market discipline.[147] This respondent stated that, unlike CRAs, credit agencies had a vast amount of information on the creditworthiness of individual borrowers that make up a bank's assets or that underpin securitised vehicles. They felt that this data could provide a much better view of the underlying risks and could be useful for specific parties who do not currently benefit from it – including the FSA and the market as a whole.

FSA response

As noted in the responses to Question 24 experience during the current crisis has caused the FSA to reassess some aspects of its approach to supervision of groups. This work remains in progress. It will take into account any insights gained from the Solvency II process.

147 Experian

The FSA will be publishing a Policy Statement on stress testing in Q4 2009. The policy will be informed by the good practice the FSA has identified from all the regulated sectors, including insurance.

It should be noted that the current equalisation provision will not be continued under Solvency II as the new regime will be based on the exit value of the technical provisions. Nevertheless, the lessons learned from the use of equalisation provisions will be considered during the design of counter-cyclical reserves.

The FSA can see that there may be merit in a greater role for credit agencies in financial services regulation and supervision and the FSA intends to consider this further.

5 Developments of FSA policy and next steps

5.1 *The Turner Review* and the associated DP were intended to stimulate debate on the issues the FSA had identified as needing to be tackled. Since publication, the FSA has been actively engaged with international partners and counterparts, firms, academics and the other members of the Tripartite on these issues. Section 3 outlined the main developments and agreements reached since March. As can be seen in Section 3, the FSA believes that the international community has made good progress against many of the objectives set out in *The Turner Review*.

5.2 There remain, however, some important issues on which further analysis and debate is required to define the optimal way forward, and where the FSA's thinking has continued to evolve over the six months since the publication of *The Turner Review*, reflecting both specific feedback to the DP and wider public debate. In a forthcoming DP, to be published towards the end of October, the FSA will set out its latest thoughts on key issues, including:

- the appropriate approach to systemically important firms, on which there has continued to be a wide ranging debate in the UK and globally. Issues to be considered here will include (i) how best to define and measure systemic importance (ii) whether large and/or systemically important firms should be subject to higher prudential standards in respect to either the quantity or quality of capital and liquidity (iii) the narrow banking debate: whether limitations should be placed on the ability of retail banks to operate in trading activities and if so how (iv) appropriate approaches to very large cross-border banks which can be either 'too-big-to-fail' or 'too-big-to-rescue' (v) the role and possible design of 'living wills' and their implementation at both national and global level;
- the need for an integrated consideration of the overall economic impact of reforms to the global capital and liquidity regimes. Feedback to the DP has strongly urged the need for careful assessment of the combined impact of the different elements of reform (for example higher overall capital, reforms to the trading book, and countercyclical capital buffers). The FSA agrees that the global regulatory community must consider carefully how the several different changes to the capital regime fit together, avoiding unintended consequences for

the real economy. Determining the optimal level of capital across the banking system raises complex theoretical issues and involves important trade-offs. The FSA will set out possible methodologies for addressing these issues. In the meantime, however, the FSA will also set out its views on the case for those banks, and investment banks, currently enjoying high profitability, conserving capital now in anticipation of higher regulatory requirements.

5.3 The forthcoming DP covering these issues will define the agenda for the second *Turner Review* conference which the FSA is holding on 2 November 2009. The FSA hopes the forthcoming DP and that conference will help engender useful debate.

6 Recommendations and implementation dependencies table

RECOMMENDATIONS AND IMPLEMENTATION DEPENDENCIES

RECOMENDATION	DEPENDENCIES	NEXT STEPS/TIMINGS
Organisations referred to in this table are BCBS: Basel Committee on Bank Supervision FSB: Financial Stability Board IASB: International Accounting Standards Board FASB: Financial Accounting Standards Board IOSCO: International Organisation of Securities Commissions FSCS: Financial Services Compensation Scheme In some cases the indications of timing for next steps reflect FSA proposals rather than formally agreed commitments by the bodies concerned.		
Capital adequacy • Higher quantity and quality of capital	FSA interim regime (4% CT1) already in place. International agreement on long-term regime required.	BCBS proposals on the quality, consistency and transparency of the Tier 1 capital base to be issued by end 2009 for impact assessment in 2010. Implementation of CRD amendments on hybrid Tier 1 capital end 2010.
• Trading book capital – Short-term amendments and significant increase in capital for some firms.	EU implementation of BCBS proposals published in July 2009. The FSA is currently involved in implementation negotiation.	BCBS QIS on final part of July 2009 proposals due in 2010. EU implementation of BCBS proposals due to come into effect by 1 January 2011.
– Fundamental Review	BCBS agreement on Fundamental Review mandate and work plan.	FSA to publish DP in Q1 2010 exploring key issues involved in a Fundamental Review.

RECOMMENDATIONS	DEPENDENCIES	NEXT STEPS/TIMING
• Avoiding procyclicality	Since March 2009 FSA adjustments (variable scalars) now being applied to counter cyclicality in minimum requirements.	Further roll out of FSA policy in line with applications from firms.
• Introducing counter-cyclical capital buffers	Ideally as part of international agreement. Conceptual framework agreed by Governors and Heads of Supervision in September 2009.	BCBS concrete proposal due by end-2009 for 2010 impact assessment.
• Changes to published accounts	Requires agreement with accounting standards bodies and regulators ideally as part of international initiative.	IASB to publish a draft standard on impairment in October 2009 for consultation, with final standard issued during 2010.
• Gross leverage ratio	Impact testing and calibration needed for implementation.	The European Commission has announced its intention to present a legislative proposal for a leverage ratio. A baseline proposal is well developed and due to be agreed by BCBS by end 2009. The Governors and Heads of Supervision have agreed that a leverage ratio should be implemented as a supplementary measure to the Basel II risk-based framework.
Liquidity		
• Major reforms to liquidity regime	FSA Policy Statement due for publication shortly. Framework will be implemented at national level pending international agreement of minimum liquidity standards.	Phased domestic implementation commences Q4 2009 through to 2010, with quantitative path possibly extending beyond this date. BCBS to propose a global standard for funding liquidity that includes a stressed liquidity coverage ratio by end of 2009.

RECOMMENDATIONS	DEPENDENCIES	NEXT STEPS/TIMING
• Consider 'Core funding ratio'	Can be implemented nationally, but global agreement on principles desirable.	BCBS to propose a longer-term structural liquidity ratio as underpinning for its global standard for funding liquidity coverage ratio by end of 2009.
Institutional and geographic coverage		
• Regulation by economic substance, not legal form	G20 commited to this. Important to get balance right and ensure proportionate and global response focused on financial stability.	AIFM Directive to be debated and taken forward in Europe. Joint Forum Report on nature and scope of regulation, including options to extend regulation, due December 2009.
• Information from unregulated entities and hedge funds	G20 commitment made; can be implemented nationally. Current powers should be fully utilised.	UK primary legislation sought, including FSA extended information gathering power, as follow up to HM Treasury's White Paper.
• Offshore countries covered by regulation	Dependent on overall political support and international coordination. G20 agreed to take action against non-cooperative jurisdictions, including tax havens, and called on international bodies to conduct and strengthen objective peer reviews.	UK to follow up on the Independent Review of British Offshore Financial Centres, due Q4 2009, which looks at taxation, financial supervision and transparency and financial stability issues.
• Increased regulation of holding companies	International support and agreement highly desirable. Dependent on overall political support and outcome of cost/benefit analysis.	Joint Forum discussing issue as part of its work on the nature and scope of regulation – see above. A review of UK position is being carried out with findings planned for 2010.
Deposit insurance in UK		
• Increase from pre-crisis level	Already implemented.	

RECOMMENDATIONS	DEPENDENCIES	NEXT STEPS/TIMING
• Consider brand versus entity and temporary large balance issues	Rules published in PS 09/11.	Consider implications of amendments to the DGSD (2010).
• Communicate to ensure consumer understanding	Disclosure requirements set out in PS 09/11.	Implementation on 1 January 2010.
	The FSCS is working with the FSA and other stakeholders to develop an awareness programme.	Implementation in 2010.
UK Bank Resolution Regime	Introduced by Banking Act, 2009.	The Government is conducting a detailed review of the resolution arrangements for failing investment banks.
Credit Rating Agencies		
• Registration and supervision of governance	EU Regulation due to enter into force in October 2009.	Existing CRAs due to apply for registration and supervisory oversight by July 2010.
	New sub-committee on CRAs formed in IOSCO which has embarked on a review of the consistency of national supervisory regimes with the IOSCO Code for CRAs.	Work is ongoing, but report expected in Q1 2010.
• Clearer communication of appropriate use	IOSCO Report on Good Practices in Relation to Investment Managers' Due Diligence When Investing in Structured Finance Instruments.	Report was published in July 2009. Focus is now on assessing uptake of findings by relevant investment managers.
	Further action required by CRAs, industry associations and regulatory bodies eg IOSCO.	Ongoing.
• Review of use of structured finance ratings in Basel II	FSA pursuing a fundamental review of the use of ratings in the securitisation framework within BCBS.	Ongoing.

RECOMMENDATIONS	DEPENDENCIES	NEXT STEPS/TIMING
Remuneration		
• UK Code	Incorporated into FSA rules for major banks and broker dealers with effect from January 2010.	FSA will review Code in Q2/Q3 2010.
• Global agreement	G20 leaders have endorsed a set of implementation standards for the FSB Principles.	Implementation by firms and supervisors to begin immediately. Support from the BCBS, IAIS and IOSCO.
Central Clearing of CDS		
• Implement central clearing for CDS	Clearing services have been launched in both the EU and US.	Intitial services launched by Summer 2009. An expansion of these services to further CDS products is expected over the coming months.
• Define strategy to migrate appropriate trades to CCPs for CDS	New targets for the clearing of eligible products have been agreed with the industry.	Targets agreed in September 2009. Regulators will be monitoring industry progress.
• Promote international consistency in the regulatory oversight of CCPs for CDS	A forum of OTC derivatives regulators has been established to define and agree information requirements from CCPs and trade repositories, and information sharing agreements between regulators.	Linked to ESCB-CESR and CPSS-IOSCO standards. Ongoing FSA cooperation with other regulators.
• Review regulatory requirements for CCPs to ensure they appropriately reflect the risks presented by CDS	ESCB-CESR recommendations for securities settlement systems and central counterparties finalised. CPSS-IOSCO are due to update their recommendations for CCPs to ensure they address the specific risks associated with OTC derivatives.	Agreed in June 2009. Regulators will make use of these standards on their supervision of CCPs. Mid 2010.

RECOMMENDATIONS	DEPENDENCIES	NEXT STEPS/TIMING
Macro-prudential analysis		
• Within UK	Bank of England and FSA need to put in place resources, methodologies and coordination processes.	Principals' Council for Financial Stability will be established by legislation in next parliamentary session.
• At European level	Depends on future EU institutional framework relationships.	New EU legislation proposed will create a ESRB, which will be designed to detect risks to the financial system and issue early warnings about systemic risk.
• Globally	FSB and IMF to enhance early warning systems and improve vulnerability assessment.	The next iteration of the IMF-FSB Early Warning Exercise will be presented to the International Monetary and Financial Committee in October. The FSB contribution will draw on the work of its new Standing Committee on Assessment of Vulnerabilities.
FSA supervisory approach		
• Supervisory Enhancement Programme (SEP)	Design and Implementation complete.	Embedding programme in business as usual activities and ongoing monitoring for continued improvement.
• Further intensification of change	Will be implemented by FSA - Macro-prudential capability. - Increased role in balance sheet analysis and accounting judgements.	In place by Q4 2009. Already underway, for example with APS analysis and creation of Accounting Review Team. FSA Discussion Paper on disclosures in accounts to be published in Q4 2009.
Firm Risk Management and Governance	To be addressed by Walker Review with FSA input.	Final Recommendation due Q4 2009.

RECOMMENDATIONS	DEPENDENCIES	NEXT STEPS/TIMING
Cross-border Banks: Global		
• Colleges of supervisors for all major cross-border firms	Colleges now exist for 30 plus major cross-border firms identified by the FSB as requiring a supervisory college.	The FSB and BCBS surveyed current practice over the summer and will review this during Q4 2009 in order to improve consistency and share good practice.
• Improved coordination and contingency planning for crisis management	FSB principles for cross-border cooperation in crisis management, April 2009. The schedule for the first meetings of crisis management groups for FSB major cross-border banks has been agreed.	The meetings will take place in Q4 2009 and in 2010.
Cross-border Banks: Within Europe		
• New European body for financial services regulation	The EU's legislative process has now begun with a view to establishing three European Supervisory Authorities.	The UK authorities (HMT, Bank of England and FSA) are working together during the negotiations to promote solutions that work effectively for the EU and the UK.
• Increased national powers over branches	The Commission has the sole right to propose legislation.	The FSA is discussing with the Commission changes to EU law to permit host states to protect better their depositors and tax-payers.
WIDER ISSUES: OPEN QUESTIONS		
Product Regulation • Mortgage market	UK specific policy decision.	FSA Mortgage Market Review published by Q4 2009.
• Wholesale products (eg CDS)	Extensive proposals for OTC Derivatives market reform set out in the joint FSA/HMT response to the EU Commission consultation on OTC derivatives.	International discussions ongoing.
Additional counter-cyclical Tools		
• Counter-cyclical LTV or LTI limits	UK specific policy decision.	FSA Mortgage Market Review published by Q4 2009.

RECOMMENDATIONS	DEPENDENCIES	NEXT STEPS/TIMING
• Avoiding pro-cyclicality in collateral margin 'haircuts'	Issue has been discussed at a global level.	FSB and CGFS reviewed the role of valuation and leverage in procyclicality earlier this year. The review will be considered as part of the collateral thematic review being undertaken. To be completed Q1 2010.
Balancing liquidity versus stability concerns (e.g. in regulation of short-selling)	FSA will apply special measures if needed. Wider legal powers (beyond market abuse justification) would give greater flexibility.	Ongoing. HM Treasury's July 2009 White Paper proposed a new financial stability objective for the FSA and extended rule-making and firm-specific powers for the FSA.

Annex 1

Acronyms

ABS – asset-backed security

AIFM – Alternative Investment Fund Managers

ARROW – Advanced, Risk-Responsive Operating FrameWork

BCBS – Basel Committee on Banking Supervision

BIS – Bank of International Settlements

CBA – Cost Benefit Analysis

CCP – central counterparty

CDS – credit default swap

CEBS – Committee of European Banking Supervisors

CEIOPS – Committee of European Insurance and Occupational Pensions Supervisors

CESR – Committee of European Securities Regulators

CGFS – Commitee on the Global Financial System

CP – Consultation Paper

CPSS – Comittee on Payment and Settlement Systems

CRA – credit rating agency

CRD – Capital Requirements Directive

DGSD – Deposit Guarantee Schemes Directive

DP – Discussion Paper

ECB – European Central Bank

EEA – European Economic Area

ESA – European Supervisory Authority

ESCB – European System of Central Banks

ESRB – Euopean Systemic Risk Board

EU – European Union

FRC – Financial Reporting Council

FS – Feedback Statement

FSB – Financial Stability Board

FSCS – Financial Services Compensation Scheme

FSF – Financial Stability Forum

FSOC – Financial Services Oversight Coucil

GAAP – Generally Accepted Accounting Principles

HMT – Her Majesty's Treasury

IAA – International Assessment Approach

IAS – International Accounting Standards

IASB – International Accounting Standards Board

ICAEW – Institute of Chartered Accountants in England & Wales

ICG – Individual capotal Guidance

IFIAR – International Forum of International Audit Regulators

IFRS – International Financial Reporting Standards

IMF – International Monetary Fund

IOSCO – International Organization of Securities Commissions

IRB – Internal Ratings Based

ISDA – International Swaps & Deriviatives Association

LTV – loan to value

MiFID – Markets in Financial Instruments Directive

NIESR – National Institute of Economics & Social Research

OTC – over-the-counter

PiT – point in time

RAO – Regulated Activities Order

RMBS – Residential Mortgage-Backed Security

SEC – Securities and Exchange Commission

SEP – Supervisory Enhancement Programme

SFA – Supervisory Formula Approach

SPV – special purpose vehicle

TTC – through the cycle

VaR – Value at Risk

List of non-confidential respondents to DP09/2

Please contact us if you would like to see any of the responses. Responses are available in full, unless the respondent requested that their feedback should remain confidential.

Responses were received from:

Abbey

Adam Smith Institute

Addleshaw Goddard

AEGON UK

Association of British Insurers

Association of Chartered Certified Accountants

Association of Corporate Treasurers

Association of Foreign Banks

Association of Friendly Societies

Association of Independent Financial Advisers

Australian Bankers' Association

Aviva plc

Axa UK

Bank of Cyprus

Barclays

Berwin Leighton Paisner LLP

Bloomberg L.P

British Bankers Association

Building Societies Association

City of London Law Society

Confederation of British Industry

Cranfield University

Deloitte LLP

Equifax

Ernst & Young LLP

Euroclear

Experian

Financial Services Consumer Panel

Financial Services Research Forum

French Banking Federation

Futures and Options Association

Genworth Financial

Global Life Zurich Financial Services

Goldman Sachs

Grant Thornton UK LLP

Guernsey Financial Services Commission

Hedge Fund Standards Board

Heriot-Watt University

HSBC

IFR - Market Intelligence

International Banking Federation

International Capital Market Association Ltd

International Financial Services

International Swaps and Derivatives Association, Inc.

International Underwriting Association

Investment Management Association

Japanese Bankers Association

JP Morgan

KPMG LLP

Legal & General

Lloyds Banking Group

Lloyd's General Counsel's Division

Lloyd's Market Association

London Investment Banking Association

LV

Margarita Sweeney-Baird

Moody's

National

Nationwide

Paragon Group of Companies'

Pearl Group

PricewaterhouseCoopers LLP

Prudential Plc

RBS

RSA Group

Scottish Financial Enterprise

Securities & Investment Institute

Standard Chartered Bank

The Actuarial Profession

The Alternative Investment Management Association Limited

The Bank of Tokyo-Mitsubishi UFJ, Ltd

The Co-operative Financial Services

The Financial Inclusion Centre

The Institute of Chartered Accountants in England and Wales

The Institute of Internal Auditors - UK and Ireland Ltd

Tony Shearer

UK Sustainable Investment and Finance

University of Leicester

Volterra Consulting

Wholesale Markets Brokers Association

There was also one response where the respondent requested that the fact they responded should remain confidential.

PUB REF: 001911

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