Feedback Statement

10/2

Financial Services Authority

Summary of feedback to the Turner Review Conference Discussion Paper (DP09/4)

July 2010

Financial Services Authority

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This Feedback Statement reports on the main issues arising from Discussion Paper 09/4 (*Turner Review Conference Discussion Paper)*.

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1 Overview

1.1 The *Turner Review Conference Discussion Paper* (DP09/4) was published in October 2009. The FSA invited comments on the DP to be received by 1 February 2010. This statement summarises the feedback received. Although this paper does not provide an FSA response to the feedback, it does set out where it will be considered in the FSA's future work programme.

1.2 DP09/4 focused on the two key issues of systemically important banks and how we can best assess the cumulative impact of global capital and liquidity reforms. It considered how to define 'systemic importance' and assessed the policy options for addressing the challenges and risks that systemically important banks present. These included:

- higher capital levels in systemically important banks;
- a greater focus on standalone national subsidiaries;
- action to reduce bank inter-connectedness in trading markets;
- the separation of 'narrow banking' from proprietary trading; and
- recovery and resolution plans (also known as 'living wills').

1.3 The second issue in the paper examined a potential approach of assessing the cumulative impact of reforms to global capital and liquidity regimes, following feedback to the first Turner Review DP (DP09/2)[1], which stated there should be a careful assessment of the overall impact of the different elements of reform.

1.4 The FSA received 28 responses from a wide variety of respondents, including banks, trade associations, insurers and overseas regulators. A full list of respondents is set out in Annex 1. Much of the feedback was in line with feedback previously received on *The Turner Review* and its associated paper (DP09/2). Many respondents commended the FSA on the leading and open approach it has taken in its analysis, while voicing their concerns on certain issues. These concerns generally focused on the wider application of the proposals to other institutions (such as insurance firms

1 DP09/2: *A regulatory response to the global banking crisis, February 2009*

and infrastructure providers) and the quantitative cumulative assessment of the potential reforms.

1.5 Many respondents reiterated support for a strong, coordinated EU and international approach so legislation is considered in full, and unintended consequences are avoided. In particular, respondents urged that any initiative that pre-empts international agreement should be consulted on as it will have an impact on London's competitiveness as a financial centre.

1.6 There were also strong concerns that an appropriate balance should be struck between financial stability and economic growth, with many respondents voicing concerns that regulators would become too risk averse and impose requirements that over compensated for past failures and stifled economic growth.

1.7 The responses generally focused on specific areas which are summarised below.

2 Systemically important firms

Defining systemic importance

2.1 DP09/4 considered how to define systemic importance and described a number of factors which make firms systemically important. These were systemic by size, inter-connectedness (through interbank exposures, the confidence channel or asset margin spiral channel) and as a herd. The DP noted that supervisors needed to identify the extent to which firms were likely to be systemic for each factor and called for metrics to be put in place, while observing that this raised the issue of whether there should be a binary size cut-off or degrees of systemic importance.

2.2 Many respondents were concerned that size was being overly emphasised when defining systemic importance. They felt there was little evidence to support size as a relevant factor and made it clear they would not support regulatory constraints on the growth of banks. Some highlighted the advantages of large banks in providing stability through the economic cycle (as wholesale and retail divisions tend to experience the impact of a downturn at different points in time) and commented that promoting diversification across customers, geographies and business lines contributed towards lowering systemic risk. Others pointed out the key role large institutions had in financing businesses, governments and projects, bringing social and market benefits. Ultimately many respondents felt that it was a firm's business model – not its size – that had emerged from the current crisis as the largest contributing factor.

2.3 Representatives from the insurance sector felt size should only be a relevant factor if the firm's failure would have an impact on the functioning of the monetary system (including banks and others whose business models rely on capital markets and market infrastructure providers) in such a way as to warrant immediate intervention through government support. They felt that those that may be systemically important due to their size, but whose failure would not pose an immediate threat to the monetary system (such as traditional insurers), should be recognised as posing less systemic risk and treated differently.

2.4 Some urged caution against over-reliance on quantitative criteria for identifying systemically important firms, commenting that different firms were likely to be important in different market conditions. They also noted the dangers of equating systemic importance with economic importance, with the view that economically important firms (e.g. large insurers) do not produce the same types of moral hazard concerns associated with banks.

2.5 The majority of respondents agreed that there should not be a systemic threshold, but rather a scale of systemic importance (thus avoiding crudely dividing firms into two camps – systemic and non-systemic). Some warned against publishing a list of systemic firms for moral hazard reasons.

Systemic surcharges

2.6 The DP outlined the FSA's current stance on systemic surcharges, namely that there is a strong case for applying some form of capital (and possibly liquidity) surcharge to systemically important banks. This could be calculated as a continuous and increasing function of measuring systemic importance. Such surcharges could reduce the probability of these banks failing and help internalise the external costs which their systemic importance produces.

2.7 While most respondents saw merit in systemic surcharges, many emphasised that they should be in line with risk. Some warned against disproportionately increasing capital for larger firms, noting that a better approach would be to reduce the consequences of these firms' failure. One respondent[2] noted that higher requirements for firms deemed too big to fail could paradoxically be counterproductive. This was because categorising them as 'systemic' could infer an apparent security, potentially placing large firms at a competitive advantage by attracting larger deposit bases. This would result in smaller firms' funding models weakening, which would encourage them to bid up for deposits they could only remunerate through riskier assets or leverage. This would in turn be likely to create a correlation among smaller firms' business models, increasing their collective systemic risk. Others also commented that any charges should be structurally neutral (taking the view that complexity does not increase the risk of firm failure and noting that some complexities resulted from complex legal and regulatory requirements and were not the firm's choice).

2.8 Some cautioned that measures taken could be subject to arbitrage as firms seek to reduce/avoid capital surcharges, creating competitive distortions. Respondents also urged care over the timescales for introducing the proposals given the current fragile state of the economy, the potential impact on lending and the associated socioeconomic effect.

Systemic importance and insurance groups

2.9 At least six respondents[3] are, or have associations with, insurance providers. They were concerned about inappropriate read-across to other entities such as insurance groups in the broader application of the proposals set out in the DP.

2 HSBC
3 Prudential Plc, Lloyd's, ABI, Aviva, IUA (International Underwriting Association), Zurich Financial Services Group.

2.10 These respondents believed suggestions that insurance groups may be a source of systemic risk were unsubstantiated, and that regulators should recognise the differences between the business models of banks and insurance groups as:

- unlike banks, insurers do not have a liquidity mismatch between their very liquid, instant access liabilities and less liquid assets. The respondents highlighted how banks are mainly financed by short term deposits that can easily be withdrawn, while their assets are usually relatively illiquid. Insurers on the other hand use premiums to invest in assets, which they can match to meet their longer term, relatively illiquid and reasonably predictable liabilities. The illiquid nature of insurance company liabilities gives them time to manage their failure without these leading to system-wide instability;
- it is unlikely that policyholders cancel their policies en masse in response to the failure of another insurer (policy cancellations are generally unattractive as they usually incur a penalty);
- insurers are not key participants in the payment systems which act as critical infrastructure and potential channels of contagion;
- insurers are not typically subject to the sort of short-term counterparty risks that some banks became exposed to due to their high dependency on inter-bank lending;
- the insurance sector is significantly smaller than the banking sector in terms of aggregate balance sheets;
- insurers tend to have low leverage ratios; and
- insurance risks are real rather than financial (i.e. they are caused by an outside event such as a natural disaster) and they are largely idiosyncratic – they are not correlated with each other or with financial markets.

2.11 Many respondents also said they did not believe it would be necessary for a government to support a traditional insurer given the nature of the business model. They also highlighted that, although AIG received government support, this was because of its proprietary trading and not its traditional insurance business.

2.12 Some[4] noted that reinsurers could potentially be a source of systemic risk, describing how a major reinsurer's failure would affect insurers that had reinsured risk with them, as they would need to reassess their risk level. Contrary to this, one respondent[5] said reinsurers essentially reduced risk, spreading risk across the insurance industry. The respondent commented that past reinsurance spirals caused by poor risk management – which put cedants (a reinsurer's counterparties) at risk – are now well understood.

2.13 Some respondents recognised that inter-connectedness with other financial sectors could be a potential source of risk for insurers, but did not view it as a source of systemic risk. They believed that counterparty risk rarely causes insurance failure (citing the main causes as poor management and a lack of control). Respondents observed that through Solvency II's recognition of market risk, insurers are better

4 ABI, Aviva.
5 IUA (International Underwriting Association).

equipped to deal with the risks generated through inter-connectedness with financial markets.

The cross-border dimension

2.14 The DP discussed cross-border issues, including 'too big to rescue', and said that any new policy options would not eliminate the possibility of any future circumstances where total group rescue was the optimal policy for the global economy. The paper considered two alternatives to the general assumption that home country governments assume responsibility for the rescue by recapitalising banking groups in their totality. These alternatives were:

- global fiscal burden sharing (where several major countries share the costs of group rescue in line with pragmatically assessing their exposure to the resulting harm). This was seen as unlikely to be politically feasible; and
- where national governments are separately responsible for the rescue through the recapitalisation of separate national subsidiaries; no government is responsible for group-wide resolution.

The paper noted that a distinction needs to be drawn between:

- banking groups that are already to a significant extent constellations of separately subsidiarised national banks; and
- globally integrated banking groups that are generally more involved in wholesale banking and trading activities.

2.15 Possible policy responses were discussed for both groups. The first type of banking groups (constellations) would be required to organise local commercial banking operations on a fully capitalised subsidiary basis, accepting that their home country government is not responsible for rescuing the whole group via recapitalisation.

2.16 The second type of banking groups (globally organised) would be required to maintain sufficiently high levels of total group capital and liquidity, so their probability of failing is very small. They would also be obliged to have recovery and resolution plans and a legal structure simplification to increase the range of realistic options available.

2.17 The DP also noted that an important issue to consider in deciding the appropriate balance of approaches is whether a trend towards more standalone national subsidiaries could detrimentally affect cross-border capital flows, and in turn global economic growth. However, the paper acknowledged that no conclusive evidence concerning this has been provided.

2.18 Most respondents recognised the difficulties posed by cross-border resolution mechanisms and encouraged greater progress to solve them. Although some commented that proposals for less capital to be required by those organised on a standalone subsidiary basis was a potential model, most questioned whether they would really be able to stand alone in a crisis affecting the parent/group and made the following observations:

- within the EU it is unclear how this approach would apply, given the apparent conflict with the freedom to provide services and of establishment in the Treaty;
- increased moves towards subsidiarisation limit the risk of contagion, but also the certainty of parental support;
- there is a tendency to overstate the extent to which constellation groups operate in separate national silos – in practice there is a continuum with most banks operating elements of both subsidiarised and integrated groups;
- the standalone subsidiarisation model could lead to trapped pools of capital and liquidity, making the system more fragmented, fragile, costly and less efficient; and
- the key is to ensure capital is sufficiently flexible at group level so group support benefits can be realised.

2.19 Overall, respondents believed firms should be able to determine the structure that best fits their business model, provided they can demonstrate it is transparent, appropriately managed and resilient. Firms should focus primarily on the quality of risk management and control at solo and group levels. This should enable the appropriate levels of capital to be assessed at each level.

2.20 A few respondents were concerned that the DP appeared to favour constellations of national subsidiaries over integrated groups and noted there were real benefits to operating on an integrated basis. They referred in particular to the benefits of flexibly deploying capital and liquidity, which could enhance the group's regulatory strength, and provide real economy benefits (e.g. financing large clients and projects). One respondent[6] was particularly concerned about potentially reduced support to subsidiaries and felt that when subsidiaries actively took customer deposits – which were then pre dominantly up-streamed to the parent bank – this should be recognised in the level of parental support offered to them.

Reducing inter-connectedness in wholesale trading: central counterparties (CCPs) and improved risk management

2.21 The DP set out the FSA's view that actions should be taken to reduce inter-connectedness in wholesale trading markets, with much over the counter (OTC) derivative trading being cleared through central counterparties. Collateral and margin call arrangements for bilateral trades also provide effective counterparty risk management, including mitigation of strongly pro-cyclical margin call effects.

2.22 Respondents generally supported the greater use of CCP clearing and a capital framework that incentivises the central clearing of standardised contracts. However they were concerned that:

- CCP clearing could create new 'single points of failure', and risks should be subject to more rigorous analysis;

6 The Financial Services Commission of the Isle of Man

- a mandatory central clearing for all derivatives contracts would force the standardisation of many bespoke contracts designed to meet client needs. This would limit clients' ability to manage their risks. Many respondents commented that customised contracts will always be needed, so a considerable number of OTC trades will never be suitable for CCP clearing;
- products which may not be suitable for CCP clearing may be forced into the system as a result of political pressure, rather than to reduce risk; and
- a framework that makes it difficult for corporates to hedge could lead to increased costs to consumers (reducing economic growth) or to less risk mitigation (resulting in earnings volatility, price instability and higher risks being retained).

2.23 Some also commented that enhanced data capture should also be introduced to increase transparency and supervisory monitoring of risk accumulation in specific areas.

2.24 There were mixed responses regarding potential new arrangements for contracts that continue to be bilateral in nature. Some respondents supported improving risk management procedures for bilateral contracts, although one[7] felt the existing requirements, which applied for the recognition of collateral for capital purposes, were sufficient. Another[8] urged the removal of requirements to impose uniform initial and variation margins for bilateral transactions, focusing instead on the quality of collateral posted and how quickly to liquidate the collateral.

2.25 Some also commented how recent events have shown that smaller, less inter-connected commercial banks are as likely to fail as large and inter-connected investment firms, noting that a focus on risk management appears to be more important than the level of inter-connectedness in lowering the risk.

Narrow banking options

2.26 The DP also considered other options for reducing inter-connectedness, including a legal requirement to separate defined 'narrow banking' activities from high risk activities (e.g. proprietary trading). In discussing how desirable the forms of this separation could take, it focused on three options:

(i) extreme narrow banking;

(ii) intermediate narrow banking; and

(iii) separating commercial from investment banking.

2.27 The paper invited responses on its assessment of the potential dangers in the extreme narrow banking model, of where to draw an appropriate boundary between 'utility banking' and 'casino banking', and its tentative conclusion that a Glass-Steagall type separation is unlikely to be practical via legal distinctions, but that its objectives could be pursued by other means.

7 JP Morgan
8 AFME (Association for Financial Markets in Europe)

2.28 There was strong support for the FSA's assertion that the extreme narrow banking model was impractical and ultimately undesirable. Most respondents agreed that an extreme option was impractical and its intentions could be pursued by other means. Some warned of the potential unintended consequences such as encouraging maturity transformation to move to the unregulated area, while others warned that cutting off deposit flows to the productive sector would starve businesses of investment and households of credit lending, leading to considerable social costs.

2.29 Most agreed that it will be extremely difficult to draw the line between 'utility banking' and 'casino banking', and agreed with the FSA's tentative conclusions that a Glass-Steagall type separation is unlikely to be a practical for modern banking. Some respondents pointed out that much of firms' trading activity is actually client driven, either directly or through hedging of exposures resulting from customers' trades, or represents market making activity and therefore does not represent the 'casino banking' that the model seeks to address. Others felt that creating a number of banks with similar narrow characteristics could in itself create systemic risk and remove the possibility of different parts of a group cross-subsidising each other in times of stress. They commented that this would lead to the banking system fragmenting and make it difficult for customers to receive a comprehensive service from a single institution.

2.30 Some noted that many banks that failed were arguably narrow and therefore these were demonstrably not safer than universal banks. They also asserted that failures of the UK institutions were not to do with proprietary trading activities. A few commented on the unusual nature of the recent crisis and noted that a 'normal' downturn was best met through the breadth, depth and diversity features of a universal bank and noted further that universal banking had much to commend it, with a widely recognised role in supporting globalisation.

2.31 In general, many felt the focus should instead be on risk identification and the forthcoming proposals on capital, liquidity and recovery and resolution plans would help to bring about a clearer delineation in activities. These, they felt, would help ensure that market risks associated with proprietary trading were sufficiently captured without the need for legislation to ban certain structures.

2.32 The Building Societies Association emphatically rejected any suggestion that restrictions on building societies should be tightened and felt its members already supply a model for utility banks by providing a stable low risk vehicle for channelling savings.

Recovery and resolution plans (RRPs)

2.33 The DP set out that the FSA believed systemically important banks should have to produce RRPs that show how their operations would be recovered or resolved in an orderly fashion. If these plans reveal serious obstacles to resolution, then steps such as restructuring may need to be taken to reduce or remove them. Possible details of this approach were considered.

2.34 Most respondents commended our work on RRPs, but they raised these concerns:

- Such plans could compartmentalise capital and liquidity buffers throughout a group's legal entity structure, amplifying the effects of new regulations, reducing profitability, decreasing assets' efficiency and increasing capital needs.
- RRPs should be separately maintained; a bank's recovery plan is a management tool to plan for severe economic downturns and should not be used as a regulatory tool for imposing additional capital requirements or initiating changes to group structures. However, the resolution plan should be produced by the regulator or authority that will execute it.
- The plans should not be used to impose specific structural requirements or restrictions on firms. They should be proportionate, business model neutral and avoid any requirements for virtual data rooms.
- Plans should be implemented globally by all major regulators and only after a consensus has been reached on recognising the plans by other jurisdictions. It was noted that harmonising legislation would not necessarily lead to consistent application across jurisdictions. The plans should not result in greater ring fencing around national boundaries.
- The high market sensitivity of a firm's survival strategy should be recognised and treated accordingly. Some also commented on the possibility of difficulties with sharing the information with every host supervisor.
- Plans could be expensive to maintain and resource intensive (i.e. the more detailed the tactical plans, the more they lose clarity of purpose).
- Insurers were concerned about extending the requirements to insurance groups. They felt that this approach would be inappropriate as the resolution of an insurance company takes place over a long period of time, and given the contrast with banks, where there was an urgent imperative on the authorities to provide support to prevent a 'run' and further contagion. It was also noted that rules already exist regarding the governance of winding up insurance firms (FSA rules and the EU Directive on the winding-up of insurance undertakings[9] were cited) so additional requirements would be unnecessarily duplicative and burdensome.
- Building societies were concerned about the application of an undifferentiated RRP requirement to all deposit takers, saying that, unlike banks, building societies did not tend to be organisationally complex, highly inter-connected or have a substantial presence overseas.

2.35 Respondents asked for clarity on some issues, including the extent to which the FSA is planning to apply the requirements to other firms, including market infrastructure bodies, and how much information firms need to give the regulator (and how often, if such information is volatile).

9 Directive 2001/17/EC of the European Parliament and of the Council of 19 March 2001 on the reorganisation and winding-up of insurance undertakings

Capital and liquidity reforms

2.36 The DP noted the strong international consensus that the global framework for prudential regulation must be radically reformed to create a more robust and resilient financial system. It referred to the general principle agreed by the Financial Stability Board (FSB) that the global banking system will hold significantly more capital and liquidity, and operate at lower levels of leverage. The paper set out the Basel Committee on Banking Supervision (BCBS) workstreams in this context.

2.37 Most respondents welcomed a greater focus on capital and liquidity requirements, while cautioning that their potential aggregate impact would be significant. They warned of unintended adverse consequences for the economy's recovery and growth and cited higher costs, restricted credit, higher unemployment and a move to the unregulated sector as some possibilities. Some acknowledged difficulties in establishing the right balance between strengthening the financial system and balanced sustainable growth, and one commented[10] that, given the political nature of this balance, decisions should not solely be taken by regulators.

2.38 Many said that bank capital ratios have already responded to the increased volatility and stressed conditions in capital markets, and this should be taken into account when considering new rules. Some emphasised that higher capital levels would not have prevented many recent banking failures, so the focus should not only be on increasing capital and liquidity levels, and cautioned that strong governance, risk management and supervisory oversight should not be overlooked.

2.39 Most respondents felt that prudential requirements should be calibrated to risk, with some emphasising that the requirements should not be linked to a firm's structure, size or status.

2.40 Most welcomed recognition by the FSA that the full transition to the new capital and liquidity regimes should be phased in over several years, and warned against moving too rapidly. There was also support for an international liquidity framework, provided that it was consistently implemented across borders.

2.41 Some large banks commented that, as well as rebuilding capital, banks must be allowed to use profits to make appropriate payments to employees if they are to retain talent and build their franchise.

10 AFME

3 Assessing the cumulative impact of reforms

3.1 The DP examined a potential approach to assessing the cumulative impact of reforms to global capital and liquidity regimes, and discussed the issues to be considered when attempting to determine the optimal level of capital across the banking system. The paper also provided initial results of modelling work carried out by the National Institute of Economic and Social Research (NIESR).

3.2 Almost all respondents expressed strong concerns over the cumulative impact of the potential new measures, with many worried about the possibility of 'double counting' (i.e. authorities inadvertently taking several disconnected measures to address the same problem). Many also felt regulators were incentivised to overcompensate for past failures and cautioned against excessive prudential requirements that could slow economic recovery. They noted that the effectiveness of regulatory change may be overestimated and could result in unintended consequences (e.g. channelling the provision of lending to unregulated sectors or limiting competition through higher barriers to entry).

3.3 The quantitative output from the NIESR modelling work was welcomed by most, but many had issues with the methodology (e.g. some were concerned that the model unreasonably assumes that a future crisis will resemble the current crisis, the crisis could solely be avoided by UK regulation, a change of regulatory regime brings no change to trend growth, the risks to the UK financial sector are unusually higher than those to other European countries' financial sectors and the model underestimates the benefit of a raised confidence level). Some also said that the NIESR model attributed the fall in UK growth wholly to the financial sector and ignored the contributions of the housing bubble, commodity price boom etc.

3.4 Some also commented on the need to expand the debate beyond the technical and were unconvinced that the public sees a welfare benefit in favouring stability over maximising growth. A definition of what is meant by financial stability and what society wants from a financial system were called for to help balance the trade offs between financial stability and economic growth.

3.5 Some respondents noted that implementing some of the proposed measures appears to have begun, such as building up capital buffers and deducting material holdings from capital, and they expressed serious concerns over this, stating that it made balance sheet planning very difficult. They sought an assessment of an appropriate transition period to introduce new requirements.

4 Developments of FSA policy

4.1 The responses received to DP09/4 and other DPs, and the FSA's ongoing dialogue on these issues with international counterparts, firms, trade bodies and other parties will continue to inform its thinking as the FSA develops policy proposals on these issues.

4.2 The FSA is working with the Macroprudential Supervision Group of the BCBS to develop proposals to address the risks posed by systemically important banks. The Group of Central Bank Governors and Heads of Supervision has stated[11] that the BCBS should develop a menu of approaches using continuous measures of systemic importance to address the risk for the financial system and the broader economy deriving from systemic banking institutions. This will form a key input to the FSB's initiatives.

4.3 Specifically, the FSA's current thinking on RRPs is being informed by the responses received to this DP and the results of a pilot exercise undertaken with a small number of banks during Q1 2010. As reported in the FSA's Business Plan,[12] the evidence gathered from the pilot exercise will be used to develop proposals for consultation in 2010/11.

4.4 The FSA will continue to work to improve its understanding of the cumulative impacts of the proposed reforms and alongside international bodies to ensure these are appropriately considered at the global level. The FSA has also taken note of many of the other concerns raised by respondents on the cumulative impact of the prudential regime, including the balance between financial stability and economic growth and society's expectations in this regard, and is currently conducting work to address them, where appropriate.

4.5 The FSA would like to thank all respondents for their continued engagement on these issues. The responses received have helped develop its thinking and prompted useful debate.

11 Statement made in the press release on 11 January 2010 by the Bank for International Settlements (BIS) following the 10 January meeting of the Group of Central Bank Governors and Heads of Supervision.

12 *FSA Business Plan* 2010/11 Section 1 – Delivering financial stability.

List of non-confidential respondents to DP09/4

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:

Association for Financial Markets in Europe

Association of British Insurers

Aviva

Banca d'Italia

Bank Indonesia

Barclays

British Bankers'Association

Building Societies Association

Capital Market Authority, Sultanate of Oman

Central Bank of Kuwait

Euroclear

Futures and Options Association

HSBC

Investment Management Association

International Underwriting Association

JPMorgan

Lloyd's

Lloyd's Banking Group

Supervision Commission of the Isle of Man

PricewaterhouseCoopers LLP

Prudential plc

Reserve Bank of New Zealand

Standard Chartered

Thailand SEC

The European Commission

The Institute of Chartered Accountants in England and Wales

Zurich Financial Services Group

An IFA also responded.

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