

The following Compliance articles are for the week ending 20 March 2009.

“The global financial system has suffered the worst crisis for at least 70 years, indeed the worst global financial crisis since the development of modern capitalism. The Review’s focus is on how we create a future banking system which is more stable and better able to serve the needs of businesses and households.”
Lord Turner, Chairman, FSA, 18 March 2009.

FSA – LORD TURNER PRESENTS HIS REVIEW

On 18 March 2009, FSA published the long awaited Turner Review which set out the blue-print for future regulation of banks and equivalent institutions. The review was requested by the Chancellor to investigate the causes of the current economic crisis and for a recommend regulatory response. As a result, the review focuses on prudential regulation and is predominantly an analysis of “how we got here” with a much smaller section suggesting the way forward.

Notwithstanding the backward looking history lesson that comprises the bulk of the review, there were six key themes for future change, these being:

1. No more “light touch” regulation
2. Sweeping changes to capital and liquidity requirements of banks
3. Regulation of the “bank-like” organizations and possibly credit rating agencies, but not for hedge funds
4. Restrictions on what were graphically described as “casino-like” activities of commercial banks
5. Support for development of clearing of credit derivatives
6. Support for an EU-wide regulator but not in place of a tougher FSA

On two positive notes:

- The Review shows thought leadership by FSA and a desire to set the global agenda on how the international prudential regulation should be structured. FSA is keen to take the lead on this, however, they must be careful not to step too far out of line with other regulators and that would encourage regulatory arbitrage and a movement of UK-based banks to other jurisdictions.
- Lord Turner addressed the press conference with authority and confidence and answered questions for an hour, and it was reassuring to see such a positive leader at the helm of FSA.
The review was accompanied by DP09/2 which puts forward recommendations for change. The paper focuses on banks and “bank-like” organizations. However as there are wider comments that may affect hedge funds and the insurance sector, the regulatory profession need to remain alert to potential further change. The closing date for comments is 18 June 2009.

Source: FSA Website

FSA – CONSULTATION PAPER ON REMUNERATION

On 18 March, FSA published a CP on whether to incorporate its Code of Practice on remuneration into the Handbook and its application to large banks and broker dealers.

As mentioned in an earlier edition of our newsletter, the Code has a general requirement that a firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management. This would become a Handbook rule. The CP also proposes that the Code’s remaining 10 principles are put into the Handbook to help guide firms on the evidence the FSA will focus on when assessing compliance.

The Code's rules and evidential provisions would apply to about 45 FSA authorized large banks, building societies and broker dealers operating in the UK.

The CP notes that in order to be effective, policies on remuneration should be implemented globally and in a consistent manner. In deciding whether to implement their plans, FSA say they will take into account whether they consider there is satisfactory alignment of implementation plans by authorities in the major financial centres.

The CP is also inviting discussion on the idea that the Code should be applied to all other FSA-authorized firms. The consulting period on implementation of the Code for larger banks and broker dealers will run for two months, until 18 May. The period for discussion and feedback on the idea of extending the Code to other firms regulated by the FSA will run until 18 June.

Source: FSA Website

FSA – PAPER ON THE BEHAVIOUR AND DETERMINANTS OF RISK-BASED CAPITAL RATIOS

As part of its series of Occasional papers, FSA has published a paper which revisits the evidence from UK banking institutions. Prepared by FSA's own in-house think tank, the "Economics of Financial Regulation Department", the paper uses bank-level panel data from the United Kingdom to investigate the factors that influence banking institutions' choice of risk-based capital ratios.

Special focus has been placed on evaluating whether and how institutions respond to changes in regulatory capital requirements and if these responses vary across the economic cycle. This issue is of particular interest to policymakers that rely on capital regulation in conjunction with other supervisory tools to affect bank behaviours and maintain market confidence and financial stability more broadly.

The paper also explores the extent to which UK banks' capital management practices were procyclical under Basel I. Understanding whether such practices existed under this less risk-sensitive (and potentially, less procyclical) regulatory capital regime is a useful first step towards determining if banks, in their capital management practices, consider swings in economic conditions on their capital positions and lending capacities, which may, in turn, impact on the severity and duration of such economic cycles.

The paper concludes that:

- There is a statistically significant association between banks' risk-based capital ratios and individual capital requirements set by regulators in the UK.
- The rate at which banks respond to changing capital requirements depends significantly on certain characteristics of the bank (e.g., size, exposure to market discipline, nearness to regulatory threshold) as well as the direction of the economic cycle.
- Whereas there was a marginally statistically significant negative association between capital ratios and the economic cycle, there was no association when focused only on the largest banks in the UK, suggesting that systemically important banks tend to maintain risk-based capital ratios over the cycle.
- There was a positive association between capital ratios and capital quality, suggesting that reliance on capital with relatively higher adjustment costs (e.g., tier 1 capital) may raise the profile of that consideration in capital management practices and lead cost-minimizing banks to maintain higher total risk-based capital ratios overall.

- There was a positive marginal effect of market discipline on total risk-based capital ratios held by UK banks. This outcome was interpreted as suggesting that banks mitigate expected market reactions (e.g., on their funding costs or ability to access certain capital markets activities) to their business decisions by holding higher capital ratios.

Source: FSA Website

FSA – TRADE ASSOCIATIONS AND INDIVIDUAL CAPITAL GUIDANCE

On 20 March, Paul Sharma, Director, Wholesale & Prudential Policy at FSA wrote to Trade Associations such as the BBA, ABI and AMI to clarify how FSA viewed Individual Capital Guidance (ICG), in the context of the current economic circumstances. This letter was particularly clear and helpful in setting out FSA's stance.

ICG is given within the Pillar 2 regime. It is FSA's intention that the ICG provided to a firm, based on the information at the time, reflects the amount and quality of capital that in general FSA consider appropriate for a firm to hold in order for the firm to meet GENPRU 1.2.26R (i.e. adequate financial resources). That rule requires that a firm hold financial resources, including capital resources, which are adequate to ensure that there is no significant risk that the firm will be unable to meet its liabilities as they fall due.

The letter goes on to make clear that ICG does not necessarily equate to the FSA's view of the level of capital that it is desirable for a firm to hold in order to have adequate financial resources in all circumstances, especially exceptional economic circumstances. FSA recognise that there may be times when the capital resources of a firm may fluctuate around the level of its ICG whilst the firm restores its capital to a position above the level of the ICG. As a result, while the firm should be clear that it needs at all times to continue to meet the requirement for adequate financial resources in GENPRU 1.2.26R, it does not automatically follow that because a firm's capital is less than its ICG the firm is in breach of that rule. Consistently with this ICG is guidance and a failure to meet ICG does not mean that automatic regulatory actions will necessarily follow, although this will always attract heightened supervisory attention.

Mr. Sharma writes "We expect firms who contact us to be able to demonstrate that volatility in capital resources around the level of ICG is temporary and not simply a result of poor capital planning. Where we are not satisfied with the explanation offered by a firm as to why its projected capital resources may fall below its ICG, even on a temporary basis, we may insist on immediate remedial action. We do expect firms to undertake on-going stress testing, to demonstrate that they understand their capital position and any actions that might be needed to meet their ICG (and other capital standards that might apply at either solo or group level)."

Source: FSA Website

ABI – RESPONDS TO TURNER REVIEW

On 18 March, ABI summarized their response to Lord Turner's review into regulation, with Stephen Haddrill, the ABI's Director General saying: "This is an important contribution, which could be a significant step towards improving regulation. Central to any reform is the need to restore confidence to both consumers and financial markets. We need a supervisory and regulatory system which supports good quality, trusted banks and other financial services companies in open, competitive markets. The global nature of businesses in London must be preserved."

Specific comments on aspects of the review were:

- Pan-European regulator: Lord Turner's recommendation for a European Regulatory Authority is a welcome acknowledgment of our arguments that we need more effective cross-border supervision. A supervisor of supervisors, covering the 27 members of the Single European Market, will greatly benefit UK insurers, the largest insurance sector in Europe. However, we believe the FSA should go further and support such a body having the powers to settle disputes between regulators over cross-border companies.
- Prudential supervision: Better prudential supervision of financial firms is essential to the health of financial services and we agree with Lord Turner that the Tri-partite arrangement is the best vehicle to achieve this. However, it needs better co-operation and to take into account macroeconomic factors in its judgments. We welcome Lord Turner's recognition that regulators must not call for more capital than is needed, as this will reduce bank lending and economic growth.
- Remuneration: Employees must not be incentivised to take excessive long-term risks for short-term gain. If remuneration policies are adopted which make firms riskier, regulators have legitimate cause for tightening up prudential standards.
- Accounting: While there is an important debate to have around the role of financial reporting in the crisis, it must be remembered that accounts are for investors and not for regulators, who have much stronger powers to obtain information about a company's financial strength.

Source: ABI Website

CML – RESPONSE TO TURNER REVIEW

The Council of Mortgage Lenders (CML) also has a view stating that they believed that Lord Turner's report provided a helpful assessment of the regulatory environment as it stands and as it is expected to change. The CML stated that they were looking forward to working with the FSA as it develops its proposals further.

Michael Coogan, CML Director General, commented: We welcome the opportunity to explore the pros and cons of limitations on products in a rational way. And we agree that this needs to be done alongside an assessment of alternative ways of regulating to achieve the same risk-mitigating objectives. We see the FSA's September paper on the future of mortgage regulation as a real opportunity to help shape a future regulatory landscape that will serve both lenders and consumers better. We look forward to working constructively and collaboratively with the industry and the FSA towards this objective."

Source: CML Website

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