

Comment piece: Turner review conference - progress towards global reform

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This comment piece looks at the points raised at the Turner Review Conference held at the QEII Conference Centre on 2nd November 2009

Introduction

This comment piece focuses on the Turner Review Conference held on the 2nd November 2009: **'Progress towards global regulatory reform'**.

The conference focussed on issues raised in the FSA Discussion Paper (DP) 09/4, which addressed the issues raised by 'too-big-to-fail' financial institutions.

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The financial crisis has highlighted the importance of large interconnected institutions within the financial system, particularly concerning the impact of such institutions failing. Regulators have found that because the social and economic impact of letting such institutions fail is so great, governments have been obliged to rescue them - at great cost. This has increased a moral hazard, where too-large-to-fail banks can take on inappropriate risk knowing the public purse will step in if things go wrong.

Furthermore, some stakeholders in institutions may operate under an assumed level of state protection, reducing their incentive to ensure prudent behaviour. This moral hazard has increased since the crisis, as governments have demonstrated their willingness (under extreme circumstances) to execute industry-wide and firm-specific rescue if necessary. Another danger is that authorities may be unable to rescue a too-big-to-fail bank, or unwilling, where the impact of the failure does not materially affect their own domestic economy.

The Turner Review Conference was called so that the industry could discuss and comment on measures raised by the FSA and others to address this issue.

It represents part of an ongoing discussion between policy makers, industry advisors and market participants that will result in wide-ranging policy measures designed to address the moral hazard created by the existence of too-big-to-fail firms.

Lord Turner and systemically important banks

Lord Turner's keynote addressed points raised in the DP 09/4 concerning systemically important banks, and as such was a good summary of the main issues discussed in the previous section.

These included:

- Systemically important banks are not just identified by size. Many smaller firms and non-banks were also forced to be rescued because of their impact on the market
- "Too-big-to-fail" means too big to be **allowed** to fail in a fashion other than whole bank rescue
- Before the crisis, regulators did not focus on this moral hazard issue. In fact the regulatory philosophy rewarded size; implicit within Basel II is the idea that more advanced approaches pursued by larger firms resulted in lower capital requirements.
- Policy responses to the risk created by large systemic banks fall into three categories:
 1. Actions to reduce probability of failure
 2. Actions to make financial firms smaller or less interconnected
 3. Actions which increase the range of resolution options available, including "living wills"
- Reducing the probability of failure.
 - This is a must for systemically large banks


- The key is to impose higher capital charges (a tax on size), demand higher quality capital particularly equity, and to include contingent capital e.g. conditions under which debt instruments must convert to equity.

Making firms smaller and reducing interconnectedness

- Reduce the inter-connectedness in counterparty relationships through the introduction of central counterparties.
- Pursue a narrow banking option. Either through a definition that splits banks into deposit takers and other financial institutions, or through a Glass-Steagall type arrangement (prohibiting commercial banks from collaborating with full-service brokerage firms or participating in investment banking activities).

For different reasons, both ideas were argued as being unworkable. However capital higher charges for proprietary trading, liquidity charges and increased levels of overall capital may result in a defacto Glass-Steagall type arrangement.


- Large cross-border groups should, where possible, be organised into constellations of stand-alone national banks. This allows national authorities to decide remedial action in their own jurisdictions in time of bank failure, therefore helping to address the too-big-to-fail issue
- For large cross border banks that cannot arrange themselves as constellations of national banks (large market trading firms, for example) increased capital may need to be held to mitigate for the increased difficulty of addressing bank failure.

 Actions which increase range of resolution options available

- One problem is in the event of failure of large cross border institutions, the home of the national regulator sees itself as responsible for the rescue. For the reason given above this may not be an ideal situation
- This problem may be addressed by either having a globally agreed burden sharing arrangement between authorities, or an approach that clearly makes each regulator responsible for the activities in its country.
- This last approach will need to be reconciled with the idea of a single market in the EU.

- Another widely accepted option is the idea of financial firms' having living wills which describe how they can be wound down in the event of failure.

- Financial wills may require firms to restructure their business, should existing structures prove impossible to wind down in an orderly fashion.

 Overall the FSA's current position in relation to systemically important banks is

- There is a strong case for increased capital and perhaps liquidity charges for too-big-to-fail institutions.
- There could be a greater focus on stand alone national subsidiaries, with a trade-off versus group level capital
- Interconnectedness in wholesale markets needs reducing through central counterparties and collateral on bilateral trades.
- A fundamental reform of trading book capital regime is required, with increased capital charges for proprietary activities.
- Resolution and recovery plans are needed with restructuring if necessary.

Other contributions from the platform

Lord Turner was joined by Philipp Hildebrand from the Swiss National Bank and Shyamala Gopinath from the Reserve Bank of India, both of whom sit on the Financial Stability Board (FSB). Later the audience was addressed by Dr. Josef Ackerman Chairman of Deutsche Bank and the Institute of International Finance, Antonio Horta-Osorio, Chief Executive of Abbey National, and Hector Sants, Chief Executive of the FSA.

The regulators were broadly in agreement with Lord Turner's analysis and the direction of the outlined policy actions

Philip Hildebrand pointed out that the momentum of regulatory change seems to have slowed down over the past year, but the work carried out by the G20 and the FSB shows that the pressure for change was still very much there. He focused on the contribution of increased capital to act as shock absorbers to stress events, and the advantages of procyclical buffers.

Shyamala Gopinath, discussed the experience of the financial crisis in India, noting that it had a higher concentration of financial assets in established banks than economies such as the US and UK. Also, Indian regulations had also been reformed in response to the Asian Crisis. These reforms had held the Indian financial sector in good stead. Measures introduced before the financial crisis included countercyclical measures, the regulation of all money market and FX transactions, and the introduction of liquid asset buffers.

She went on to counsel that post-crisis the financial sector is usually very good at drawing out raising new policies. However the industry view is usually narrow, and hence the suggested reforms do not usually consider clearly enough the impact on the wider economy. Consequently, some of the policy initiatives will have unintended consequences that need to be carefully analysed.

Joseph Ackerman did not clearly support much of the initiatives cautioning that the industry must proceed with great care. Points he raised included:

- The world economy needs large banks, they bring many advantages, particularly to international trade. They could not be replaced by a constellation of small banks.
- Larger banks invest more in infrastructure, provide liquidity, knowledge and execute arbitrage, all crucial to the effective operation of financial markets.
- The truth is that banks will ultimately be supported by the state. Any new regulations should take this fact on board.
- Capital held by many banks has already been raised. The market will already anticipate any rising of capital requirement. The FSA is not correct when it believes that increased equity will be of comfort to holders of debt issues, hence some of the assumptions may be overly optimistic.
- Size is not an evil to be addressed. It is the interconnectedness of firms that poises a systemic risk.

- If necessary authorities must have the power to restructure and sell subsidiaries without shareholders consent.
- The reforms must be internationally consistent; otherwise we risk further fragmentation of the global financial markets which economically could hurt us all.

Antonio Horta-Osorio agreed with many of the points made by Josef Ackermann, but concentrated his speech on defining the factors determining systemic risk and many of the actions (Capital, liquidity, better risk management etc.) that could be used to address it.

Summary

Overall, this conference was not about coming to a conclusion but more about stimulating discussion. The regulatory authorities are clearly pointing to how they intend to address large systemic firms. The comments by Joseph Ackerman and Antonio Horta-Osorio show that the analysis needed before these measures become policy is not fully completed and the industry and others with an interest are to be urged to make their contributions during this formulating period.

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