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# The Turner Review And Discussion Paper 09/2 - A Regulatory Response To The Global Banking Crisis

On 18 March 2009, the Financial Services Authority (FSA) published a Review of the global banking crisis, conducted by Lord Turner, Chairman of the FSA (the "Review") along with the FSA's Discussion Paper 09/2 (the "Discussion Paper").

Please click [*here*](http://www.fsa.gov.uk/pubs/other/turner_review.pdf) to access the Review and [*here*](http://www.fsa.gov.uk/pubs/discussion/dp09_02.pdf) to view the Discussion Paper.

The Review provides Lord Turner's recommendations for reforming UK and international approaches to the way banks are regulated. It offers an in-depth look at the three underlying causes of the crisis (macro-economic imbalances, financial innovation of little social value and important deficiencies in key bank capital and liquidity regulations) along with 38 recommendations which the UK and the international community will need to consider to improve regulatory standards, supervisory approaches and international cooperation and coordination. The Review distinguishes areas where the FSA have taken action, areas where the UK can proceed nationally and those that require international agreement, in particular:

* Fundamental changes are needed in the regulatory approach to capital, liquidity and accounting;
* A central role for much tighter regulation of liquidity;
* A system-wide approach is needed to identify and deal with macro-prudential risks, to complement stronger micro-prudential supervisions of individual firms;
* Regulation of Credit Rating Agencies to limit conflicts of interest and inappropriate application of rating techniques;
* Changes need to be made to the scope of regulation of "shadow banking" activities to make sure that the economic substance of activities are regulated, not the legal form - increasing the reporting requirements for unregulated financial institutions such as hedge funds, and regulator powers to extend capital regulation; and
* The international framework for the regulation and supervision of cross-border banks needs strengthening in the light of the crisis. The Review recommends combining a new European regulatory authority (a European "supervisor of supervisors") and increased national powers to set the standards and oversee supervision.

The Discussion Paper is limited to the issues set out in Chapter 2 of the Review. It provides further background to those issues and discusses options for the policy choices for supervisory authorities around the world to create a significantly stronger global regulatory and supervisory framework.

The Review and the Discussion Paper are both seeking to propose a significant impact on the banking sector and on other financial services sectors. A summary of the FSA's proposed ***Actions Required To Create A Stable And Effective Banking System*** is attached below.

Comments on the Turner Review and the Discussion Paper are due by 18 June 2009.

On 27 March 2009, Lord Turner spoke at the Turner Review Conference which highlighted several areas for debate. It also concentrated on the fundamental recommendations and the important open issues in the Turner Review. Lord Turner's speech and power-point slides can be viewed [*here*](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0327_at.shtml).

## Actions Required To Create A Stable And Effective Banking System

### Capital adequacy, accounting and liquidity

1. The quality and quantity of overall capital in the global banking system should be increased, resulting in minimum regulatory requirements significantly above existing Basel rules. The transition to future rules should be carefully phased given the importance of maintaining bank lending in the current macroeconomic climate.
2. Capital required against trading book activities should be increased significantly (e.g. several times) and a fundamental review of the market risk capital regime (e.g. reliance on VAR measures for regulatory purposes) should be launched.
3. Regulators should take immediate action to ensure that the implementation of the current Basel II capital regime does not create unnecessary procyclicality; this can be achieved by using 'through the cycle' rather than 'point in time' measures of probabilities of default.
4. A counter-cyclical capital adequacy regime should be introduced, with capital buffers which increase in economic upswings and decrease in recessions.
5. Published accounts should also include buffers which anticipate potential future losses, through, for instance, the creation of an 'Economic Cycle Reserve'.
6. A maximum gross leverage ratio should be introduced as a backstop discipline against excessive growth in absolute balance sheet size.
7. Liquidity regulation and supervision should be recognised as of equal importance to capital regulation.
   * More intense and dedicated supervision of individual banks' liquidity positions should be introduced, including the use of stress tests defined by regulators and covering system-wide risks.
   * Introduction of a 'core funding ratio' to ensure sustainable funding of balance sheet growth should be considered.

#### Institutional and geographic coverage of regulation

1. Regulatory and supervisory coverage should follow the principle of economic substance not legal form.
2. Authorities should have the power to gather information on all significant unregulated financial institutions (e.g. hedge funds) to allow assessment of overall system-wide risks. Regulators should have the power to extend prudential regulation of capital and liquidity or impose other restrictions if any institution or group of institutions develops bank-like features that threaten financial stability and/or otherwise become systemically significant.
3. Offshore financial centres should be covered by global agreements on regulatory standards.

#### Deposit insurance

1. Retail deposit insurance should be sufficiently generous to ensure that the vast majority of retail depositors are protected against the impact of bank failure (note: already implemented in the UK).
2. Clear communication should be put in place to ensure that retail depositors understand the extent of deposit insurance cover.

#### UK Bank Resolution

1. A resolution regime which facilitates the orderly wind down of failed banks should be in place (already done via Banking Act 2009).

#### Credit rating agencies

1. Credit rating agencies should be subject to registration and supervision to ensure good governance and management of conflicts of interest and to ensure that credit ratings are only applied to securities for which a consistent rating is possible.
2. Rating agencies and regulators should ensure that communication to investors about the appropriate use of ratings makes clear that they are designed to carry inference for credit risk, not liquidity or market price.
3. There should be a fundamental review of the use of structured finance ratings in the Basel II framework.

#### Remuneration

1. Remuneration policies should be designed to avoid incentives for undue risk taking; risk management considerations should be closely integrated into remuneration decisions. This should be achieved through the development and enforcement of UK and global codes.

### Credit Default Swap (CDS) market infrastructure

1. Clearing and central counterparty systems should be developed to cover the standardised contracts which account for the majority of CDS trading.

#### Macro-prudential analysis

1. Both the Bank of England and the FSA should be extensively and collaboratively involved in macro-prudential analysis and the identification of policy measures. Measures such as countercyclical capital and liquidity requirements should be used to offset these risks.
2. Institutions such as the IMF must have the resources and robust independence to do high quality macro-prudential analysis and if necessary to challenge conventional intellectual wisdoms and national policies.

#### FSA supervisory approach

1. The FSA should complete the implementation of its Supervisory Enhancement Program (SEP) which entails a major shift in its supervisory approach with:
   * Increase in resources devoted to high impact firms and in particular to large complex banks.
   * Focus on business models, strategies, risks and outcomes, rather than primarily on systems and processes.
   * Focus on technical skills as well as probity of approved persons.
   * Increased analysis of sectors and comparative analysis of firm performance.
   * Investment in specialist prudential skills.
   * More intensive information requirements on key risks (e.g. liquidity)
   * A focus on remuneration policies
2. The SEP changes should be further reinforced by
   * Development of capabilities in macro-prudential analysis
   * A major intensification of the role the FSA plays in bank balance sheet analysis and in the oversight of accounting judgements.

#### Firm risk management and governance

1. The Walker Review should consider in particular:
   * Whether changes in governance structure are required to increase the independence of risk management functions.
   * The skill level and time commitment required for non-executive directors of large complex banks to perform effective oversight of risks and provide challenge to executive strategies.

#### Utility banking versus investment banking

1. New capital and liquidity requirements should be designed to constrain commercial banks' role in risky proprietary trading activities. A more formal and complete legal distinction of 'narrow banking' from market making activities is not feasible.

#### Global cross-border banks

1. International coordination of bank supervision should be enhanced by
   * The establishment and effective operation of colleges of supervisors for the largest complex and cross-border financial institutions.
   * The pre-emptive development of crisis coordination mechanisms and contingency plans between supervisors, central banks and finance ministries.
2. The FSA should be prepared more actively to use its powers to require strongly capitalised local subsidiaries, local liquidity and limits to firm activity, if needed to complement improved international coordination.

#### European cross-border banks

1. A new European institution should be created which will be an independent authority with regulatory powers, a standard setter and overseer in the area of supervision, and will be significantly involved in macro-prudential analysis. This body should replace the Lamfalussy Committees. Supervision of individual firms should continue to be performed at national level.
2. The untenable present arrangements in relation to cross-border branch pass-porting rights should be changed through some combination of:
   * Increased national powers to require subsidiarisation or to limit retail deposit taking
   * Reforms to European deposit insurance rules which ensure the existence of pre-funded resources to support deposits in the event of a bank failure.

#### Open questions for further debate

1. Should the UK introduce product regulation of mortgage market Loan-to-Value (LTV) or Loan-to-Income (LTI)?
2. Should financial regulators be willing to impose restrictions on the design or use of wholesale market products (e.g. CDS)?
3. Does effective macro-prudential policy require the use of tools other than the variation of countercyclical capital and liquidity requirements e.g.
   * Through the cycle variation of LTV or LTI ratios.
   * Regulation of collateral margins ('haircuts') in derivatives contracts and secured financing transactions?
4. Should decisions on for instance short selling recognise the dangers of market irrationality as well as market abuse?

*This note contains a summary only of certain issues raised in the FSA Discussion Paper "A regulatory response to the global banking crisis" and its contents do not constitute legal advice. Charltons is qualified to advise only as to matters of Hong Kong law.*

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