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Client briefing
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The Turner Review and its impact on the future of banking

In October 2008, the UK Chancellor of the Exchequer commissioned the chairman of the UK's Financial Services Authority to review the causes of the financial crisis and to make recommendations on the changes in regulation and supervision required to ensure a more robust banking system. Lord Turner's review (The Turner Review: a regulatory response to the global banking crisis) was published on 18 March 2009. In this paper, we examine some of the main findings of the review and consider their likely impact on the banks and "bank-like institutions" which are its express focus.

Reasons for reform

The review starts with analysis of the causes of the crisis (the main causes having already been outlined by Lord Turner in his highly-regarded Economist lecture on 21 January 2009), namely:

- the response of the financial services sector to the demand for increased returns from countries with savings surpluses;
- excessive growth of debt and savings shortfalls in some countries, including the UK, and over-reliance by some banks on wholesale funding sources;
- the mismatch between the supranational growth of the financial services sector and the limitations of regulators confined by national borders; and
- some basic assumptions underpinning the regulatory framework were flawed, including: the market is the best mechanism for establishing economic value; prices supported by markets will reflect risks and thereby constrain excessive risk taking; securitised credit results in reduced concentrations of credit risk; and market risk can be predicted by mathematical modelling.

The proposed reforms

In setting out his proposed reforms, Lord Turner starts with the assertion that there has been "inadequate focus on the analysis of systemic risk and of the sustainability of whole business models". The key reforms are as follows (we have not cited the reforms which were included in the review but which have been announced previously by the FSA):

Capital, accounting and liquidity

- the amount of regulatory capital required to be held by banks will be significantly higher than at present, although this increase will be introduced in phases while the economic downturn persists;
- required capital ratios for systemically important banks should permit only high quality capital (i.e. capital which currently counts as Core Tier 1 and Tier 1 capital) to be held. Dated subordinated debt will not count as regulatory capital;

Key Issues

FSA Chairman sets out proposed reforms to regulation and supervision of banks and non-banks which pose bank-like risks: a milestone in banking and financial regulation

Reforms propose significant increases in capital costs of banking business

Capital costs of trading book to be significantly increased

Banks to be required to hold counter-cyclical capital buffers and to operate within a gross leverage ratio backstop

Supervision of liquidity and macro-economic risk to become top regulatory priorities

Regulation to apply on basis of economic substance of a business rather than its legal form

Banks and bank-like institutions to become subject to intensive supervision by the FSA

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- capital requirements in respect of trading book positions will be reformed, including by the introduction of capital charges to cover default and credit risk and in respect of which transactions can be included in a bank's trading book. These changes will result in increases in capital requirements for some bank trading books of more than three times their current level;
- the introduction of overt counter-cyclical capital buffers, under which banks would be required to increase their capital in successful years (when losses on loans are below long term averages), creating capital reserves which can be drawn upon in years of above-average losses. The FSA is considering whether the amounts of these buffers should be at the discretion of the FSA (in which case the FSA will need the data and analytical skills to exercise such discretion) or should be determined by formula. The review prefers that the amounts should be determined by formula and suggests that buffers of 2-3% of risk weighted assets might be required at the peak of each economic cycle;
- as a further counter-cyclical mechanism, published accounts should reflect anticipated future losses (rather than the current position of reflecting only the position as at the date of the accounts) and create a non-distributable "Economic Cycle Reserve", to set aside profit in good years to anticipate likely future losses;
- the introduction of a gross leverage ratio backstop (i.e. a cap on the acquisition of assets, including under derivative contracts, in proportion to capital held). The review cites the examples of the Canadian maximum gross leverage ratio of 20:1 and the Swiss banking regulator's recent introduction of a backstop in order to shrink the trading books of Swiss banks;
- liquidity regulation and supervision is to have central importance. In addition to the liquidity reforms announced by the FSA in Consultation Paper 08/22 (Strengthening liquidity standards, December 2008), the review indicates that the FSA will consider the introduction of a "core funding ratio" (i.e. loans to deposits ratio), either as a cap on lending or as an indicator which would cause the FSA to adjust the liquidity requirements which are particular to the bank in question;

Increasing the scope of regulation

- given the increased costs of running a banking business that the above capital and liquidity reforms will give rise to, the review stresses the importance of reducing the ability of bank-like activities to be conducted beyond the scope of regulation. Therefore, the future approach to licensing of such activities will be to apply licensing requirements on the basis of the economic substance of a particular business rather than its legal form. For example, off-balance sheet vehicles which create significant economic risk must be treated as on-balance sheet for regulatory purposes. Further, regulators must be able to apply prudential regulation (such as capital and liquidity rules) to hedge funds or other types of financial intermediary if their activities become bank-like or systemic in importance. To enable macro-prudential regulation to be conducted effectively, regulators must be able to gather extensive information on hedge fund activities;
- to reduce regulatory arbitrage, offshore centres must become subject to internationally agreed regulatory standards;

Deposit insurance

- the review indicates that consideration should be given to a pre-funded deposit insurance scheme and for EU-wide co-ordination of deposit insurance cover, which could include pre-funding;

Risk-based approach to remuneration

- when assessing the risks in an institution, the FSA will have a strong focus on the risk consequences of the institution's remuneration policies and will enforce a code of practice on remuneration (the code includes a requirement that payment of deferred bonuses should be linked to financial performance during the deferral period), with increases in capital requirements being a potential consequence of failing to comply with the code. However, the review does not identify excessive remuneration as a primary cause of the financial crisis. The review indicates, ominously for highly-paid traders at banks, that the increased capital cost of trading book activity referred to above is likely to have the effect of reducing remuneration in respect of such trading;

Derivatives trading: netting, clearing and central counterparty

- support for current proposals to shift standardised credit default swap trades to central counterparty trading during the summer of 2009;

Reforming macro-prudential supervision

- macro-prudential analysis needs to be conducted by both the Bank of England and the FSA. Macro-prudential analysis needs to be conducted on a global level, pooling insights from macro, sector-wide and institution-specific analysis, with a view to reaching agreement on required changes to macro-prudential policy;

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The FSA's supervisory approach

- as indicated by the FSA's Hector Sants on 12 March 2009, the FSA's supervisory approach to banks is undergoing a radical shift away from a principles-based approach in which the focus was on individual institutions rather than systemic issues, systems and controls rather than business models, probity of senior management rather than their technical skills, and an emphasis on conduct of business regulation over prudential regulation. The new approach of "intensive supervision" will have the following features (some already announced in the context of the Supervisory Enhancement Programme which resulted from the supervisory failure in respect of Northern Rock): a significant increase in the resources dedicated to the supervision of high impact firms (but short of the level of supervision found in the "bank examiner" model employed by the U.S. Office of the Comptroller of the Currency); shift in focus from systems and controls to business outcomes and the sustainability of business models; a greater willingness to adjust capital and liquidity requirements to address business strategies that create undue risk to the bank or the system; FSA approved persons to be assessed on technical skills as well as probity; and a focus on remuneration policies;
- the review adds two significant elements to the previously announced shift to "intensive supervision": the FSA will develop skills in macro-prudential analysis (in addition to its development of skills in respect of sectoral risk); and more intensive interaction with bank management and auditors on published accounts and accounting judgements. The FSA's recent reviews of bank balance sheets in the context of bank recapitalisations and applications to the Asset Protection Scheme have highlighted differing approaches by banks to valuation of trading book assets and the allocation of assets between trading and banking books;
- the review requests further debate on the question of whether the FSA should play a role in product regulation (for example, imposing a maximum loan-to-value ratio in respect of residential mortgages);

Risk management and governance

- although detailed proposals from the FSA await the outcome of the Walker Review, the review indicates that the following changes in respect of banks' risk management will be required: assessment of technical competence of senior risk managers; assessment of governance in respect of risk oversight; risk management considerations to be reflected in remuneration policies; and skill levels and time commitment of non-executive directors to be increased;

Regulation of large banks

- the review rejects the proposal that institutional separation of utility and investment banks should be required;

Regulation and supervision of cross-border banks

- the review emphasises the importance (and limitations) of increased international co-operation between regulators, but in light of the inherent limitations to such co-operation, highlights the likelihood of an increasing national regulatory focus on the resilience of local legal entities. For example, the FSA will be more willing to require major international banks to operate as subsidiaries in the UK and to increase capital requirements on local subsidiaries. This will lead to higher overall levels of capital and liquidity requirements at a group level;
- the structure of EEA bank passporting and the division of home and host state responsibilities is unsustainable and requires reform at an EU level, such as the ability of host state regulators to oversee the capital and liquidity of banks operating via branches in the host state or the ability of regulators to require that a bank conducts its business through a host state subsidiary rather than through a branch;
- the EU should consider replacing the Lamfalussy committees (such as CESR) with a new pan-European authority with standard-setting powers and oversight powers in respect of supervision by national regulators; and
- the review requests further debate on the question of whether the FSA should play a role in product regulation (for example, imposing a maximum loan-to-value ratio in respect of residential mortgages).

The FSA also published a Discussion Paper (DP09/2) on 18 March 2009 to address some of the proposals in the review, with responses due by 18 June 2009.

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Conclusions

The review is a milestone both in banking and in financial regulation. Many of the reforms it proposes will have a significant impact on the banking sector and on other financial services sectors. Some of the reforms are already being implemented and others will only take shape in the context of international regulatory initiatives, reflecting the conclusions to be reached by the G20 in early April. What is clear is that the cost of banking is to increase significantly and that banking is to be "de-risked" by giving the adoption of risk the increased costs which market forces previously failed to impose.

As banks are to be "de-risked", with individual remuneration falling as a result, it is likely that high risk/return businesses will increasingly migrate away from banking groups (a continuation of the trend towards the creation of hedge fund managers and private equity houses). However, the more successful of these non-bank businesses will hit a ceiling, in that they will be subjected to bank regulation once they become bank-like in the risks they create. A key issue for non-bank financial services businesses is how the FSA will determine that a non-bank has become "bank-like".

Given the real costs to nation states of banking failures, there is likely to be a move towards nationally based measures, at the expense of the (until recently) liberal UK regime of allowing extensive banking business to be conducted in the UK under light passporting arrangements and within the scope of exemptions to UK regulation. A key issue for the UK financial services industry is the extent to which the introduction of these measures will take away one of the main reasons for the attractiveness of the City as a location for conducting financial services business.

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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