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FSA Update

7 March 2011

At the FSA last week:

- **First Retail Conduct Risk Outlook published**

  The FSA has published the first issue of its Retail Conduct Risk Outlook (RCRO), which looks at how a range of current, emerging and potential risks could affect customers. The RCRO analyses the environment in which the FSA, authorised firms and consumers operate. It assesses the main macroeconomic trends, the changing regulatory landscape, developments in firms and markets, and key issues affecting consumers – and the risks these all pose. The RCRO, together with the forthcoming Prudential Risk Outlook, replaces the previous FSA publication, the Financial Risk Outlook.
  http://www.fsa.gov.uk/pubs/other/rcro.pdf

- **Report published on systemic risk from hedge funds**

  The FSA has published a report titled "Assessing the possible sources of systemic risk from hedge funds - A report on the findings of the Hedge Fund Survey and Hedge Fund as Counterparty Survey". The report sets out the results of the FSA's latest Hedge Fund Survey conducted in September 2010 and the Hedge Fund as Counterparty Survey conducted in October 2010. These are conducted every six months as part of the FSA's work on assessing risks to financial stability from outside the boundary of prudential regulation. The report concludes that the latest results suggest that the footprint of surveyed hedge funds remains small within most markets and leverage is largely unchanged, so that risks to financial stability through the market channel seem limited at the time of the latest surveys. In addition, counterparties have increased margin requirements and tightened other conditions on their exposures to hedge funds since the crisis, increasing their resilience to hedge fund defaults. Nevertheless, some risks to hedge funds remain, particularly if they are unable to manage a sudden withdrawal of liabilities during a crisis period, potentially resulting in forced asset sales. Forced asset sales during stressed market environments may exacerbate pressure on market liquidity and efficient pricing.
  http://www.fsa.gov.uk/pubs/other/hf_survey.pdf

- **Guidance issued on reverse stress-testing**

  The FSA has issued proposed guidance on "Reverse Stress-Testing: Frequently Asked Questions". It takes the form of responses to questions raised by members of the industry during two rounds of presentations that were held in April/May and September/October 2010. Comments are requested by 16 March 2011. In particular, questions were asked in the following areas: (1) scope of application of the requirement; (2) process – timings, definition of business model failure; (3) scenarios – how many, time horizon, incorporation of management actions; (4) governance; and (5) use of the outputs of the exercise.
  http://www.fsa.gov.uk/pubs/guidance/GC11_08.pdf

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- **Handbook development newsletter issued, renamed**

  The FSA has published issue 132 of what used to be its Handbook development newsletter, now renamed the Policy development update.
  http://www.fsa.gov.uk/pubs/handbook/hb132.pdf

- **FSA speaks about creating the FCA**

  Hector Sants, the FSA's Chief Executive, has given a speech about the opportunities created by the government's intention to establish a specialist regulatory authority focusing on consumer protection and markets: the Financial Conduct Authority. Mr Sants began by acknowledging that, historically, both the FSA's approach and its powers have proved inadequate to meet the expectations of society with regard to protecting consumers in financial matters. He then set out his vision of the FCA's consumer protection agenda, which, he stated, will be based on a proactive and intensive approach and consist of the following four elements:

  - addressing structural deficiencies in sectors and the market place as a whole which limit or impair consumer choice and experience;
  - delivering intensive supervision of firms to ensure they are treating customers fairly – in particular, focusing on point of sale practices, product manufacturing frameworks and firms' governance and culture;
  - making proactive product-based interventions, often on a thematic basis when sound business analysis shows the product is likely to cause more harm than benefit; and
  - ensuring that in the event failure has occurred, the appropriate level of redress and compensation is achieved, and where necessary taking action against firms and individuals to deliver effective 'credible deterrence'.

  Mr Sants argued that, in order to work, the FCA will need stronger powers of intervention than the FSA currently has. In particular, he expressed strong support for powers to intervene to ban specific products. He also noted that the Treasury's consultation document raises the possibility of the FCA having formal powers to refer firms to the competition authority and to make formal market investigations to determine whether such referrals are necessary, and indicated that he strongly support these proposals. However, he emphasised that these new powers will require both consumers and the industry to trust and have confidence in the FCA and its judgments.

  On the subject of the FSA's consumer 'tool-kit', Mr Sants said "Another key element of the FCA's approach to policy-making will be striking the right balance between rules and principles. I have previously said that I expect the FCA to shift towards more detailed prescription, and I take the opportunity today to re-emphasise that point. Effective enforcement and redress requires clarity of responsibilities and a process which can stand up to clear external scrutiny. It is thus inevitable that a conduct regime will lean more towards rules than principles as this is a necessary consequence of its focused objectives."

  Turning to the regulation of markets and wholesale conduct, Mr Sants argued that the FCA must be prepared to intervene early to deal with emerging wholesale conduct issues, particularly where these have a link to retail markets and consumers. However, he stressed that the likely increased focus by the FCA on wholesale conduct needs to be achieved whilst continuing to recognise the difference between investor protection and consumer protection.

  Mr Sants also discussed the European context of the FCA's work in light of the newly created European Supervisory Authorities (ESAs). He highlighted the importance of being able to influence decision-making in this wider European framework, and the need for effective domestic coordination and cooperation between the regulatory authorities to ensure the UK's views are best represented.

  Finally, Mr Sants discussed the transition to the new regulatory structure. In particular, he indicated that, in preparation for the transition, the FSA will be moving to a new management structure in April 2011, replacing the current Risk and Supervision business units with the Prudential Business Unit and Conduct Business Unit.
  http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2011/0302_hs.shtml

- **Lord Turner speaks about regulatory reforms**

  Lord Turner, Chairman of the FSA, has given a lecture (with slides) at Clare College, Cambridge, in which he argued that regulatory reforms in the wake of the financial crisis have not been radical enough. Amongst other things, Lord Turner suggested that:

  - Basel III is a major step forward, but in an ideal world, equity ratios would be set much higher;
  - addressing the 'too big to fail' issue by making it possible to resolve banks smoothly is an essential element of improving financial stability, but it is not necessarily a sufficiently radical response to the crisis;
  - regulators must ensure they understand the drivers of shadow banking and guard against

the re-emergence of new risks in new financial mutations;

- complexity and interconnectedness are important in themselves, and specific regulatory action to offset the externalities created may be required;
- if measures to make competition more effective are not always capable of generating optimal results, neither taxation nor state provision should be excluded from the policies considered – in particular, Lord Turner indicated that there may be a case for financial transaction or other financial activity taxes; and
- constraints on pay within banks, even if effective, will not in themselves constrain the level of pay in other segments of the financial system, including in the shadow banking system, to which financial activities currently performed by banks could in future migrate. http://www.fsa.gov.uk/pubs/speeches/0218_at_clare_college.pdf http://www.fsa.gov.uk/pubs/speeches/0218_at_clare_college_slides.pdf

Paul Tucker, Bank of England Deputy Governor for Financial Stability, responded to the lecture by highlighting what he regarded as the most important challenges for regulators. Amongst other things, he argued that:

- the crisis happened partly because the authorities did not keep up with developments in capital markets, and regulators need to attend to risks beyond banking (in shadow banking etc.) by developing policies on firms and funds that perform similar economic functions to banking, such as money funds;
- it is vital that regulatory capital requirements for banks more or less accurately capture their risks – in this context, Mr. Tucker underlined the importance of the Basel Committee on Banking Supervision's current work to review fundamentally the capital requirements for banks' trading books;
- resolution regimes should be enhanced, but, at the same time, global systemically important financial institutions should carry greater loss absorbing capacity than implied by Basel III; and
- in practice, regulators are going to have to be open-minded about quasi-equity instruments contributing to greater loss absorbing capacity for systemically important financial institutions, with Contingent Capital bonds (CoCos) currently being the leading candidate.

Mr Tucker concluded by emphasising that whether or not the Bank of England's new Financial Policy Committee proves to be a success will depend not only on its ability to identify risks, but also on whether it can ensure that the wider debate about stability does not end.
http://www.bankofengland.co.uk/publications/speeches/2011/speech477.pdf

FSA Update will return on 18 March 2011.