

**Response from the Financial Services Authority (FSA) to the Treasury
Committee report on *Banking Crisis: Regulation and Supervision***

1. We welcome the Committee's report on *Banking Crisis: Regulation and Supervision*. In this memorandum we respond to those detailed conclusions and recommendations which are relevant to the FSA.
2. The issues raised in the Committee's report are high on our agenda as we work with other authorities in the UK, the EU and internationally to improve the regulatory framework for the future. We look forward to continuing to engage with the Committee on these issues.
3. Since giving evidence to the Committee, we have continued with our work on our supervision of firms and on the wider regulatory issues arising from the crisis. This includes:
 - **Turner Review Feedback Statement:** On 30 September we published a Feedback Statement setting out our analysis of the responses we received to the March 2009 Turner Review and associated Discussion Paper, and reporting on the progress made since March in implementing change and in achieving international agreement. The feedback we received raised some important issues relating to detailed implementation, but in general supported the broad thrust of the agenda proposed in the Review and now being pursued. Our further Discussion Paper, published on 22 October (*The Turner Review Conference Discussion Paper, A regulatory response to the global banking crisis*) focuses on two issues where there is not yet a clear consensus, where debates have suggested new approaches since we published the Turner Review and where the FSA's thinking continues to evolve. These two issues are how we deal with systemically important firms and how to assess the cumulative impact of the various capital and liquidity changes being proposed. These are important questions on which we hope our paper will stimulate debate.
 - **Liquidity requirements:** On 5 October we published our final rules on the liquidity requirements expected of firms. The new rules will require changes to firms' business models and will bring about substantial long-term benefits to the competitiveness of the UK financial services sector. Specifically, the rules include: an updated quantitative regime coupled with a narrow definition of liquid assets; over-arching principles of self-sufficiency and adequacy of liquid resources; enhanced systems and controls requirements; detailed and more frequent reporting requirements; and a new regime for foreign branches that operate in the UK. This integrated approach involves analysing risk at an individual firm level, with supervisors being supported by sector analysis and high quality technical advice from specialists in prudential and conduct risk. We now seek to make judgements on the judgements of senior management and take action if, in our view, those actions will lead to risks to our statutory objectives.
 - **Restructuring:** As the Committee is aware, since March 2008 we have been working hard to deliver intensive supervision. This has required greater resource, more technical expertise and a reassessment of risk. In October we

implemented a new FSA operational structure designed to better align our internal operating model to our core activities of identifying and mitigating risk, supervision and enforcement.

4. In our response, we identify the recommendations relevant to the FSA and cite the relevant extract from the report, followed by our response.

FSA supervision

We welcome the speed of progress made by the FSA under the Supervisory Enhancement Programme in recruiting staff, and boosting training, in order to improve its scrutiny of UK banks. Although it is difficult, and too early, to tell what impact the SEP has had on the banks' behaviour, we are encouraged by the fact that the financial services sector has clearly noticed a change in approach. The SEP is a necessary, but not sufficient, response to the problems of the financial crisis. (Paragraph 13)

5. We welcome the Committee's support for our Supervisory Enhancement Programme. We have made clear that we cannot go back to business as usual and accept the risk that a similar crisis occurs again in ten or 20 years' time. Radical change is needed. We are confident that the Supervisory Enhancement Programme, combined with changes in regulatory philosophy and in substantive regulatory requirements (in particular, on capital and liquidity), is well designed to reduce the risk that past mistakes are repeated.

The FSA must develop sufficient self-reliance to stick to its guns in the face of criticism from industry or politicians, because ultimately, the job of the FSA may be to make unpopular decisions from time to time. (Paragraph 23)

6. We have acknowledged that in the past there was a strong mindset among regulators that financial innovation was always beneficial, more trading and more liquidity creation was always valuable, and that ever more complex products were beneficial because they allowed a more precise matching of instruments to investor demand for liquidity, risk and return combinations. We have had to change that mindset and we have now done so.
7. We are imposing at firm level a far more assertive style of supervision. We are no longer willing to assume that market discipline and incentives will always lead firms' management to make optimal decisions. We are now actively making judgements on whether business models and business strategies create undue risks for the whole financial system.

In addition to the FSA developing the confidence to make unpopular judgements and act on the basis of them, we are in favour of the supervisor receiving some automatic tools to put sand in the wheels of financial expansion, without having to prove beyond all doubt that its actions are necessary in the face of resistant firms. (Paragraph 24)

8. We support the development of a formula-driven ('automatic') approach to setting counter-cyclical capital buffers and/or forward-looking general provisions that would build up in periods of strong economic growth and be

available to firms to use in a downturn. This would increase the resilience of the banking system and should slow down any excess credit expansion. In order to be effective, such rules should be agreed internationally, and we are working to that end through the Financial Stability Board and the Basel Committee on Banking Supervision. We require firms to hold capital relative to the level of risk in the activities they undertake. Our capital framework already goes further than the Basel II rules and uses stress tests to calculate how much capital a bank needs in order to withstand a severe potential stress and emerge not only solvent but still well capitalised.

Approved Persons regime

The FSA's assessment of whether senior bankers were fit and proper for their posts appears to have been little more than a tick-box formality, unless the applicant had a criminal record or gave some other evidence of a shady past. That bar was demonstrably set too low. We welcome the acknowledgement from the FSA that a candidate's competence, as well as their probity, will now be thoroughly reviewed before taking up a senior post in a bank. We recognise that there may be some dangers in the FSA assessing competence, not least because the FSA will become exposed to accusations of incompetence itself, if it makes a wrong judgement. (Paragraph 31)

9. As outlined by our Chief Executive, Hector Sants, to the Committee, in reviewing the recent firm failures, we considered what can be done to improve the quality of decision-making by firms' management. In recent months we have taken a number of steps to improve our processes and practices for approving and supervising individual senior managers in firms.
10. In July 2009 we confirmed an extension of the Approved Persons regime for those that perform a 'significant influence' function (SIF) in firms. In particular we have:
 - extended the scope and application of our regime to include individuals employed by a parent undertaking or holding company (which is not itself regulated in the EEA) whose decisions or actions are regularly taken into account by the governing body of an FSA regulated firm;
 - extended the definition of the 'significant management' controlled function to include all proprietary traders who are not senior managers but who are likely to exert significant influence on a firm; and
 - amended the application of the approved person regime to UK branches of overseas firms based outside the EEA.
11. In addition, in October 2009 we wrote to the CEOs of all relationship-managed regulated firms to explain how our more intensive regulatory approach applies to approving and supervising senior personnel performing SIFs. The letter reminds CEOs that it remains the firm's responsibility to ensure that the candidates they put forward for senior roles are fit and proper to perform the role in question, and that firms should, therefore, have robust recruitment, referencing and due diligence processes in place. As part of the Approved

Persons process, we will undertake close vetting of appointments and will interview candidates applying to perform certain SIF roles in particular firms. In the period October 2008 to September 2009 we have conducted 172 SIF interviews, resulting in 18 candidates withdrawing their applications. This shows that there is considerable scope for some firms to be more robust in their own recruitment processes.

12. Events over the last two years have also raised serious questions about the role, competence and performance of non-executive directors (NEDs). In a Consultation Paper in December 2008 (*The Approved Persons regime – significant influence function review*) we set out our proposals to look at NEDs more closely where we believe they should have intervened more actively within a firm's management. Before making a final decision on this issue, we wish to consider the relevant recommendations from *The Walker Review* and the Financial Reporting Council's review of the Combined Code. We aim to publish a further Consultation Paper in December 2009 which will include further proposals to strengthen our approach to approving SIFs.

We recommend that the FSA assess whether bank executives should possess relevant qualifications. We would like to see banking qualifications become one of the core indicators against which the FSA can assess a candidate's competence. If a candidate has no relevant qualifications, the onus should be on them to prove to the FSA that they have relevant compensatory experience. To this end we recommend that the FSA work with the British Bankers' Association to draw up a list of relevant qualifications, and perhaps even work to encourage academic institutes to design new qualifications tailored towards the skills required of banks' senior management. (Paragraph 32)

13. We strongly agree that it is important for bank executives to have the right level of skills and experience. As noted above, we have recently written to all CEOs of relationship-managed firms reminding them that it remains the firm's responsibility to ensure that the candidates they put forward are fit and proper to perform the role in question, and that firms should, therefore, have robust recruitment, referencing and due diligence processes in place.
14. In the course of implementing our more intensive supervisory approach in this area, we may find instances where we are happy to approve a candidate for a senior, influential role, but where the interview has highlighted areas of development for the individual concerned. In these instances we may ask the individual and firm to put an action plan in place to complete appropriate training or development in those areas. We will then follow up with the firm and the candidate to check that the action has been completed.
15. Our Training and Competence rules cover qualification requirements. We will review these rules in 2010, including any need for training and competence requirements for firms' senior management, and will take the Committee's views into account in that context.

Due diligence by banks' creditors and others

It would be extremely dangerous if the FSA were to become the single point responsible for the identification of failure. It is important that investors and others conduct due diligence and necessary scrutiny of banks... A balance needs to be struck by the FSA which places sufficient incentive on them to perform satisfactory due diligence. We recommend that the FSA outlines its thinking on the appropriate level of protection for creditors of banks and how it proposes to do this. (Paragraph 36)

16. We agree it would be undesirable for creditors of banks to believe that they could rely on the FSA to protect their interests, without them needing to undertake their own due diligence. It is important, therefore, that creditors – as well as shareholders – understand our role. The regulation and supervision of firms is based on our statutory objectives; we aim to mitigate risks to these objectives, rather than risks to shareholders or creditors. It is very important that shareholders, as owners of the business, discharge their responsibilities properly, including by scrutinising business strategies and assessing management competence.
17. The powers in the Banking Act 2009 are intended to increase the authorities' options for resolving a troubled bank. While there are a variety of legal safeguards and compensation mechanisms that apply when these tools are used, they are not intended necessarily to make creditors whole. As the Committee noted in its report, only certain types of deposit are protected by the Financial Services Compensation Scheme (FSCS) when a firm fails. Work is under way to support the use of these tools in all circumstances, including in relation to large banks. For instance, we have already made rules to require firms to maintain a 'Single Customer View' which will aid depositor payout if a bank enters the Bank Insolvency Procedure. As the Committee notes elsewhere in its report, work on 'living wills' is intended to prepare for the failure of a bank and we set out our thinking on that in our 22 October Discussion Paper. However, there is a balance to be struck in designing the appropriate regime in which banks should operate. An environment in which bondholders and senior creditors face greater costs is likely to affect the funding of banks. It was for this reason that the Tripartite Authorities ruled out making depositors a preferential class of creditor.

Systemically important firms

Those banks which are too big to fail must no longer be able to take advantage of that fact for private gain. Market discipline must be reintroduced in order to realign the incentives of bank investors and managers. We welcome the ideas put forward regarding a 'tax on size' administered through the capital regime. (Paragraph 44)

18. As we noted in our 22 October Discussion Paper, it is clear that the future regulatory regime must include effective answers to the 'too big to fail', 'too interconnected to fail' and 'too big to rescue' problems.

19. Our Paper aims to stimulate debate on the range of possible policy responses, and we welcome contributions to help us finalise our policy position. Our current stance is:
- There is a strong case for applying some form of capital (and perhaps liquidity) surcharge to systemically important firms, both to reduce the probability of them failing and to require them to internalise the externality costs which their systemic importance produces;
 - This capital surcharge approach could be combined with an approach to global banking groups which places greater emphasis on the standalone sustainability of national subsidiaries, with an overt global understanding that home country authorities will not consider themselves responsible for the rescue of entire groups;
 - Action should be taken to reduce interconnectedness in wholesale trading markets, with much OTC derivative trading moved to central counterparty clearing systems, and with collateral and margin call arrangements for bilateral trades which reduce the dangers of strongly pro-cyclical margin call effects;
 - Reforms to the trading book capital regime should significantly increase capital requirements, and differentiate more strongly between basic market-making functions which support customer service, and riskier trading activities, with a bias of conservatism in relation to the latter; and
 - Systemically important banks should be required to produce recovery and resolution plans ('living wills') which set out how the operations would be recovered or resolved in an orderly fashion.
20. While any discussion of systemically important firms will tend to focus on banks, we recognise that other firms and infrastructure providers (both regulated and unregulated) can potentially be systemic, even though the risks they pose can be very different. This means that, while our recent Paper focuses on systemically important banks, we will, in due course, consider how a framework for systemically important firms in general could be developed.

Capital requirements must tackle any incentives that banks have to grow or merge merely for the sake of becoming 'too big to fail'. Further, and admittedly more difficult, since capital requirements are a form of insurance, they should ideally be calculated on an expected loss basis, taking into account both the probability of a bank's failure and the potential costs of such an event occurring. (Paragraph 45)

21. On incentives for banks to grow or merge, we are taking a keen interest in the sustainability of banks' business models and are providing greater challenge to banks' business plans, including plans to grow or merge.
22. In the past there have been cases of mergers, especially cross-border mergers which had been motivated in large part by diversification benefits designed to reduce the overall capital requirements of the combined group. Such claims for

merger-related capital relief will be subject to greater scrutiny, and there may be a case for disallowing them or imposing off-setting capital charges for the operational risk associated with business integration.

23. On the calculation of capital requirements, our capital framework goes further than the Basel II rules and uses stress tests to calculate how much capital a bank needs in order to withstand a severe potential stress and emerge not only solvent but continuously maintain a core tier 1 capital ratio of at least 4%. The established Basel II capital requirements were calculated to cover not just the 'Expected loss', taking into account the probability of failure, but also the 'Unexpected loss' expected to occur only with a very low probability. We recognise, of course, that the potential losses and probabilities turned out to have been estimated with inadequate data and models, and failed to capture all risks.
24. As outlined in our 22 October Discussion Paper, there is a strong international consensus that the global framework for prudential regulation must be radically reformed to create a more robust and resilient financial system. In future, the global banking system will hold significantly more capital and liquidity and operate at lower levels of leverage. Within the context of this general principle, agreed by the FSB, the Basel Committee of Banking Supervisors (BCBS) has a series of work streams to design the details of:
 - an overall regime of higher capital requirements, with higher quality capital (more focus on Core Tier 1 capital) and higher minimum ratios;
 - a countercyclical element to capital, with capital buffers built up in good years to be drawn down in recessions;
 - a possible capital surcharge for large systemically important firms;
 - significant increases in trading book capital, with more rigorous definition of trading risks reflected in higher risk-weighted assets, and thus higher capital requirements even before the impact of changes in required ratios; and
 - a new liquidity regime, with increased buffers of clearly liquid assets and some type of structural mismatch ratio.
25. We will need to ensure that the cumulative effect of this package of measures is carefully considered, identifying both costs and benefits.

Capital requirements

The FSA proposals to subject proprietary trading activities carried out by retail banks to much higher capital requirements is welcome, and the bare minimum given the failure of the concept of 'liquidity through marketability' that previously underpinned the relatively low capital requirements of trading books. Calculating how swingeing those capital requirements ought to be is a tricky balancing act. As they get tougher, their impact will get closer and closer to that of a prohibition on proprietary trading. A ban may not be necessary if firms are given sufficient incentive to separate their trading units from their retail banking

activities of their own accord, but a ban should not be ruled out by the FSA as an option at this early stage. (Paragraph 53)

26. Trading activities appeared lucrative to bankers because of low funding cost and low capital requirements. The low funding costs can be attributed to a range of factors, including financial innovation (especially secured financing, such as Asset Backed Securities and repos), the implicit government guarantee, and arguably monetary policy. The low capital requirements resulted from capital rules for trading book exposures that were largely based on banks' own Value-at-Risk (VaR) methodology, and which failed to capture adequately key risks, including an inadequately short window for market data and omission of counterparty risk. The Basel Committee has already announced an incremental risk charge (we are proceeding with early implementation of the incremental default risk charge for 2010) and a fundamental review of trading book capital, which looks set to address more of the shortcomings (e.g. stressed VaR to cover risks of market stress).
27. As outlined in our 22 October Discussion Paper, we believe there must be a limit to the extent to which implicit government guarantees support unnecessary levels of risky proprietary trading. An important open issue is whether this restructuring of complex integrated groups should go as far as requiring – within the same overall group – clear separation between the retail deposit-taking businesses and any businesses involved in proprietary trading activities. One possible approach is to recognise a trade-off, with the capital surcharge for systemically important banks lower for those groups which go further in the direction of clear legal separation of different activities.
28. At this stage we are not ruling out anything, including potentially punitive capital charges or outright banning of certain types of activities. But we are seeking international agreement on the way forward, to maintain a level playing field between banks in the UK and elsewhere.

We agree with the Governor of the Bank of England that highly complex, inter-connected banks should face higher capital charges than simpler banks, because they impose a greater risk on the financial system as a whole. In order to inform such flexing of the capital regulations, we recommend that the FSA initiate work to increase its understanding of the extent and nature of the interconnections between financial firms. (Paragraph 55)

29. Our 22 October Discussion Paper addresses the issue of systemic importance and how it can be measured. In general, a firm is systemic when its collapse would impair the provision of credit and financial services to the market, with significant negative consequences for the real economy. The factors which make firms systemically important fall into three categories (although firms may combine elements of these factors): systemic by size; systemic by interconnectedness; and, systemic by herd. Measures of inter-connectedness can be very challenging given the speed and extent to which they can vary, on a daily or even intra-day basis. That said, it is relatively straightforward to identify a group of large and highly inter-connected firms that are likely to be systemically important in all circumstances

30. We are already working on a range of possible policy measures to deal with systemic large complex financial institutions (LCFIs), including requirements for more and better capital. We are working with the Basel Committee and Financial Stability Board to determine an internationally coordinated approach to systemically important, internationally active LCFIs.
31. As part of the FSA restructuring referred to above, we are expanding our Financial Stability team to become a new division, focusing on macro-prudential analysis and on understanding the extent and nature of interconnectedness in the financial system.

Tripartite correspondence

Lord Myners told us that the FSA had been charged with a new requirement to advise the Chancellor twice a year on new areas of innovation and their consequences for systemic risk, and any statutory changes that would be required to take account of that. We recommend that the FSA's advice to the Chancellor on new areas of innovation and their consequences for systematic risk should be published. (Paragraph 59)

32. Information on any material systemic risks from new innovations are already highlighted and published in our Financial Risk Outlook and in the Bank of England's Financial Stability Review. We will consider the publication of this additional information in line with current guidelines which state that any correspondence between the Tripartite Authorities would be subject to the deletion of any market sensitive or confidential information.

Understanding of banking activities

The FSA should only permit banking activities that it understands, and that it has confidence that the bank concerned understands. (Paragraph 62)

33. We agree with the Committee's view that it is important that both the FSA and firms themselves understand the banking activities that are being conducted.
34. As noted earlier, in March 2008 we launched our Supervisory Enhancement Programme. As part of this programme, we have significantly increased the number of specialist and supervisory staff (280 additional staff by the end of 2009) and introduced a new training and competence scheme to ensure that our staff are properly equipped to do the job, which involves a regulatory testing regime for existing supervisors. We believe we have made good progress on this and will continue to make the necessary improvements to our organisational effectiveness, ensuring we are staffed by the right people, in the right jobs, with the right infrastructure.
35. As to ensuring that banks make sure that they understand their own business, our work on Significant Influence Functions, outlined above, is designed to ensure that banks appoint to their boards and senior management positions individuals who have the skills, expertise and knowledge required in those roles. Our assessment of such individuals now focuses more than in the past on

technical competence in risk management, the ability to understand the data and the fundamentals, and to apply that practically to the role in question.

Product regulation

We are instinctively wary of placing too much reliance on product regulation, because it tends to be a blunt instrument. Typically it creates new opportunities for the identification and abuse of loopholes and work-arounds, and restricts some legitimate uses of the product concerned. We believe however, like the FSA, that regulators should keep an open mind and look at each product on its own merits. If, for example, a particular product has some legitimate uses and benefits, but these are significantly outweighed by inappropriate uses, the FSA should look very closely at restricting their use. (Paragraph 64)

36. The Turner Review challenged, in particular, the idea that we should avoid regulating financial products. The term 'product regulation' encompasses a whole spectrum of possible measures, including, in extremis, pre-approving or banning products. However, we may also require firms to demonstrate that they have scrutinised the features, functionality, design processes, risk management, and lifecycle of products in the retail market and assessed the resulting benefits to consumers.
37. We agree with the Committee that our approach to regulation should not be overly reliant upon product regulation, but that we should keep an open mind to the utility of product regulation in addition to our consideration of the sales and marketing of products, where disclosure alone may not be sufficient.
38. In deciding whether to regulate financial products we need to balance the fact that product regulation could potentially improve consumer outcomes, but it could also change competition dynamics within the marketplace and we would need to be sensitive to the economic effects and wider environment. We would also need to consider the costs and limits of product regulation which, like any other single regulatory tool, is unlikely on its own to deliver the answer. For example, our recent Mortgage Market Review Discussion Paper proposes a form of product regulation as one important component of a package of proposals to reform that market.

Living wills

Improving bank resolution mechanisms is a vital component of financial services sector reform. Currently, the fact that there is no means by which large, complex banks can be resolved encourages complacency in these banks, contributing to the moral hazard dangers discussed above. The Special Resolution Regime is an important mechanism, but its usefulness is reduced somewhat by its inability to cope effectively with the resolution of a large, complex bank. That weakness derives from a lack of information about how major banks are internally structured, an issue which must be addressed. We fully support the proposal of each bank writing a 'will' and subjecting that will to regular evaluation by the Bank of England. Banks may not like it, they may even threaten to domicile elsewhere, but in our opinion this is a reform that is clearly needed. (Paragraph 76)

39. This is an area we are developing further; we agree that adequate preparations for difficult times are important. We outlined our current views on living wills in our 22 October Discussion Paper. This includes the need for resolution plans to identify the actions that firms would need to take to enable the authorities to use the Special Resolution Regime (SRR) tools (or for the firm to be placed into insolvency, if the SRR is not applicable). As noted above, we have already made rules requiring firms to introduce a 'Single Customer View' by the end of 2010. This will cover, for each customer, the deposits they have with the bank and the extent to which they are covered by the FSCS.
40. We will require further resolution planning from systemically significant firms, falling into three broad categories:
- firms will need to be able to assure the authorities that they can provide at short notice the data that is necessary for the authorities to assess the resolution options;
 - firms will need to have undertaken an analysis of the potential barriers to the authorities being able to exercise the SRR powers: implementing the bank insolvency procedure; transfers to a private sector purchaser (whole firm and partial transfer); use of a bridge bank (whole firm and partial transfer); temporary public ownership of the deposit taker; and temporary public ownership of any holding companies; and
 - firms, together with payments, clearing and settlement infrastructures, will have to conduct an analysis of how the firm could 'unplug' itself from the relevant infrastructure so that the infrastructure itself remains robust and continues to operate and so that damage to other participants is minimised.
41. We expect that authorities will require relevant firms at all times to have made ex ante preparations and produced plans for recovery and resolution. Once a firm has produced these plans they will be subject to review by the FSA, in consultation with the Bank of England. We will assess the risks identified by these plans and the actions proposed by the firm to mitigate them. This will form the basis for considering whether further actions are required by the firm to remove obstacles to recovery or resolution. This may include the need for structural change and/or off-setting measures such as capital and/or liquidity where the organisation of the group and its regulated activities could pose a risk to implementing the living will.
42. In taking forward the implementation of living wills, we will work closely with the Bank of England and HM Treasury, as well as international colleagues through the Financial Stability Board, developing common approaches where possible but also recognising that living wills will need to be tailored to the recovery and resolution frameworks in individual jurisdictions. We believe that it is important for the UK to begin its domestic implementation of living wills in parallel with ongoing international work.

Counter-cyclical

The Basel capital rules are the result of over a decade of negotiations and planning. Unfortunately they do not work, or at least do not work in a crisis, which is precisely when they are most needed. Arguably they have made things worse by distracting the attention of leading experts, and have had the effect of driving much financial activity off balance sheet altogether. There may be a place for risk-based capital requirements, but there is also undeniably a need for a minimum level of capital based on a bank's size. We welcome the steps being taken in the UK and in the international arena to introduce a leverage ratio as a backstop measure to prevent banks being able to reduce their capital levels to an unacceptable level. (Paragraph 89)

There is now a burgeoning consensus that counter-cyclical capital requirements are needed; the debate has moved on to what that means in practice. We believe that such requirements should, as much as possible, be based on simple rules... Nevertheless, there is a place for regulatory judgements, so there should be some limited flexibility in the application of the rules. (Paragraph 95)

43. We set out our views on policy tools to address pro-cyclical in March 2009 in *The Turner Review* and accompanying Discussion Paper. We are developing policy options along those lines and participating in international policy work to develop tools to counter pro-cyclical. On 6 September international agreement was reached (in the Group of Central Bank Governors and Heads of Supervision, the oversight body of the BCBS) on the need to introduce a framework for countercyclical capital buffers above the minimum requirement. The framework will include capital conservation measures such as constraints on capital distributions. The Basel Committee plans to review an appropriate set of indicators, such as earnings and credit-based variables, as a way to condition the build-up and release of capital buffers. Many details still need to be clarified, but it appears likely that the eventual outcome will meet the Committee's call for policy tools that have a strong basis in rules and aim to build up buffers during good times.

Liquidity regulation

Solutions to the problems of liquidity regulation need to distinguish between idiosyncratic failures of liquidity risk management at specific firms, and widespread liquidity crises caused by the freezing of entire asset markets. In the former case, the regulator's onus should be on ensuring that financial institutions are given the right incentives to manage the risk, in order to avoid moral hazard. In situations where there is systemic market freezing, liquidity should be viewed as being a public good, and be provided for by the central bank. Analysis of the maturity mismatch between assets and liabilities on a bank's balance sheet might be one angle from which to approach liquidity regulation in the future, and we would welcome the FSA's views on this matter. (Paragraph 99)

44. One of the key conclusions of *The Turner Review* was that, once recovery was assured, the banking sector needed more and better quality regulatory capital, capital requirements that did not exacerbate the business cycle, and stronger

liquidity regulation. The main forum for agreeing global capital standards in these areas is the BCBS and, at the London Summit, the G20 asked the BCBS to work with national authorities to develop a new global framework for liquidity and strengthen prudential requirements.

45. The BCBS, now expanded to include all the G20 nations, has made good progress towards delivering on this commitment and in July 2009 it held its first meeting in its newly expanded form. Following this the BCBS announced it would issue a consultation by Q1 2010 which will include proposals to strengthen the quality of bank capital; build up cyclical buffers that can be drawn down in periods of stress; and introduce a leverage ratio as a backstop to Basel II. Further, Governors and Heads of Supervision have publicly announced that we will 'introduce a minimum global standard for funding liquidity that includes a stressed liquidity coverage ratio requirement, underpinned by a longer-term structural liquidity ratio'.
46. As well as taking part in international discussions, we have also made significant progress on domestic implementation of our reformed liquidity regime. Consistent with commitments to implement the new regime from Q4 2009 onwards, we have completed our consultation on our new liquidity framework. Our Policy Statement 'Strengthening liquidity standards', published on 5 October, contains our new rules on the liquidity requirements expected of firms.

Loan-to-Value ratios

We look forward to examining the FSA's proposals for regulatory reform in the area of loan-to-value ratios. (Paragraph 102)

47. On 19 October we published our Discussion Paper on the future regulation of the mortgage market, in which we set out our views on how we can ensure a sustainable mortgage market that works for consumers. A question that had already generated considerable debate was whether we should cap loan-to-value (LTV) or loan-to-income (LTI) ratios. We have also considered the case for specifying debt-to-income (DTI) ratios. We already use LTV thresholds for prudential purposes. These thresholds are not hard limits beyond which no lending can occur, but are used to set capital requirements which rise as the LTV increases. This is because LTV remains an important indicator of risks to a firm.
48. Our analysis suggests that LTI ratios do not take into account individual expenditure, therefore do not accurately reflect affordability, and would therefore be a blunt and also ineffective policy lever to ensure responsible lending. We therefore see no case for imposing an LTI cap. With regard to LTV caps, in turn, our analysis shows that high LTV ratios appear to be much less a determining factor for individual defaults than factors such as the level of the applicant's credit impairedness. For example, standard mortgages of 95-100% appear less likely to default than self-certified mortgages of 75-90%. Also, average LTV ratios have actually not increased over the past decade or so but slightly decreased. From this, we believe the case for imposing an LTV cap on consumer protection grounds is not clearly proven.

49. We do not, however, rule out the application of LTV, LTI or DTI caps in future as tools that could be employed as part of a wider counter-cyclical macro-prudential framework (a discussion which is out of the scope of the review) or in light of further analysis of the pattern of arrears and repossessions as the current downturn continues. Also, there are some products that combine several borrower and/or product risk characteristic in a single mortgage transaction, and we are currently assessing which of these combinations are so inherently unsuitable for an applicant that they should be banned (e.g. a 95% LTV mortgage on an interest only basis to a credit impaired applicant).

Macro-prudential supervision

Devising an appropriate institutional framework for macro-prudential supervision is extremely important and should not be rushed. We agree with the argument made by each of the Chancellor, the Governor and the Chairman of the FSA that it is necessary to reach an agreement on the precise instruments needed in the macro-prudential toolbox, before considering which organisation should wield those tools. (Paragraph 113)

50. In its paper on reforming financial markets, the Government set out a variety of tools that could be deployed to reduce macro-prudential risks. Following this, the government plan to introduce a Bill this autumn, which will lay out how they will work with us, the Bank of England and international partners, both to develop a framework for monitoring and assessing macro-prudential risk and for analysing fully the impact of the range of macro-prudential tools on the wider economy. We will participate actively in these discussions.

Cross-border banks

The existence of large, complex, cross-border banks brings both benefits and dangers. As the Governor has said, whilst banks may be global in life, they are national in death, because if such a bank were to fail, the regulator in the bank's home state would have the responsibility of resolving the firm. Not only would this be an unenviable task for the home state authorities, it would also present problems for host states, as they would have very little control over the fate of the firm's banking operations within their countries. This makes all the more critical the insistence on a 'will' for any bank operating in the UK. Colleges of supervisors are certainly a good idea, as they will provide a forum through which information about large banks can be shared, but we doubt that they are enough on their own. We support the idea that the national banking units of global banks should be obliged to establish as stand-alone subsidiaries of the parent group, regulated and supervised by the host state regulator. The capital of these stand-alone banking units would need to be ring-fenced to prevent the parent group snatching it away upon failure of the global bank. We recommend that the FSA should consider how feasible such a system would be, including whether or not it could be implemented unilaterally without international agreement. Sacrifices to efficiency of global firms in peacetime would be a price worth paying for the reassurance that a possible crisis could be contained within national boundaries if the firm failed. (Paragraph 132)

51. As outlined in *The Turner Review* we recognise this is a difficult issue and something that has to be considered carefully. Since the publication of the Review, the EU Commission and Council have agreed the broad outline for reform of the EU's regulatory architecture. The existing Level 3 advisory committees will each be transformed into European agencies called European Supervisory Authorities (ESAs). In addition to the existing Level 3 responsibilities of advising the Commission and promoting supervisory convergence, the new ESAs are likely to be given the following further competences:
- powers to develop binding technical standards for adoption as Commission rules, in areas to be specified and subject to Commission endorsement;
 - supervisory powers over entities with pan-European reach, initially confined to including CRAs;
 - powers to take binding decisions addressed to national authorities, in order to settle certain disagreements between supervisors;
 - powers to take binding decisions addressed to firms where the requirements are directly applicable and the national supervisor is failing to apply them; and
 - crisis powers to take decisions binding on national supervisors and firms.
52. It was also agreed that the exercise of these powers should not impinge in any way on the fiscal responsibilities of Member States.
53. However much we improve confidence in supervisory processes across Europe, it can never wholly exclude the risks created to host country depositors by cross-border operation, nor the dangers to the system in the case of large banks headquartered in smaller countries which might lack the resources to rescue them. As we said in *The Turner Review*, we have to recognise that in addressing it there are only two intellectually pure ways forward. One would be to accept full supervisory integration, underpinned by one pre-funded European deposit insurance scheme and by a shared European fiscal responsibility for a rescue if ever required and appropriate. The other would be to remove branch passporting rights, with host countries free to demand separate subsidisation of potentially stand alone national operations. Each of these intellectually pure answers would achieve an alignment of responsibility with power, but in two radically different ways.
54. The one certainty in the debate has been that there is no support for either of these intellectually pure solutions. Instead we will continue to seek to combine a single market with a still national approach to ultimate fiscal responsibility, and with supervision delivered by national authorities which are close to the operations of the regulated firms. That compromise can be made to work and deliver stability; however, it will also require greater coordination and cooperation through the ESAs, and ensuring that legitimate host country national interests are recognised by making it clear that host states have the right to receive all prudential information about entire groups.

55. This approach will also require allowing host states to take proportionate and measured steps to restrict the activities of branches in response to clear prudential weakness not adequately addressed by the firm or its home supervisor ahead of any. We appreciate that there may be concern that powers of this sort could be abused and used for commercial or protectionist measures (rather than for market confidence or consumer protection reasons), and we are willing to debate how best to reduce the possibility of abuse, for example through the ability of home states to appeal to the ESA.
56. Throughout all this we continue to be committed to working with our international colleagues to ensure that entities for which we have responsibility are effectively regulated and where we have either home or host responsibilities that we carry out these functions properly. This will include working to develop the effectiveness of supervisory colleges.

6 November 2009