THE INSTITUTE OF CHARTERED ACCOUNTANTS
IN ENGLAND AND WALES

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Our ref: ICAEW Rep 02/10

Your ref:

Financial Stability Division
Financial Services Authority
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Dear Sir

Discussion Paper 09/4: A regulatory response to the global banking crisis

The Institute of Chartered Accountants in England and Wales (ICAEW) welcomes the opportunity to comment on the consultation paper *Discussion Paper 09/4: Turner Review Conference Discussion Paper: A regulatory response to the global banking crisis: systemically important banks and assessing the cumulative impact* published by the Financial Services Authority (FSA) in October 2009.

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INTRODUCTION

We welcome the opportunity to respond to this paper, and believe that the ICAEW is one of the few organisations with a perspective that covers all financial institutions and the wider implications for society.

The discussion paper contains careful and thoughtful analysis: we agree that there is not a silver bullet solution. In that context we welcome the FSA's commitment to consultation in areas such as this that are inherently complex and its commitment to maintain the better regulation agenda in the form of rigorous cost/benefit analysis. While we agree with the objectives of the paper, as always the devil is in the detail, and we are currently at a stage where the proposals (perhaps understandably) lack detail. That is needed to inform a comprehensive analysis.

Regulators must therefore ensure that they consider the spectrum of changes that are being proposed in aggregate to ensure that the overall impact is sensible, and that the timing of its implementation does not have untoward macroeconomic consequences, and that there are no other unintended consequences: eg imposing similar corporate structures on all groups might - through increased homogeneity - in some cases increase the vulnerability of the system as a whole.

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It is essential that there is international co-ordination in considering proposals to address systemically important firms in order to limit the problems caused by regulatory inconsistency. Ideally proposals should flow top down from international/global agreement to regional and then national levels. The need for a considered and thoughtful approach to systemic firms is not simply a UK problem.

The development of the UK Special Resolution Regime has established a good base for the consideration of future resolution mechanisms in the financial services industry. The regime is well respected globally and the faculty supports the ground work that the UK has done as a starting point for future cross-border work.

SCOPE OF THE DISCUSSION PAPER

We acknowledge that the scope of the paper is purposefully focussed on the response to the global banking crisis and the topic of systemically important banks and does not consider the wider aspects of systemically important firms, such as insurance entities. We would point out that further and different analysis would be needed to demonstrate the nature of the issues, if any, and explore the potential solutions with respect to other financial entities. The proposals and considerations outlined in this discussion paper should not be automatically read across to all entities, without proper consideration both of recent experience and future plausible scenarios.

In this context it will be important to monitor the impact of Solvency II on the wider system: eg will it bring about changes in dependence on credit ratings; will it encourage or discourage herding; will it tend to bring about a convergence in business models?

Interaction with the European Commission proposals on supervisory structure

Alongside the developments and consultation taking place in the UK it is worth considering the interaction with the major supervisory proposals at European level:

- ***European Systemic Risk Board (ESRB)*** – we broadly support the introduction and operating model of the new ESRB, although we have some reservations over its size and central bank focus. In the context of the current debate on systemically important firms, we remain unclear as to how this structure fits with the analysis proposed by the FSA and how it will interact with the supervision/resolution of systemic institutions on an ongoing basis.
- ***European System of Financial Supervision (ESFS)*** – we support consistency of rule-making for prudential supervision, although this needs to be done sensitively. There remain some issues about a one size fits all approach and the impact that this might have on the supervision of individual firms. We are still concerned about the transfer of binding mediation powers to the proposed new European Supervisory Authorities (ESAs) and the potential conflicts that may arise between EU colleges and global colleges, for instance in the interaction with 3rd country supervisors.

DEFINITION OF SYSTEMIC FIRM

In trying to determine what factors or criteria could be used to determine systemic firms, a range of elements need to be considered:

- Size should not necessarily be the main criterion: there are some big simple firms and some small complex firms. Nevertheless, it is a relevant factor, since a large complex firm has a bigger impact on others than a small firm;
- Interconnectedness (which needs to be measured in a number of ways that go beyond direct credit exposures to other financial firms);
- Substitutability (can customers easily get the same service elsewhere – if not that may be a reason to prevent failure);
- Complexity of products and organisational/geographical entity structure; and
- Geographical spread.

Clearly this is a complex issue, and the criteria need to be dynamic. What is systemic in one case may not be systemic at another point in time eg Dunfermline (considered systemic in 2009) was smaller than Barings (not considered systemic at the time).

We would not support a list of 'systemic' firms being published for the moral hazard that this introduces, and the risk of confusion as firms are promoted or relegated from a list that the media may describe as consisting of firms that are too big to fail.

In that context, we have considered whether the word 'big' in too big to fail is misleading and simplistic and whether it is possible to propose an alternative such as too complex to fail or too-big-an-impact to fail. In the discussion paper, too systemically important to fail is used, which captures the complexity without being as pithy.

As we have set out above, systemic risk needs to be defined in the round across a range of factors and in a way that does not lead to marked threshold/cliff effects at a particular size/boundary.

We also welcome the way in which the analysis is not confined to reducing the likelihood of systemic firms failing, but also examines ways in which the impact on others might be reduced, and how any failure might be handled more smoothly.

SYSTEMIC INFRASTRUCTURE

One aspect of the issue that may be underplayed in these proposals is the crucial importance of the financial infrastructure. For instance, routing more activity via central counterparties is typically seen as a risk-reduction measure, but in extreme circumstances may make the system more vulnerable by introducing a single point of failure into the system. These issues already arise with current payment and settlement systems, where very significant progress has been made in making the arrangements more robust over the past 25 years, but the issue requires deeper analysis than is presented in this paper.

QUALITY OF CAPITAL

As part of the proposals to deal with systemically firms, there is a wider debate on whether Tier 1, or core Tier 1, should be the only type of capital eligible for prudential purposes in the long term, following a sufficient time for transition. The recent proposals from the Basel Committee serve to emphasise the importance of this point.

We believe that ideally capital needs to have loss absorbency in going concern as well as gone concern situations, particularly in cases where it is difficult to countenance the failure of an organisation. For systemically important firms this argues for Tier 1 and more specifically core Tier 1 capital within that ie equity share capital. Clearly some of the developments in the area of contingent convertible capital need to be considered in this area, where the instrument is of a type that will convert into equity.

The ongoing debates on the 'quality of capital' will need to feed into the overall capital calibration and be introduced over a timescale that is appropriate for the wider economy, and avoids excessive disruption to capital markets.

CHAPTER 3

- Whether or not some non-banks fall into the too systemic to fail category requires further analysis, but we agree that the activities of unregulated affiliates of supervised firms need to be considered in the context of consolidated supervision.

Section 2

- Figure 1 (showing capital ratios falling with size) is consistent with the benefits of diversification – at least as judged at a micro level – rather than with any non-risk-related factor. But if systemic firms have a bigger impact on others if they fail, there is an issue as to whether these externalities are currently adequately captured by the supervisory regime.

- If not it suggests that risk-based capital be replaced by risk-and-impact based capital. This is a significant step. The hope is that this is equivalent to risk-to-the-system based capital, but that has yet to be demonstrated.

Section 4

- As stated earlier, we agree it is important not to divide firms crudely into two camps - systemic and other – and to take into account factors other than size, drawing on the IMF/BIS/FSB paper referred to by the FSA.

Section 5

- We agree that the issue of systemically important firms can be addressed in a number of ways (ie making firms less systemic and/or less likely to come close to failure, and/or reducing the consequences if they do), and regard such distinctions as helpful. Attempting to tackle the issue in a piecemeal fashion is unlikely to be successful.

Section 6

- The analysis of the cross-border dimension is persuasive. Fiscal burden-sharing is unrealistic, and the powers of any regulator over a branch in respect of prudential issues – be these capital or liquidity – distinctly limited. As such there are clear attractions to host regulators in the subsidiary model (which may need to be supplemented by large exposure rules on upstreaming deposits to affiliates, and/or limits on parental funding, to limit contagion) but even for retail business it is unclear how this could be brought about within the single market European legislative framework.

- For wholesale banking the supervisory case for subsidiarisation is as compelling, but the business counter-arguments are very strong – a Balkanisation of capital fragments trading activities and risks causing serious long-term damage to market liquidity and arguably to competition. As such it is crucial for a full cost/benefit analysis to be carried out on this aspect of the proposals, which puts the business costs against the reduction in systemic risk that might result.

- See also our comments in Section 9.

Section 7

- Introducing more buffers into the system through the operation of eg central counterparties is to be welcomed as a concept, but only if in so doing it does not create new “single points of failure”. These risks are recognised in paragraph 3.35 but as noted above should be subject to much more rigorous analysis than in the Discussion Paper.

Section 8 – utility banking versus casino banking

In considering what can be done in the area of structural reform to banking operations, the focus should be on reducing the impact of problems arising from the riskiness of firms and applying capital and liquidity treatments in relation to this risk.

The focus should be on the impact and riskiness of specific activities rather than the size of the institutions per se, and the degree of resilience to withstand issues.

We would reiterate that international consistency and co-ordination is key.

Turning to comments on the four options set out by the FSA:

Option 1 – extreme narrow banking
We agree that the FSA's characterisation of this option would not resolve the fundamental issues, not least because of the impact on the price of a fixed supply of gilts, and because the firms outside the perimeter could have a significant impact on financial stability.

The proposal does however raise interesting questions about 'what a banking system is for' and might provoke further discussion/consideration about future payment models and business models for retail banking operations.

Option 2 – intermediate narrow banking
The prime examples of this have not fared noticeably better than other structures and we therefore agree that this is not a straightforward solution. Indeed, given the risks in property lending, it is difficult to see that such firms offer a persuasive low-risk alternative to universal banking.

Option 3 – Glass-Steagall type approach
We agree with the FSA such an option is very difficult and is not necessarily practical – even simple products may require trading activities to manage them such as plain interest rate swaps. Indeed, the previous US system gradually fell into disuse in part because of such complications.

The proposals on capital, liquidity and living wills that are set out will arguably help bring about a clearer delineation in activities than is the case at present, without the need for legislation to ban certain structures which could well prove difficult to enforce effectively.

The FSA's question on 'where an appropriate boundary can be drawn' is almost impossible to answer. If the boundary is drawn by activity then it is very difficult, if by volume of trades then there are similar issues. Any attempt to create such boundaries is always troublesome. The focus should be on the risk of activities rather than any legal split a priori – some non-trading book activities have proved equally damaging to firms. Commercial real estate is perhaps the most obvious such example.

Running a casino as opposed to betting in it is often considered a lower-risk and potentially profitable business. There may be analogies here between market-making as opposed to position-taking. However, it is difficult to distinguish between the two in legal terms, as the former inevitably involves the latter, if only on a fleeting basis.

We would therefore not support a legal split between different forms of banking, not least because we doubt it is possible to develop an appropriate risk-based definition for the split.

Conclusion

We agree that none of the alternative options are obviously better than the existing models. This leads to the key conclusion that one needs to understand the weaknesses of whichever structural solution is in operation and learn to mitigate those.

This requires a focus on pre-resolution (reducing probability of problems occurring) and post-resolution actions (crisis management and wind-down procedures) as the FSA has correctly identified.

Section 9 – current FSA policy stance and issues for debate

We strongly believe that capital should be applied to specific risks and impacts rather than being based on arbitrary factors. Capital should not therefore necessarily simply be based on size or volume of activity per se.

Where increased capital or other measures are applied (such as increased supervisory involvement), a ladder of sanctions avoids the dangerous cliff effects that can arise with single level thresholds.

We recognise that it is difficult to reconcile the branch/subsidiary issue and the increasing focus on national regulatory and fiscal responsibilities with a single EU market – this tension will remain unless we get greater agreement to cross-border resolution mechanisms. We would encourage further progress in this area. Simply requiring increased co-operation between EU supervisors and requiring a hub/spoke model with non-EU legal entities may not be a sufficient solution.

In terms of whether a subsidiary model (for capital and liquidity) might avoid risk spreading from one region to the other we refer you to our comments on section 6, and make the following observations:

- First of all, within Europe this approach is not possible to impose because of the continuation of the single market. However, if the arguments for subsidiarisation were sufficiently strong it would be wise to re-examine this case again.
- For non-EU groups national supervisors can already require subsidiary models if they deem it appropriate, but subject to issues about competitiveness and inter-regulator cooperation.
- Increased moves to subsidiarisation limit the risk of contagion, but also the certainty of parental support. It is important to analyse both. It is also important to ensure that where there is subsidiarisation, the extent to which this protects local creditors from problems elsewhere in the group is made clear – ie how much financial, operational and management ring-fencing is in fact in place.
- There continues to be a need for wider discussions on cross-border resolution and burden sharing frameworks and mechanisms to support this, both within regions and across regions.

OTC Derivatives

In seeking to reduce the inter-connectedness of firms, there is a need to avoid the unintended consequences for the end-user community from steps designed to increase stability within the financial sector. This may ultimately reduce the management of risk if certain institutions pull back from engaging in Over the Counter (OTC) products/hedging.

There is reasonably broad support for enhanced data capture, and the use of Central Clearing Counterparties (CCPs), where appropriate. Enhanced data capture would allow for increased transparency and supervisory monitoring of risk build-up in specific areas and this would allow for enhanced macro-prudential monitoring.

The development of CCPs does concentrate the counterparty risk in certain places. Given that the OTC market is a global marketplace regulators should not therefore compel specific regions to have CCPs. There need to be robust standards for CCPs to mitigate the increased systemic risk that may arise.

CHAPTER 4

The global response to the financial crisis includes a vast range of proposals, particularly on capital and liquidity. This smorgasbord could prove to be a 'death by 1000 cuts'. As such there is an urgent and well articulated need to consider an overall cost benefit analysis and also a calibration exercise. We are pleased that this has been recognised by the FSA, EU and Basel Committee.

In looking at this issue, it is necessary to consider the balance between financial stability and economic growth. A first step in this must be to define what is meant by financial stability and what society wants by a financial system. At the moment, this definition of stability and the core objectives of a financial system are still missing to a large extent and this makes any such analysis difficult. In its absence – and we are aware of some of the interesting analyses of the costs of financial crises in the past which in part address this point – some will argue that it is acceptable to have higher growth in most years and suffer the very infrequent breakdowns of the type we have experienced recently.

We would welcome further analysis of the perceived trade-off, while agreeing with the FSA's initial conclusions that this analysis is very difficult to perform, that there is not a single model that allows one to do the analysis, and the difficulties with the numerous assumptions that need to be made all mean that the proposed analysis should have a very significant health warning attached to it.

Annex 1 – on living wills

We welcome the proposal that groups spell out details of their corporate structure, staffing, IT arrangements etc in a way that makes clear how this relates to each firm within the group. Legal entities matter. Regulators need to understand in advance how far a particular legal entity is dependent on another – ie whether or not fire breaks are in place, and the nature of any key dependencies.
Such information needs to be shared with local supervisors across the globe in an efficient and effective fashion. The home supervisor has a key role to play in this respect.

We also welcome the idea that firms should plan their survival strategies more fully than has been the case before – but would emphasise how important it is to respect the market sensitivity of such information. There may be some difficult issues about sharing this information with every host supervisor. There are similar issues about analysis of the barriers to effective resolution, and the unplugging by a group from trading and payment infrastructures.

Regulators and other public bodies need to improve their planning procedures for the resolution of a troubled firm. We welcome recent improvements in this area in the UK.

It is unclear to us how far firms need to provide to their regulator a mass of intra-group transaction data if this is volatile and moves rapidly, but it is crucial for the FSA to satisfy itself that firms are capable of producing such information even under conditions of stress. Given the risk of operational disruption, it might be good practice to generate such information on a regular basis even if it were not to be shared as a matter of course with regulators.

There are important issues about how far such information will be used to drive simplification in corporate structures, and other remedial action, such as the separation of activities into low and high risk categories carried out by separate firms within a group, which as noted earlier raises a variety of definitional issues. If it is to be used in this way it is highly desirable for such action to be co-ordinated internationally, so that groups go through this process at much the same time as one another, and that it is a one bite of the cherry exercise, rather than one where every host supervisor can reopen the debate.

Please contact me should you wish to discuss any of the points raised in this response.

Yours sincerely

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