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Turner Review: Proposals for UK and International Regulatory Reform

The Chairman of the UK Financial Services Authority, Lord Turner, has recently published a Review[1] of the regulatory reforms likely to be required in light of the global financial crisis. The Review sets out reasoned and far-reaching proposals for reform which go beyond much that has hitherto been acceptable to first-tier regulators worldwide.

If the proposals are adopted, all institutions in the financial sector are likely to be affected. It is noteworthy that many of the predictions made in our influential October 2008 client publication "Financial Markets in a Time of Global Turbulence"[2] were reflected in the Review.

Institutional reform

Turner advocates a continuance of the UK's approach of having a single regulator across business lines, to ensure consistency of regulation between economically similar activities whether they are characterised as banking, broking, insurance or otherwise. This seems sensible and indeed an approach that should be adopted in the US and elsewhere.

He recognises the need for a systemic regulator, and the fact that this function is most logically carried on by the central bank (in the UK, the Bank of England). He rejects the idea suggested by a UK opposition party report[3] that the central bank might also be given the power to supervise institutions prudentially, arguing that this would mean a dangerous split between conduct of business and prudential regulation since conduct of business matters can also be prudential, particularly in the context of product regulation (e.g. restricting mortgage lending by value of the security or borrower's income, which has both prudential and conduct of business aspects). The logic of this point is debatable but there seems little point in moving prudential supervisory staff back from the FSA to the Bank of England, having done the reverse in 1998. There is indeed some sense in ensuring the regulator is able to take a fully rounded view of institutions it is tasked with supervising.

Approach to regulation

The Review rejects the FSA's previously "light touch" approach to regulation, which was effectively a tool of regulatory competition to attract financial business. The FSA's much-vaunted "principles-based" approach to regulation, a corollary of this, is also criticised. This approach was always highly suspect as a legal matter given the lack of certainty as to the application of many

1 "The Turner Review: A Regulatory Response to the Global Banking Crisis" (18 March 2009). Available at: http://www.fsa.gov.uk/pages/Library/Corporate/turner/index.shtml.

2 http://www.shearman.com/files/Publication/4c4a6bf1-6b75-4078-a87c-1c8b12f9239b/Presentation/PublicationAttachment/12f13522-080a-448b-a985-3b666c1110e6/ESAG_102108.pdf.

3 "The Tripartite Review: A review of the UK's Tripartite system of financial regulation in relation to financial stability - Preliminary Report" (March 2009). Available at: https://www.tripartitereview.co.uk/uc/admin/8ec5/ospe.php3?SES=c04ded64722c6c1cff1ea1dd22145d9d&syid=7284&sid=7285&act=start&js=15&flash=1000.

of the so-called "principles". The concept is to be replaced with "intensive supervision" that focuses on key business outcomes: a more aggressive approach which the industry should (according to the FSA's CEO, Hector Sants) "be afraid of".

Increased FSA resources will be devoted to the regulation of high impact firms. There will be a focus on business models, strategies and risks, which was lamentably lacking in the run-up to the crisis. The technical skills of boards and senior management will now be scrutinised: hitherto, we're told, the focus had been merely on probity. There will be a focus on remuneration policies to ensure that bonuses do not encourage risk-taking or short-termism. There is also likely to be a greater focus on accounting treatments.

Regulatory coverage

Turner recognises that the primary causes of the current crisis are to be found within the regulated community. However, the opportunity should, in his view, be taken to regulate more thoroughly various sectors which have up to now escaped proper regulation. This includes offshore funds, which are to be regulated through their fund managers in an enhanced manner. The FSA will have powers to gather information on the funds through their fund managers. Regulators will also have powers to extend prudential regulation of capital and liquidity to such entities. Furthermore, in the case of systemically important funds, the regulators should have power to impose further restrictions and ultimately to require local, offshore regulation.

Capital adequacy, accounting and liquidity

Turner accepts the consensus that regulatory capital requirements have been pro-cyclical and that they heightened the boom (and are now exacerbating the downturn).

The key change advocated by Turner is for "through the cycle" rather than "point in time" estimates of default probabilities (which is something the FSA is already insisting on, in advance of any international agreement). Risk models based on recent (e.g. up to 5 years') data following a period of prolonged growth may underestimate risk at a time when an analysis of macro-economic cycles would point to a greater risk of a fall in asset prices and an increased default risk. A counter-cyclical capital buffer will be required to be built up in times of growth, to be used in a downturn. Spain already uses such a model and, indeed, this was the practice until the 1980s in the UK before the introduction of rules based on the Basel capital accords. An innovative suggestion is for accounting rules to be changed for financial institutions so as to require a similar buffer, through the creation of an 'Economic Cycle Reserve'. This could be shown on the profit and loss account, appropriately labelled, to ensure it is taken into account by the market in assessing performance and creditworthiness, and by banks themselves in assessing compensation. Turner believes that higher capital charges will not spell an end to profitability in the banking industry. On the contrary, the report suggests that stronger capital ratios should ensure lower equity risk premia for banks as well as lower credit risk premia on bank debt instruments, reducing the cost of equity and debt capital for banks, thus offsetting any increase in capital charges.

Turner is highly critical of the more liberal capital treatments previously applied to "trading book" assets. Notably, many "trading book" assets were in fact held by institutions through to maturity or at least for the long term; and risk weightings failed to take proper account of the risks of an illiquid market developing. A re-assessment of the banking book/trading book distinction is proposed. The Review also envisages greatly enhanced trading book capital charges, perhaps ultimately involving required capital of at least three times that currently stipulated.

These measures should also be considered alongside European proposals that the originator of securitised or transferred assets should retain at least 5% unsecuritised on its own balance sheet. Whilst securitisation is unlikely to end as a result of these changes, it may be less extensive and less prevalent than before.

In addition, various technical changes are to be made to capital rules to address particular shortcomings exposed by the current financial crisis. There will be a revisiting of the reliance placed by Basel II on credit ratings. There are proposals for a new "gross leverage ratio" to provide an absolute limit on the ratio of gross assets to Tier 1 equity (or some other appropriate factor) and a new "core funding ratio" to ensure balance sheet expansion takes place on a sound, sustainable footing. More detailed and restrictive liquidity requirements (which the FSA has already proposed for the UK) will be argued for internationally. It is doubtful, however, whether such rules will improve liquidity to such an extent as in all circumstances to prevent a repeat of the Northern Rock episode. An institution that is rumoured to be insolvent is unlikely to attract funding, no matter how reliable its capital resources might objectively appear to be.

It is recognised that these steps need to be slowly and carefully implemented in the recession that we face: under Turner's cyclical capital model, now is the time that reserves should be applied, not built up.

Credit rating agencies

The Review takes a relatively cautious line on the regulation of credit rating agencies. It endorses existing EU proposals to regulate agencies in their disclosures and management of conflicts, and advocates taking steps to ensure there is widespread appreciation of the fact that credit ratings speak only to matters of credit rather than liquidity or market value. Turner also argues that ratings should be confined to products in relation to which a consistent rating (based on historical record and adequate transparency) is possible. In the case of complex structures such as CDO-squareds, Turner recognises that their virtual extinction perhaps renders debate about rating them somewhat academic; however, he does advocate new rules to guard against the reappearance of such "innovations" once memories fade.

Credit Default Swap (CDS) market infrastructure

Turner supports the initiative to force CDSs to be cleared by a central counterparty. This point is now almost universally accepted. Shearman & Sterling is working closely with ICE US Trust and ICE Clear Europe to bring clearing functionality to the CDS markets.

Commercial ("utility") banking vs investment banking

Turner rejects calls to impose a Glass-Steagall type split between commercial and investment banking regulation. He believes such a split is now unworkable in light of the current structure of financial institutions internationally and the benefits of securitisation of credit by banks (within limits). He also notes that many investment banks are generally now of sufficient systemic importance for there to be a need to provide "lender of last resort" facilities to them. Instead, he proposes stringent restrictions on the activities of deposit-taking entities, including new restrictions on trading book activity through heightened capital charges (discussed above) and enhanced supervision of liquidity risk, to reduce the risk of recent events recurring.

Cross-border supervision

Turner rightly identifies problems in cross-border regulatory co-operation. On a global level, there is not enough of it. Within Europe there is too much deference embedded in the pan-European directives to the regulator in the institution's place of incorporation. Both situations are unacceptable. In Europe, the situation that emerged in the context of Iceland highlighted that the regulators have only limited powers to protect local consumers from banks which operate cross-border out of other, smaller, European countries where there is a lower level of state backing. Turner therefore raises the possibility of requiring some institutions wishing to do business cross-border to establish local subsidiaries and thereby become subject to the full panoply of local regulation. This would tie together the regulatory supervisory role and contributions to depositor protection schemes with the central bank most likely to need to bail out the situation should a problem emerge.

Turner also suggests creating a new single European regulatory supervisory authority. This would set standards and oversee supervision, and be significantly involved in macro-prudential analysis. The current supranational harmonising authorities, including CESR based in Paris, are insufficiently expert or credible to perform such a function.

Mortgage regulation

In general, the Review concludes that product-based regulation is unwise as it gives opportunity for regulatory arbitrage that can be harmful. The main example cited is that of AIG's trading of CDSs.

However, one set of products for which Turner does propose specific product regulation is mortgages. Turner notes that the UK housing market bubble was widely predicted to burst, as loan-to-value ratios and loan-to-income ratios soared to unprecedented levels. However, at the same time, some lenders - particularly Northern Rock, Bradford & Bingley and Alliance & Leicester, which have all been nationalised or rescued through mergers - continued to issue 100% and greater mortgages at the top of the housing market bubble. There are proposals to consider introducing rules limiting the loan-to-value level of mortgages based on price-to-earnings ratios and other possible measures.

Global debate

The evolving global debate regarding the approach to future international regulation and supervision of the financial sector is concerned with the creation of a more robust financial and banking system. At the end of February, the European High-Level Group on Financial Supervision published its de Larosière Report,[4] setting out the framework for a new regulatory agenda, stronger coordinated supervision in the EU and effective crisis management for the protection of EU citizens. The de Larosière Report highlights the need for EU supervisory coordination, an issue that must also be addressed at an international level. Turner now sets out what the UK would regard as acceptable. The topic will be discussed again at the G20 Summit in London on 2 April, when the US's views – which will be key to any outcomes – will for the first time be properly factored into the analysis.

[4] http://ec.europa.eu/commission_barroso/president/pdf/statement_20090225_en.pdf.

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