Dear Hector

A regulatory response to the global banking crisis

As you know, LIBA is the principal trade association in the United Kingdom for firms which are active in the investment banking and securities industry. Its objective is to ensure that London continues to be an attractive location for the conduct of investment banking business.

LIBA appreciates the opportunity provided by the Turner Review and associated Discussion Paper DP09/2 to discuss regulatory, supervisory and structural issues. We welcome the clear expression of regulatory thought contained in these documents. We share the FSA’s concern to identify issues that have contributed to recent instability and to determine what can most sensibly be changed to provide greater security in the future without sacrificing the essential features which make London and the UK home to a thriving innovative and competitive financial industry.

In considering the questions raised in the Discussion Paper and the Review document the following clear themes emerged as of critical significance. Our full response to the questions is attached in the Annex to our response.

International coordination and consistency is essential.

The FSA is one of the major global supervisors and contributors to global and EU regulatory policy, and in the UK market also acts on occasion directly as a regulator (in the formal sense of “rulemaker”). London is home to one of the most significant international financial centres. In this context it is crucial to ensure to the greatest extent possible that the UK supervisory and regulatory approach is consistent with global and EU agreements, and that it does not move ahead into areas where other regulatory bodies may not agree to move at all. We are glad that the FSA is acting as a thought leader, but the timing of its contributions needs to be carefully managed so
that its proposals mesh properly with the global processes and influence the global consensus effectively. Although there may be times and issues where a more nationally based approach is suitable and necessary, these occasions are rare. There are more gains to be made from the perspective of global financial stability, as well as for the effective risk management of globally active firms, from international consistency than from a patchwork of idiosyncratic regulatory regimes.

**Competitiveness matters**

Closely allied to the importance of international consistency is that of retaining competitiveness. London’s status as a major financial centre means that due weight must be placed on this as well as financial stability concerns. HM Treasury has recognised this through its sponsorship of the “Bischoff Report.” While high quality supervision and regulation is an essential part of London’s strength, unnecessarily onerous local regulation and poor quality of supervision will drive business away. The UK is not the only credible base for financial services in Europe.

The health of London as a competitive market place rests not only on prudent and sensitive regulation but on market innovation. In this regard the sometimes disapproving note directed at innovative approaches and attitudes in the Review and Discussion Paper is a concern. Innovation brings challenges but without it there will be sterility and contraction. Harnessing innovation, while examining its developments critically, is the most constructive approach.

**Prudential issues**

In the context of specific prudential discussions we would like to draw attention to areas of particular concern: the trading book environment, VaR Models, valuation and procyclicality.

As a preface to our more specific comments on the trading book, we would make the general point that the trading activities of firms have performed and continue to perform useful functions, including the facilitation of client business whether it be accessing capital markets, or hedging or mitigating the risks of clients’ (or the firm’s own) business. The boundary of ‘socially useful’ activity must not be drawn in a way that would limit firms’ ability to serve the market’s legitimate needs. Clearly there are issues that need to be addressed to ensure that the standards surrounding trading practices and the health of the market can be fully maintained, and we commit to working with the regulatory community to identify the most effective solutions.

More specifically, we agree that a review of the trading book regime is reasonable and fully understand concerns with respect to the treatment of illiquid assets and “boundary” issues between the banking and trading book environments. In the context of this work, however, it is important to recall and build on the strengths of the trading book, namely the enhanced environment it creates for risk management including the ability it offers firms to manage positions through offsetting and hedging.
Naturally it is essential that the boundary be policed effectively by firms and regulators and we strongly advise against any return to simplistic lists of eligible instruments to manage this boundary.

In progressing the international work, however, we stress that changes to the trading book treatment should not unduly focus on credit risk or assume that remedies suitable to the banking book environment (where credit risk is the primary risk) will be suitable to the trading book. We also consider that regulators should not turn their back on the use of models either in the trading book, or banking book environment. It is important to understand the limitation of models and not place undue or unfeasible reliance on their output as this will lead to imprudent outcomes. For example, firms would note that Value at Risk models are not designed for tail risk per se and firms apply other techniques to capture tail risk. Thus if VaR is taken to be a good proxy for tail risk, then problems will inevitably emerge. The art is ensuring that tools are fit for clearly defined purpose.

The discussion paper also addresses valuation and procyclicality. The FSA appears to conclude that both fair value accounting and cost less impairment accounting as currently implemented have a procyclical impact. Although we understand the basis of this argument, we think it needs to be further developed and the evidence more fully assessed as we feel that there are numerous elements within the existing capital regime that dampen the cyclicality of the trading book capital requirements (e.g., Through the Cycle ratings, stress tests and add-ons and fair value accounting). In particular we note that the use of fair value accounting has facilitated the early identification of problem assets, enabling firms to take quick action: it did not create the problem assets. Moreover accounting and prudential regimes each have a different focus and care will be needed to ensure neither is compromised.

Policy formation
The Turner Review and Discussion Paper represent an intensive and welcome effort by the FSA to showcase and communicate its thinking. More broadly, we encourage the FSA to continue to ensure it has in place high quality policy formation functions so that it is able to act vigorously, communicate successfully and persuade the global regulatory community of its views when international and regional agreements are being developed. It is vital that the FSA is fully capable of successfully influencing the regulatory standard setters.

Better Regulation
The disciplines of good policy formation, rule making and enforcement need to be maintained, at national, EU and global levels. The Turner documents represent a good example of this as they contribute significantly to a reflective policy debate. We encourage the FSA to continue to champion the principles of Better Regulation domestically and in the international arena. For example, the international regulatory response to the crisis has shown considerable activity, including the creation of new structures, and expansion of resource and participants, ranging from G20
governmental summits to an ever faster pace of legislation in the EU, not all of which has been congruent with broader global thinking. What has been noticeable in all of these international initiatives is the haste. Policy initiatives are decided upon and delivery targets set very quickly indeed. A “medium term” time horizon for a set of major policy decisions can be as short as 6 months. We are concerned, particularly now that the immediate volatility of the crisis has now subsided, that this rate of progress is too rapid, and gives insufficient time to assess the range of likely outcomes and consequences of these policies, given that measures that are being put into place will be permanent and not temporary.

In our view there is a critical need for the regulatory community to analyse clearly and assiduously, including with full impact analysis, how initiatives interact and support (or even conflict with) each other. This analysis is necessary to prevent the build up of systemic risks or instabilities in the future. There remains a need for a focus on the most proportionate way to solve problems which are identified. In this context, we broadly support the concept of an “outcomes focused” regulatory approach on the understanding that the concept is consistent with and intended to deliver the same effect as FSA Handbook, General Provisions, (GEN 2.2.1): "Every provision in the Handbook must be interpreted in the light of its purpose."

**Aggregate Impact**

There is now an international consensus on the importance of identifying and assessing macro economic and macro prudential trends. There remains a significant gap, however, in assessing what the cumulative effect of the many individual micro prudential proposals can or will be. We strongly encourage the FSA to remedy this in conjunction with its global colleagues, but also to begin to put resource in place to assess this issue.

Taking the level of regulatory capital as an example, the calibration of regulatory proposals needs to be analysed carefully. To date there appears to be an embedded assumption that a whole sequence of major reforms are needed to ensure the financial services sector can withstand extreme tail events and that the (unquantified) lost output to the UK and global economies will be a fair trade for such stability. This may be the correct answer, but as yet the analysis supporting this view has not been performed and the policy choices are not being made on an informed basis.

We look to the FSA for an indication of how the regulatory programme will be taken forward and how it will be communicated to the industry. We hope that the FSA will take a lead in G20 and EU debates to identify clearly what the prudential regime should deliver, and, consequently, what are the right tools to deliver it. In this context, it is important to be aware that there will be a limit on the number of binding constraints that can be applied to firms without severe restriction of business and damaging flow through into the wider economy. Supplementary monitoring measures with clearly defined trigger points for further supervisory intervention would be a constructive approach to explore. Undertaking such analysis should lead to clarity on which of the range of possible regulatory initiatives will be pursued and
which will not, as well as, importantly, identifying a likely range of consequences on the micro and macro scale.

**Supervisory Approach**

The optimal model for the supervisory relationship with industry is based on proportionality of approach and should foster trust, mutual respect and rigour. The dialogue needs to be constructive and needs to flow in both directions. We wholly support the FSA in its identification of the need for raising standards in supervisory practice and agree that an intensification of supervision is appropriate. At the same time, we are concerned that intensity of approach will be confused with “penal” or “punitive approach” which would be damaging both for the recovery of firms active in London and specifically damaging to the openness and health of the regulatory relationship. The FSA is keen to shift from review of systems and controls into assessing the judgements of senior management. Setting aside potential concerns relating to shadow management if this brief is wrongly interpreted, it is critical that the FSA recognises that challenging a firm’s business strategy requires a very elevated skill set. Considerably more resource would be needed within the FSA, both in number and quality, to deliver this shift in approach effectively.

**Colleges and the group dimension**

Although the Discussion Paper debates several aspects of group issues, on balance, the FSA’s thinking seems less developed in these areas. We would welcome further discussion with the FSA over time on these issues, particularly in respect to the branch passporting framework in the EU (ie right of establishment) where we are anxious to retain the strengths of the single market while recognising that there are practical issues to be faced in terms of risks and resolution practices. It should be possible to work within the spirit of EU legislation and avoid any need to press for the “subsidiarisation” of EEA branches in the UK.

We think that much progress can be achieved on a purely pragmatic basis. Information sharing, cooperation and coordination between supervisors can deliver shared insight and risk analysis and identify issues that would be otherwise invisible at a domestic entity level. We welcome the fact that the FSA is a supporter and proponent of the college of supervisors system and we ask that the FSA put ever greater efforts into advocating and facilitating an efficient global delivery of these mechanisms.

**Macro Prudential and Macro Economic issues**

It is clear that there is a strong global consensus that attention must now be given to creating a macro prudential overview. The definition of “macro prudential” is, however, less agreed. This uncertainty means that vigilance will be needed in several areas.
First, there is the risk that practical implementation or enforcement of supervisory activity arising from macro prudential data gathering and analysis might be inefficient or duplicative. It is important that the boundaries between the roles and activities of the supervisor and the central bank (not only at national level but internationally also) remain clear. On a practical basis firms are keen to ensure that there will be maximum coordination (including meetings, information gathering, data reporting etc) between the relevant authorities, whether at domestic level, for example between the Bank of England and FSA, or internationally.

Second, there appears to be an implicit assumption in many current regulatory communications that macro prudential oversight and initiatives will provide the “missing piece” of the jigsaw and act as a panacea or an effective safeguard against any future instability or build up of localised or system wide risks. We think that any such assumption is too bold. Much macro prudential analysis will lead to an ambiguous conclusion and it is therefore not merely difficult, but potentially highly unwise to build a system that will rely on a mandatory regulatory response to a particular macro prudential signal. The appropriate response may be regulatory, but it may also be fiscal or monetary and we caution against the “macro prudential authorities“ limiting their possible range of actions.

We look forward to continuing to engage with the FSA on the important issues of regulatory reform. I am copying this letter and enclosure to Lord Turner, and to the FSA’s Tripartite partners.

Yours sincerely,

Jonathan Taylor
Director General
London Investment Banking Association

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