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Dear David

FSA Discussion Paper DP09/2: A regulatory response to the global banking crisis (the "Discussion Paper")

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response in respect of FSA Discussion Paper DP09/2: "A regulatory response to the global banking crisis" has been prepared by the CLLS Regulatory Law Committee (the "Committee"). Members of the Committee advise a wide range of firms in the financial markets including banks, brokers, investment advisers, investment managers, custodians, private equity and other specialist fund managers as well as market infrastructure providers such as the operators of trading, clearing and settlement systems.

We are writing to respond to a number of the issues raised in Discussion Paper DP09/2. We have in the main focused on the issues which have legal as well as market implications, and accordingly have not sought to respond to each individual question in the Discussion Paper. Our comments on certain sections of the Discussion Paper are set out below.

SECTION 6: SCOPE OF REGULATION

1. Unregulated activities within regulated groups

We agree that supervisors must understand the totality of risk that a financial services group is running (paragraph 6.7). While acknowledging the importance of holding companies in setting a group's direction, we query the extent to which the FSA's "limited direct powers over the holding company" are a real impediment to effective group supervision in view of the inclusion of a holding company within the prudential supervision of groups. The FSA may wish to set out in more detail the current problems that it is encountering and how its present powers are inadequate (paragraph 6.8, 6.9).

It is correct that the FSA cannot regulate an unregulated parent company through influencing its subsidiaries. Such an extension requires primary legislation. The FSA states "further work needs to be done to identify the costs and benefits of such an approach, both in the UK and with the international standard setting bodies". We concur: such a radical change requires careful consideration and wide

consultation to ensure that it is proportionate and effective. Furthermore, any such change requires international co-ordination to maintain a level playing field (paragraph 6.11)

2. Unregulated entities within regulated groups

We agree that supervisors should "have the information necessary to have full visibility of … any relationship between a regulated and a related unregulated entity and the aggregate exposures of the group to particular unregulated activities", and that this can be gained through regulatory reporting. The FSA should state how its present information gathering powers are inadequate for this purpose.

It seems appropriate, as the FSA suggests, that capital and liquidity may be needed to mitigate group risk. However, the corollary that this could be complemented by "stringent restrictions or prohibitions on certain types of relationship, for example on connected, intra-group lending … " raises concerns. This would be an inappropriate restriction on the freedom of management to run a business (paragraph 6.12 – 14).

We favour the extension of the FSA's current approach of "indirect regulation" of unregulated entities or sectors, which it uses in relation to hedge funds through focusing on regulated prime brokers and indeed, by regulating the managers. This seems an appropriate way of seeking to ensure that a problem in the unregulated sector is measured by firms exposed to it and contagion risk addressed. Firms are likely to be able and willing to monitor their exposures to or relationships with unregulated financial entities (paragraph 16.15 - 16). But we would not favour the extension of this policy to "restrict the type, amount or concentration of business that the regulated firms undertake with unregulated entities or the specific unregulated activities" (paragraph 6.17 – 20).

We concur that it is not practicable for regulators to seek to define which unregulated activities are likely to pose systemic risks (paragraph 6.24 – 27).

3. Global and consistent implementation

The need for any policy response to be implemented globally and consistently is a recurrent theme in this Discussion Paper. This calls for the FSA to move swiftly with industry support to formulate an appropriate solution, and then to work actively to ensure that its voice is heard both in EU and other fora. The FSA should resist the temptation of being "first to market" with its own implementation, as this will risk placing the United Kingdom at a relative disadvantage.

SECTION 7: SYSTEMICALLY IMPORTANT FIRMS

We commend the FSA for publishing its views in advance of other regulators internationally, however we would urge the FSA to ensure that its regulatory response to systemically important banks is formulated only once the debate in the international arena is concluded, and to ensure that its regulatory response is on a competitive footing with its international counterparts. Those banks which might be identified as of systemic importance within the UK market will compete (in a manner that smaller institutions often cannot) in other markets with banks and financial institutions from other countries and the FSA should not seek to place them at a competitive disadvantage in those markets at least until the issues have been debated in global fora and a clear case has been made for specific UK-only steps.

In our view, further regulation is not required in order to reduce the likelihood of systemically important firms failing, or to reduce the impact if they do. Instead, a greater focus by the FSA on risks inherent in the business models of banks, and of the economics of banks' business is necessary. This would be coupled with a greater intensity of focus by the FSA, on a proportionate basis, on those institutions identified as posing systemic risks.

The FSA already has rules requiring firms to have adequate systems and controls including appropriate risk management systems, and these rules combined with the FSA's "Intensive Supervision" process focussing on effective risk identification and management of such risks within firms would be an

appropriate regulatory response to reduce the likelihood of such firms failing, or to reduce the impact if they do.

We are not convinced that the proposed "across-the-board" options would achieve the desired effect of reducing the likelihood of a firm's failure. Without rehearsing the debates concerning what caused UK banks to fail, it is clear that in each case, there were a number of different factors at play. For example, as the FSA identifies, banks which specialised in a narrow field failed (e.g. Northern Rock and mortgage lending) as well as banks with more wide ranging activities (RBS).

In our view, separating out utility banking from investment banking activities as well as being practically difficult to implement would not ultimately serve the needs of banks' customers, who require large, international banks.

As the FSA identified, a judgement as to which firms are systemically important may not be straightforward. It may be difficult to draft any legislation or regulation with a sufficient degree of certainty as to which firms fall within the ambit of the regulation/legislation. Prioritising of supervisory resource, on the other hand, does not suffer from this issue.

SECTION 8: GROUPS AND INTRA-GROUP EXPOSURES

1. Maintaining the current "free access" model

The FSA makes the point that recent events have challenged the value that can be ascribed to assumptions that a group will support its subsidiaries (paragraph 8.4). The FSA considers the possibility that this risk could be countered by requiring a multi-jurisdictional group to operate "using a series of national entities that each had operational and financial independence" (paragraph 8.5). We would be concerned that this would, while affording theoretical protection, have the effect of substantially diminishing the benefits that have flowed to markets and consumers alike from a globalised market for financial services. We are therefore relieved to note what we understand is the FSA's conclusion that "On balance, the FSA believes that firms should continue to be able to run operating models that straddle legal entities and countries, even if this creates more complexity in the day to day oversight of the firm and creates difficulties in a bankruptcy." We agree that further work remains to be done to assess the correct supervisory approach, and consider that an adjustment to the current supervisory model would be an appropriate response that worked with the grain of the market (Box 8.1; paragraphs 8.6 & 8.11).

2. Structure of operation

The FSA notes that many groups are run through matrix management structures that can give rise to conflicts between obligations in respect of regulated firms and the wider group. The FSA considers that "such conflicts need to be identified and managed appropriately by senior management of firms, so that … they do not give rise to undue risk. It should also be clear that the individual entity's senior management has paramount responsibility for compliance with solo regulatory requirements". We concur, and suggest that the FSA makes it clear that this issue is already addressed through the obligations placed on the senior managers of regulated firms through the operation of SYSC and APER or otherwise states in what respects the present regime is inadequate (8.12).

SECTION 9: INTERNATIONAL ARCHITECTURE

1. Early warning and challenge: macro-prudential supervision

It is beyond the remit of the Committee to consider the policy arguments in favour of "macro-prudential" supervision of the type suggested (which would entail considering whether it is feasible for any macro-prudential supervisor to identify trends at an early enough stage and with a sufficient degree of consensus to enable effective action to be taken on the basis of its analysis). However, on the assumption that supervision of this type is to be implemented, we suggest that the following issues should be borne in mind.

We agree with the FSA's view that, in order for such a system to be workable, it is essential that the body making the relevant assessments has the authority and political independence to ensure that it is able to come to conclusions that may "create discomfort for national authorities from time to time" and that national authorities are willing to defer to its recommendations. Under current proposals, it is envisaged that various different institutions might carry out a macro-prudential supervisory role at different levels: the IMF and the Financial Stability Board at a global level; the European Systemic Risk Council at a European level; and some combination of the FSA and the Bank of England within the UK. We agree with the FSA's statement that "in order to be truly effective…such oversight needs to be done at a global level"[1]. This implies that any regional or national system of macro-prudential supervision should operate within a global framework and should take due account of any conclusions and recommendations made by the relevant global body.

We consider it essential that, in order to ensure accountability and effectiveness, any macro-prudential supervisor should operate within the framework of a clear set of explicit objectives. In particular, it should be clear whether the remit of the body, having identified trends that may threaten systemic stability, is to suggest regulatory responses in order to maintain stability or to achieve a macroeconomic effect. For example, the imposition of leverage or funding ratios are tools that could be used for the purpose of achieving macroeconomic effects such as dampening the economic cycle as well as supervisory effects of preserving the stability of individual institutions or the financial system as a whole. However, it is not clear that the former is a legitimate aim of a supervisory authority. It will also be important (although difficult) to define clearly the extent to which national and regional supervisors are obliged to have regard to any analysis or recommendations made by the macro-prudential supervisor.

2. Supervisory colleges

It is assumed in the Discussion Paper that supervision of banks and investment firms will remain a national responsibility, since "supervisory authority is inextricably linked with fiscal responsibility and political accountability"[2]. On this basis, an international supervisory architecture needs to be focused on making individual supervisors work better together, rather than establishing a single supervisor or group of supervisors to work on a cross-border basis. Accordingly, we agree with the logic of encouraging or even requiring the formation of colleges for the major international banking and financial services groups but would make the following points:

- there are limitations in what colleges can and should achieve and they should be established in a way that makes their objectives clear. In particular, on the assumption that supervision remains a national responsibility, colleges should not stray into prescribing or requiring national supervisors to act in a particular way. We would therefore support "a vision of colleges as relatively informal arrangements in which a small number of key supervisors of a group come together periodically to share information about the risks facing the group, their views of the controls and their supervisory actions[3]".
- colleges can be seen as a means of redressing the imbalance between the powers of the home and host state supervisors of an international group. It is therefore important that they should operate in a way that ensures that appropriate information is provided to host state supervisors and that the concerns of host state supervisors are given due consideration.
- in arriving at the constitution of colleges, an appropriate balance needs to be drawn between effectiveness and inclusiveness. The tiered approach suggested in the Discussion Paper seems a sensible way of balancing these imperatives.
- we agree with the emphasis placed by the FSA on the operation of colleges on a global basis and its observation in relation to the rather more formal but geographically limited arrangements being put in

[1] Box 9.1, p.147.

[2] FSA position and objectives, p.146.

[3] Paragraph 9.5, p.150.

place under the CRD that it is important that the "arrangements put in place at EU level complement, rather than undermine, the operation of global colleges"[4].

3. Crisis management arrangements

We agree with the FSA's view that this is an "essentially different" matter from ongoing supervision and that it is a sufficiently complex area to merit a separate institutional structure in dealing with it.

4. Passporting and branching

The passporting regime brings into sharp focus the difficulty of host state supervisors having the responsibility of dealing with the effects of failed institutions in their country without the power to prevent a failure. It implies a limited exception to the general principle mentioned in section 2 above, and on which the FSA's approach in the Discussion Paper is based, that supervision of banks and investment firms should remain a national responsibility. That exception is based on the premise that passporting banks and financial institutions are subject to a set of common standards that are recognised by the host state supervisor, and that the host state supervisor can rely on compliance with those standards being supervised and enforced in practice by the home state supervisor. We appreciate the concerns of the FSA in relation to the way in which the passporting regime has operated in practice. We consider, however, that in addressing these issues, emphasis should be placed on ensuring a more common set of standards that is consistently and effectively supervised and enforced by the relevant regulators, rather than on limiting the operation of the principle of passporting. On this basis:

- we support the FSA's suggestions in relation to an effective system of peer review. Participation in colleges of supervisors should give an enhanced opportunity for host state supervisors to raise concerns with home state supervisors.
- we agree that host state supervisors should have sufficient powers over branches to be able to obtain sufficient information to assess the systemic risks posed by the operation of the branch in their own country and rights to obtain information (and explanations) from home state supervisors as to their supervisory approach to the institution in question. Host state supervisors should also be able to use their supervisory powers in relation to conduct of business matters to ensure that any risks posed by branches are appropriately identified in marketing and promotional materials.

5. EU level rulemaking and oversight body

Although emphasising that supervisory authority should remain a national responsibility, the Discussion Paper suggests that there is scope for the centralisation of rulemaking in a single EU body. We note that this suggestion has not been adopted in the Communication from the Commission on European financial supervision (which adopts the rather more limited aspiration that the proposed new European System of Financial Supervisors should "contribute to the development of a single set of harmonised rules".) As mentioned in section 4 above, we agree with the need for greater harmonisation of substantive rules in order for the passporting regime to function effectively. However, we note the tension of this approach with the position expressed in the Discussion Paper that supervision (even within the EU) needs to remain a national responsibility because it is "inextricably linked with fiscal responsibility and political accountability", the same is not true of rulemaking. The logic of retaining supervision as a national responsibility is that, because the consequences of the failure of financial institutions are felt as consumer detriment, harm to financial stability and ultimately as costs to compensation systems and national governments rescuing failed institutions in the country in which the institution operates, the appropriate regulatory burden to be placed on financial institutions in terms of intensity of supervision is a matter for that country to decide. It is not entirely clear why the same argument does not apply in relation to the

[4] Paragraph 9.7, p.152.

appropriate regulatory burden to be placed on institutions in terms of the substance of the rules with which they must comply.

SECTION 10: MARKET ISSUES

1. Credit ratings agencies

It is clear that credit ratings agencies perform a function in the market which is of systemic importance and has a direct impact on the capital requirements of banks and financial institutions. As such we agree that regulatory oversight and transparency are an appropriate response, but that this is a matter for co-ordination at an international level given the nature of CRA groups and the scope of their activities.

2. Transparency

The FSA has acknowledged that a lack of trading transparency does not appear to have played any major role in the crisis. This is consistent with the conclusions of the 2008 bond market review at EU level. In light of this we would take the view that limited or no further regulation is required. We note the FSA's comments that it may be that greater transparency will increase market confidence, although no specific evidence was provided for this. To the extent that this is the case we would suggest allowing the market to develop such levels of transparency as participants require and therefore support the FSA's comment that industry-led initiatives are to be encouraged.

In any event, and consistent with comments elsewhere in this response, we would caution the FSA against introducing requirements in this area which go beyond international standards in the burden they impose (noting that EU bodies have initiated reviews in this area) and/or for which no specific market failure has been identified.

As regards disclosure of the nature of products to investors, we agree that this is an important part of a properly functioning market. However, it may be that this is an area where closer supervision under the current legal and regulatory regime is appropriate rather than greater regulation and we would therefore not propose the FSA promoting measures in this field in the international fora.

3. Strengthening market infrastructure

We support the FSA's work on the range of initiatives designed to strengthen the infrastructure for OTC derivatives. We think, however, that there are a number of legal and operational issues that need to be carefully worked through with the CCP, the clearing members and their clients in order to make CCP clearing an attractive proposition to participants in the CDS markets, and the markets for other OTC derivatives. For example, the collateral requirements created at each stage of the clearing process should be carefully worked through to ensure that the CCP model does not create considerably more onerous collateral requirements on clearing members and their clients than a contract that is not cleared through a CCP. In addition, the portability of CCP cleared contracts in the case of a default by a clearing member should be examined.

The FSA should take into account the fact that a considerable quantity of CDS products are not suitable for clearing (cf. paragraph 10.70of the Discussion Paper) because of their highly customised nature, and as such would not meet any reasonable test of standardization. As such, there will still remain a large proportion of CDS contracts where counterparty risk is still an issue, and as such we support the thematic review of collateral management processes for CDS contracts that are not suitable to be cleared through a CCP.

We support the FSA's work in ensuring supervisory cooperation for clearing arrangements of CDS products on an international level, and for work in ensuring that firms are not limited in their ability to manage risks effectively across jurisdictions. As acknowledged by the FSA, we think this is particularly important given the international nature of the CDS market, and the markets in other OTC derivatives.

We support the FSA in looking at this area again.

As regards settlement arrangements, we agree with the possibilities for change outlined by the FSA in the Discussion Paper.

Please let us know if you wish us to clarify any of our responses, or suggest more specific proposals.

Yours sincerely

Margaret Chamberlain
Chair
CLLS Regulatory Law Committee

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