

March 2009

09 / 2 *newsletter*



This newsletter provides a summary of DP09/2. Please see the section 'Who should read this paper?' to see if DP09/2 is relevant to you.

Financial Services Authority

The Turner Review and Discussion Paper 09/2 – a regulatory response to the global banking crisis

Why are we publishing these papers?

Following the banking crisis, the Chancellor of the Exchequer asked Lord Turner, in his capacity as our Chairman, to review and make recommendations for reforming UK and international approaches to the way banks are regulated.

We are now publishing the Review and a supporting Discussion Paper (DP). The Review takes an in-depth look at the causes of the financial crisis, and recommends steps that the international community needs to take to enhance regulatory standards, supervisory approaches and international cooperation and coordination. The review focuses on long-term solutions rather than the short-term challenges and distinguishes areas where the FSA has already taken action; those where the UK can proceed nationally; and those where we need to achieve international agreement. It also discusses wider issues raised

by the crisis that merit further discussions. The accompanying FSA Discussion Paper is confined to the issues considered in Chapter 2 of the Review. It gives further background to those issues and sets out our initial thinking on how they can be translated into practical policy proposals. It discusses options for the policy choices that need to be made to enable supervisory authorities around the world both to deal decisively with the problems of the past and to equip them to react swiftly and effectively to any future developments that may, once the current crisis is over, again threaten to undermine financial stability.

Who should read the papers?

Although the focus in the DP is on banking and investment banking activities, elements of it are much broader in their potential application and will be of interest to other types of regulated firms, including insurance firms. Section 11, on our supervisory approach is relevant to all regulated firms. The proposals set out in this DP, once implemented, will result in a significantly stronger global regulatory framework and global banking system. This outcome is clearly highly relevant to consumers.

What is the background to this?

The current crisis has made it quite clear that the financial system is both global, in the sense that national markets and many of the institutions that operate in them are highly inter-connected, and highly complex. There is no single cause of the current crisis, rather a combination of factors that have exposed some fundamental weaknesses in the financial system. The causes include the increase in global imbalances, the resulting demand for US securities and the stimulus given by falling yields to increasingly complex forms of financial innovation.

As part of this securitisation delivered an apparently endless supply of cheap funding, which in turn helped fuel credit expansion. This in turn helped expand property markets, including in the US and UK, and led to rapid property price inflation.

In the financial sector there was an accompanying significant rise in leverage, not only within banks and investment banks, but in off-balance sheet or standalone vehicles such as asset-backed commercial paper conduits, structured investment vehicles and money market funds. Large positions in securitised credit and related derivatives were increasingly held by banks and 'near banks', typically funded by short-term borrowing, often raised through commercial paper and medium-term note programmes.

These related developments created a mixture of asset price bubbles, a generalised under-pricing of risk and historically very high levels of leverage and maturity transformation which, since the crisis began in the summer of 2007, have unravelled quickly and with devastating impacts.

What do the Review and DP aim to achieve?

The Review sets out a wide-ranging series of changes that are needed to banking regulation and associated supervisory practice. In some areas the FSA can and will take action on its own, but in others international agreement will be needed. In particular:

- fundamental changes are needed in the regulatory approach to capital, liquidity and accounting;
- there needs to be a system-wide approach to identify and deal with macro-prudential risks, to complement stronger micro-prudential supervision of individual firms;
- changes need to be made to the scope of regulation to make sure that the economic substance of activities are regulated, not the legal form; and
- the international framework for the regulation and supervision of cross-border banks needs strengthening in the light of the crisis. As part of this the Review recommends a new European body which will be both a standard setter and overseer in the area of supervision.

Consistent with this, the DP notes that we are seeking to achieve five outcomes for the global banking regulatory and supervisory framework:

- banks are better capitalised and more resilient to liquidity shocks throughout the business cycle;
- the regulatory framework in general, and its capital component in particular, do not amplify the business cycle;
- supervisory and crisis management arrangements for cross-border financial services groups are effective and reflect the interests of host countries as well as those of the home;
- any material risks to financial stability posed by unregulated activities or firms are identified and controlled; and
- macro-prudential and other risks to financial stability are identified at both the international and national levels and effective action is taken to mitigate them.

What happens next?

We are asking for your views on the Turner Review and our DP; please send them to us in the way set out in the DP by 18 June 2009. We will then set out in a Feedback Statement how we plan to take the proposals forward.

The Financial Services Authority (FSA) invites comments on this Discussion Paper (DP). Comments should be submitted by 18 June 2009. This DP contains a number of questions for respondents, which can be submitted using an electronic response form. The FSA would prefer you to use this electronic form when sending your responses. Comments should be sent by electronic submission using the form on the FSA's website at (www.fsa.gov.uk/Pages/Library/Policy/DP/2009/dp09_02_response.shtml).

Alternatively, please send comments in writing to:

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It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure.

A confidential response may be requested from the FSA under the Freedom of Information Act 2000. The FSA may consult you if it receives such a request. Any decision the FSA makes not to disclose the response is reviewable by the Information Commissioner and the Information Tribunal.

How can I get the full Discussion Paper?

You can download the full Discussion Paper from:

www.fsa.gov.uk/pages/Library/Policy/DP/2009/09_02.shtml

Or you can order hard copies of the paper:

Phone our helpline on **0845 608 2372**, quoting reference **DP09/02**

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The Turner Review

Can be viewed and downloaded at:

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