

‘Next steps for banking’ – a BBA series

February 2010

CHAPTER 5: *Impact assessments and systemically important firms*

The UK banking industry has largely adopted a ‘can do’ attitude when it comes to the regulatory reform programme. This is true in terms of proposals relating to UK-specific arrangements and also proposals from international and European intergovernmental and regulatory bodies. Good progress continues to be made on many of the regulatory actions identified in the March 2009 Turner [discussion paper](#). We have included an account of these in our [response to the second Turner Review discussion paper](#). The measures taken to strengthen the regulatory regime in which banks operate constitute the first step in ensuring that the financial system is made more resilient to shocks.

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The action plan

We believe that a concerted action plan by the Financial Stability Board on behalf of the G20 is essential. There should be three components to this plan:

1. The resilience of the financial system should be strengthened by imposing **capital and liquidity requirements** on banks, plus measures to mitigate interconnectivity;
2. Measures should be introduced to **reduce the impact and systemic effect of bank failure**; and
3. **Intergovernmental and cross-agency cooperation should be improved** - on regulation, on supervision, on risk assessment and on crisis management.

The UK is at the cutting edge of this activity. UK banks are already holding much more capital and liquidity resources than set out by the international standards setters of Basel; and are actively engaged with the authorities on Recovery and Resolution Plans (living wills) so, should there be a further crisis, it can be handled more effectively.

The UK is also ahead of the game when it comes to special resolution arrangements that allow for a bank to be unwound in an orderly fashion. This legislation allows the authorities to adopt a broader range of approaches in the event that failure necessitates their use.

The importance of international agreement

To achieve enhanced global financial stability we need to proceed on the basis of international agreement. This agreement must include international standards on further changes to the capital and liquidity regimes being implemented in all relevant jurisdictions; and an international framework for cross-border crisis management. Other countries must put in place effective resolution arrangements and there should be better cooperation and coordination across borders. We welcome early examples for this such as the MoU between the Bank of England and the US Federal Deposit Insurance Corporation (FDIC).

Reducing systemic risk

In terms of further 'systemically important' measures specifically identified in Turner's second discussion paper, the BBA considers that:

- A balance of measures needs to be found that enables progress towards a position in which no institution is 'too important to fail';
- In proceeding in this direction the authorities will need to maintain the focus on reducing systemic risk through a robust, risk-based capital framework and liquidity regime;
- Measures aimed at reducing interconnectedness, including through increased use of central counterparty clearing in key markets, will make a significant contribution to reducing systemic risk;
- Approaches should be structure-neutral and internationally consistent; as the FSA suggests, risk is multifaceted and the experience of the financial crisis does not support limiting banks by scope or scale;

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- Improvements in international cooperation on regulation and supervision, including cross-border resolution, are essential;
- Authorities must make a distinction between measures to reduce risk of systemic failure and measures to reduce the impact of failure;
- Recovery and resolution plans have an important part to play, but should be more about governance and legal certainty and less about detailed information requirements and data management;
- Business strategy and governance should focus on recovery – that is the prevention of failure. Banks should remain in full ownership of their ‘recovery’ plans which need to be credible, capable of execution and kept up to date;
- In the event of failure the resolution plan should enable the use of any relevant resolution tool available to the authorities;
- Aspirations for the imposition of comprehensive virtual ‘data rooms’ should be abandoned; this will make the concept of recovery and resolution plans more attractive internationally;
- In determining next steps the authorities should avoid the introduction of measures that either work against the direction of the steps that have been taken or are in the process of being taken, as identified above, or require the investment of time and capital in less optimal proposals; and
- At all times the UK authorities need to promote international solutions and the adoption of common timetables.

One size doesn’t fit all

While it is inevitable that the consideration of how to address systemic importance will be undertaken in the knowledge of the approaches under discussion in the US, it is important to bear in mind that there are significant differences in both the nature of our respective industries and the way in which the financial crisis has been dealt with. In terms of the nature of the industry, the US is a vastly different market to the UK. While it has, on the one hand, a small number of huge institutions that operate on a cross-border basis, over 90 per cent of retail banking is provided through local institutions smaller than the average UK building society. This reflects the localised nature of much of the US economy and the restrictions that have been applied to US retail banks for much of their existence. It would be a mistake, however, to conclude that this fragmentation has resulted in these institutions not being of systemic importance. Over 160 have required FDIC intervention in the past two years and many others face uncertainty as a result of their concentrated exposure to the US real estate market.

Analysis of the US failures clearly shows that, firstly, failed banks have predominantly been the simple savings and loans institutions; secondly, the investment banking arm of an institution which is also a deposit taker has not been the cause of the banking crisis; and thirdly it is the universal bank which has proven to be the most sustainable model throughout the extraordinary difficult times. To sum up, activities that banks undertake must be addressed from the perspective of what has actually happened rather than from assumptions. We should not overlook either the lessons to be learned from the US Savings and Loans crisis in the 1980’s, nor the consequences of proposals from some that would have the effect of moving certain high risk functions

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into the less regulated arena, thus allowing a systemic situation to be created outside the more closely regulated banking sector.

It is also the case that US government intervention in support of the US banking industry has differed hugely from the support provided in the UK. The UK government intervention was based predominately on providing balance sheet support and liquidity facilities and on commercial terms. In his December 2009 Pre-Budget Report, the Chancellor pointed out that the expectation is that the UK taxpayer will make a profit from this intervention and the banking industry agrees with that analysis. In the US, the TARP programme was for the government purchase of certain non performing assets and at their current valuation there is a shortfall to the taxpayer. This has resulted in the additional levy announced recently to ensure repayment. Looking forward, it would be reasonable to conclude that this US 'Financial Crisis Responsibility Fee' need not be a part of the global response being taken forward on a coordinated basis - through the G20 and other intergovernmental fora. However, we recognise as an industry that there is a keen interest in ensuring there is minimal fall-back on taxpayers' finance should a future crisis occur – we agree with this and are working to achieve this.

The importance of impact assessments

The second part of Turner's latest discussion paper sets out the FSA's approach to assessing the combined impact of the different elements of reform in progress. These reforms include higher levels of overall capital and liquidity, trading book reforms, countercyclical capital buffers and possible capital surcharges for systemically important banks. The need for such analysis was a major theme in our response to the March 2009 discussion paper and has been consistently repeated in our industry responses to individual proposals within the reform programme.

An impact analysis is an essential part of the exercise since there are clear trade-offs between requiring banks to hold more, better quality capital and liquidity resources and their capacity to lend into the economy. This must be recognised and quantified in order to determine the right balance for further regulation.

We welcome the work that has been undertaken by the National Institute of Economic and Social Research on behalf of the FSA, but believe that further attention needs to be paid to a stronger and better substantiated analysis - particularly of the impact on the wider economy. At all times the authorities must resist the temptation to resort to the "public good" argument or give the misleading impression that the very substantial increases in the cost of regulation will have little impact other than on the bank itself. Increasing the quantum of bank capital must have an effect on the supply and pricing of credit to households and businesses. The question is where the balance between financial stability and economic growth should be drawn.

Banks are already holding more capital and it is essential that serious thought is given to the timetable envisaged for any further increases. Since the intention is that the reform package should support and not damage sustainable economic growth, the transition period is clearly a critical consideration because of the stimulus currently supporting the economic recovery. If the transition period is too short, the impact on capital will be significant and the market reaction severe. But a gradual transition period will send a clear message to the markets that banks can remain strong and earn their way into the capitalisation required.

We also see this work as providing a platform on which an informed debate about the social and economic consequences of the regulatory regime can take place. For example, it is evident that some of the changes being contemplated for mortgages, such as loan-to-value limitations, have the potential to have a wide societal effect. The consequences of the regulatory measures in hand are clearly of considerable public interest and it important that the Treasury and the Bank of England also conduct impact analyses from their own perspectives. This is an initiative to which the UK banking industry proposes to contribute.

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We fully accept that there is a need for the industry and regulatory authorities to work towards reducing the prospect and potential scale of future government intervention in the banking system. This should be done on the basis of a proper understanding of the causes of the crisis, the basis of the interventions undertaken and the impact that remedial measures – particularly in the key areas of capital and liquidity – will have on the availability of credit and the wider economy.

Policymakers need to avoid focusing on regulation to the exclusion of other important considerations. There were underlying macroeconomic causes to the crisis, as identified in the March 2009 Turner Review, and these need to be fixed too if financial stability is to be achieved. Consideration also needs to be given to specific structural features of the UK economy as well, such as the imbalance between housing supply and demand, which arguably means that UK housing markets will inherently be prone to overheating.

To read our full response to the second Turner Review discussion paper, please click [here](#).

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