TREASURY, RISK AND FINANCE PROFESSIONALS

ACT

# The Association of Corporate Treasurers

**Comments in response to**

## *Turner review: a regulatory response to the global banking crisis and the accompanying FSA discussion paper DP 09/02 – A regulatory response to the global banking crisis*

18th March 2009

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## The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the back of these comments and on our website www.treasurers.org .

Contact details are also at the back of these comments.

We canvas the opinion of our members through our monthly e-newsletter to members and others, *The Treasurer magazine*, topic-specific working groups and our Policy and Technical Committee.

The ACT welcomes the opportunity to comment on this matter.

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## General

The ACT welcomes the report by Lord Turner and the assessment of actions required that has been published by the FSA. These papers make a thorough assessment of the problems contributing to the global banking crisis and take a measured view of what regulatory reactions could help prevent a repeat crisis.

The ACT has generally taken as basic premises[1] that

> "Regulation commonly represents a barrier to entry, restricts competition and innovation and increases costs. It should thus normally only be used as a last resort where there is evidence of an actual or potential market failure or in

[1] ACT Policy and Technical Manifesto: http://www.treasurers.org/technical/manifesto

> quasi-monopoly areas where competition is insufficient, industry codes etc. have failed and where the public good from regulation manifestly exceeds the costs it engenders."
>
> "Where regulation is to be applied it should be with a bias towards light-touch- and principles-based regulation to lower costs and preserve as much flexibility as possible."

Clearly some improvement in the effectiveness of regulation and supervision is in order, co-ordinated on an international scale, but implemented locally. There was market failure in both the sense that some markets ceased to clear and the sense that other outcomes, in which all parties could be better off, existed unfulfilled.

But at all times regulators should remember that the banking system exists to serve the wider business and consumer communities. A key need for society is to have effective mechanisms for maturity transformation. The twin goods of the provision of capital to business and sound demand deposits, properly regulated, allow the economy to flourish. Prevention of systemic collapse is therefore important, but at the same time the burden – the costs of and any reduction in service or financial products available from – regulation will fall on the customers and could have a depressing effect on the wider economy. A considered response seems to be essential.

We take the view that the flourishing of sound, deep and liquid financial markets in general is a very good thing for non-financial services companies and society generally. In the absence of such markets the opportunities of non-financial services companies would be much diminished and overall welfare diminished. British and European business benefits from having a vibrant financial sector on its doorstep in London.

**International dimension**

It is easy for commentators now to condemn both the bankers and the regulators for allowing the banking community to overstretch themselves, make bad lending decisions, etc., thus leading to the recent liquidity crisis, credit crunch and taxpayer bailouts. However, the real fault was structural: if banks were legally entitled to take the types of risks they undertook, even though unwise, and if other banks were doing so and making serious profits, it would have been an exceptionally brave and public spirited board of directors that ordered its management to desist from such activities – and in the real world, of course, few such boards existed.

The banking authorities of the world therefore have a rare opportunity now to take concerted action to put in place a regulatory regime that should reduce for systemically vital banks and their managements the ability and, therefore, temptation to engage again in such risky business with implicit public support but without proper risk protection and capital backing (which might make some of it unattractive). However, this can only work if it is done on a globally consistent basis. This is not to say that there must be a global or even regional (e.g. EU-wide) regulator. On the contrary, such a regulator would risk being be monolithic, too bureaucratic and unwieldy and lacking real accountability. However, the minimum standards that national regulators of economically important countries should be obliged to enforce must be uniform, in principle if not in detail, so as to reduce the potential for damaging jurisdictional/regulatory arbitrage. We should comment that regulatory arbitrage in which trade moves away from regulation which is unnecessary, excessive or overly expensive to comply with is wholly beneficial for society at large. It is good that jurisdictions compete to regulate appropriately.

There is now is a unique opportunity to be seized by responsible governments, greatly to reduce the risk of taxpayers once again having to come to the rescue of irresponsible but important banks. If concerted minimum regulation principles are not widely agreed, competitive pressures between banks will make the choice of where to do business a risk-multiplier for-all.

If the UK authorities put in hand the sort of new regulation that we support in this paper but this is not the approach adopted by all major jurisdictions, further consideration would be necessary to consider both the competitive position and the risks of contagion.

**Capital and Liquidity**

Inadequate liquidity is likely to be the trigger for a crisis and of course adequate capital to absorb losses is critical too. We broadly endorse the idea of an increase in regulatory capital to be held and that of the (re-)introduction of the build up of counter-cyclical buffers in the good years.

We see the activities of banks and near-banks in building their own trading books as largely separate from the main functions that serve our members working in treasury departments in non financial companies. Some activities seem on such a scale as to be beyond the level at which customers benefit. There are advantages in banks using their balance sheet to make markets and add to liquidity, but large-scale risk taking of this kind for its own sake is not a function which should be supported by society at large as represented by the lender of last resort (and capital provider of last resort or market maker of last resort) role of the authorities.

We therefore support the idea that capital required to be held against the trading book should be increased. We do not see it as a criticism that this could lead to a sharp reduction in such activity, as was Lord Turner's intention in proposing the trading book capital charge. Under the existing regime it is possible to change materially the capital held against an asset merely by reclassifying the purpose for which it is held. This seems to provide excessive and needless opportunity for regulatory arbitrage. If an asset is intended to be held only for a short time, the capital backing it might be expected to be needed for only a short time. But if the asset is held for longer, the capital will be needed for longer. The *amount* of capital needed seems to be unaffected by mere "intention" – though if contractual protection is available, the risk might be changed to a counterparty (credit) risk which can be dealt with in the normal way.

We have debated whether the proprietary trading and investment banking activities should be separated from the commercial banking activities as was the case with the Glass Steagall Act. Opinions are divided, but we have concluded, as did Lord Turner, that that this would not in any case achieve acceptability within the US and continental Europe and would therefore be a step too far.

We do however question whether the holding by a bank of extra capital for the proprietary trading business is sufficient to de-risk this sort of activity such that the implicit support from the authorities for its liabilities, in extremis, would be justified in all cases. There could be merits in imposing some cap on certain assets classes within the overall cocktail of activities embodied in a banking group and with implicit support availability. It is important to recognise that banks can make substantial losses on conventional lending, not just on trading desk assets.

Once the market loses confidence in the bank because of a perception of poor asset quality it rapidly refuses to fund it. This is what has happened in the present crisis. If the institution is to be saved or wound down in an orderly fashion, support by the authorities or protection of the courts is necessary. Market confidence needs to be more robustly based than it was. For this reason, it will be important for the new regulatory system not only to control capital and liquidity (and perhaps also to be able to curtail the relative amount of more risky types of activity) but also to involve the supervision of asset quality with necessary enforcement provisions and embrace appropriate bank insolvency procedures.

One of the causes of the liquidity crisis was the opacity of banks' asset quality coupled with the lack of knowledge as to how deeply banks were holders of sub-prime assets through the securitisation process. In other words, market ignorance of banks' asset quality led participants to assume the worst. The seizing up of the interbank market and the sudden price drop of and illiquidity of ABSs, etc. followed. Therefore, a regulatory regime (worldwide) that focussed on asset quality as well as capital adequacy and liquidity prudence should provide the market with greater confidence and help reduce the risk of the type of paralysis we have recently witnessed. If that requires restrictions to be imposed on certain types of credit (for example, in the residential mortgage lending sphere, absolute limits on LTVs and LTIs), or the requirement of other credit support so be it.

A factor of such a regime would, of course, be its pro-cyclicality: as the credit standing of an asset fell, additional capital would need to be held against it. If this was happening to a range of assets, capital adequacy might be tested, with knock-on effects. However, the build-up of counter-cyclical buffers referred to above should mitigate this.

We would expect that eventually institutions will find ways around the proposed changes and markets will balloon and collapse again. It has always been thus. So modelling and simulations by the authorities will continue to be necessary. But additionally, action to have any such institution review its business model and, after dialogue, make changes will need to be in the minds of the authorities. In future, we hope, it will not be considered appropriate for the authorities to agree that an institution has a flawed business model and take no action with the institution. While the authorities should not be able to act arbitrarily or capriciously, some consideration should be given to how exposed they really would be were they to intervene at a relatively early stage.

**Reforming macro prudential policy**

System level vulnerability to the problems of a single institution depends on the size and linkages of the institution. It is not dealt with by study of the institution alone. The financial crisis has shown that a concentration on micro prudential supervision and a watering down of the wider financial stability functions previously carried out by the Bank of England have left a weakness. Perversely, specific regulation can cause a lack of diversity in the system and the problem of contagion across firms. The ACT very much welcomes the renewed focus on the resilience of the banking and financial system as a whole. We do not support the creation of an international regulator with the lack of flexibility and responsiveness that that could entail, but we do think it essential that regulators in the major centres globally enforce uniform minimum principles and co-ordinate their information and actions.

We would support Lord Turner's recent suggestion that there be a EU supervisory agency whose function would not be to regulate, but to oversee the consistent application by the different national regulators of the (supposedly uniform) regulatory regime.

We think that an understanding of the financial system as a network is important and should influence regulation. However it is also important to consider the underlying factors and the behavioural decision making of node and link managers as well. Human beings make the system more likely to change behaviour for good or ill than programmed system simulations may imply. Critical nodes may require more capital etc.. This would be very difficult to manage, even if superficially attractive. It could tend to drive trade away from those higher capital (i.e. higher capital cost) nodes, tending to reduce their criticality, and no doubt unwelcome to the proprietor of the (formerly) critical node.

In general, as costs and non-cost factors such as service delivery change, other nodes can replace formerly critical components or new critical nodes develop. This can happen very quickly as node managers respond to signals from a doubtful node – precipitating collapse of that node.

That dynamic systems require a form of dynamic regulation is a commonplace. But not untrue. Achieving this in a global network is very difficult – but a key shared responsibility of the international community.

Overall on broad (meso level) financial services industry rather than institutional level regulation and any economy wide (macro level) steps we think that arrangements need to be somewhat tentative, flexible and adaptable as experience with it grows. It seems probable that the world will need to gain experience with a whole new regulatory scheme as unexpected events and developments arise.

**Scope of regulation**

The papers propose to treat non-regulated firms on the basis of the economic substance of their activities. We think that this is an important principle other than for incidental or low volume activity. Without it, the effects of regulatory arbitrage will be major, with activity tending to move over time to the non-regulated sector with its own systemic risk unchecked by regulation.

A debate is necessary as to whether systemically important firms should be set higher capital etc. requirements. There are attractions to focus this only on the largest firms. That is firms too large, too interconnected, too diverse or too complicated to be allowed to fail or to rescue – and probably, well before that stage, too large to manage efficiently, and so drags on the rest of society. The point we advocate would not only be to discourage formation of very large firms tending to fall into the categories of concern. It would also be to encourage the voluntary breaking up of existing such firms as managers and shareholders sought to escape some of the scale and scope diseconomies implicit in the models and explicitly imposed by regulation (including through capital requirements). This could be an attractive idea from a competition point of view as well as from a risk point of view. (See also the discussion under large banks, below.)

We urge further study rather than dismissal of the idea.

**Branching and passporting**

We note the discussion of these topics in the papers[2]. We see a couple of basic principles:

- If a bank is operating through a subsidiary, the subsidiary should be regulated as a stand-alone entity. If there is a parent or fellow subsidiary guarantee, that might comfort depositors or holders of its paper but possibly not regulators. In any case the parent and fellow subsidiaries should be included on a consolidated basis in the subsidiary's single lender limit and other prudential stipulations – local regulation otherwise being a mere sham in such cases.
- With branches, if there is any possibility under the insolvency law etc. of the jurisdiction of the home incorporation, that the (UK) branch obligations might not rank fully alongside the obligations of the entity in that home jurisdiction, then the branch should be regulated similarly to a subsidiary, including a single lending limit for deposits etc. transferred to the parent bank in the home country and to fellow subsidiaries.

**Risk based approach to remuneration**

As supporters of market based solutions where possible the ACT would not wish to see remuneration caps as such. However, we believe that managers must put more than their reputation at risk if their behaviour is reckless, so claw back mechanisms or deferred and conditional payment mechanisms are necessary. (This should apply to all companies, not just financial sector companies.)

On the other hand the proposals to look at the risk consequences of remuneration policy are a sensible and important way forward, particularly in the area of the trading book.

Some of the skills and knowledge of the financial system that bankers possess can also be found in the corporate treasurer community who are after all often on the other side of deals transacted by banks. However there is a difference in that corporate treasurers tend not to be trading per se, but rather are transacting to meet specific financing or hedging needs or other requirements of their underlying commercial business. The ethos and approach of a treasurer is very different from a risk taking trader. It should be possible for financial firms to change their own cultures and approaches to risk, to comply with regulation and good governance in some intermediate position.

[2] We found the consideration of the topic in E. Cerutti et al., How banks go abroad: Branches or subsidiaries? Journal of Banking & Finance 31 (2007) 1669–1692 is useful background on this topic. Now available on the World Bank's website at http://siteresources.worldbank.org/DEC/Resources/How_banks_go_abroad_Branches_or_subsidiaries.pdf

**Clearing and central counterparty**

The FSA is working on a range of initiatives for greater use of central counterparties and robust clearing house arrangements, in particular with regard to credit default swaps and other derivatives. Where this can be effected without loss of utility or material increase in costs of the derivatives concerned we welcome this. However we are nervous of any momentum to seek the standardisation of all OTC derivatives. Companies make use of derivatives (largely FX, interest rate and commodity rather than credit) to hedge their risks. Any regulatory changes should be careful not to remove the flexibility that companies enjoy at the moment to enter into tailored hedges that exactly match their risks.

If standardised derivatives are introduced to permit exchange trading, companies will be left with basis risk and possibly hedges which will not qualify as hedges under accounting standards. If implemented the IASB would need to reassess its effectiveness criteria for hedge accounting, particularly allowing changing combinations of derivatives. Companies may benefit from the transparency and narrow spreads available in exchange traded derivatives – although spreads in the types of derivatives companies are concerned with are historically quite low). But they will need to be able to use OTC for non-standard derivatives and to achieve more precise hedges or to deal with the basis risk arising from standard contracts. A move to exchange traded derivatives where practical would be helpful but OTC derivatives need to remain possible too. A well informed market will determine the balance between the types.

In principle, an institution and its client should be able to enter into legal contracts of their own devising which both agree. In seeking to remove risk in the financial sector there is the danger of inadvertently preventing good risk management in the non-financial company sector.

**Credit rating agencies**

The data presented in the discussion paper demonstrates that corporate ratings have proved to be good indicators of credit risk, while weaknesses have been seen in the ratings of some structured products. If the reliability of some ratings is in doubt then you may be right to be concerned about the use of ratings in regulatory formulas. Given that corporate ratings have performed well we would be concerned if any review were to lead to higher risk weighting being applied to rated corporates. It is noteworthy that the problematic ratings occurred in an area where a few sponsors were responsible for a material portion of the income of an agency, whereas in rating corporates no corporate is a material portion of the income of any of the major agencies.

However, we consider that ratings are a useful input to credit considerations and we would be very cautious about forbidding their use for regulatory purposes as we doubt the general availability, year in year out, of adequate information in this area in general.

Looking at ratings' use for investment purposes, we do think that complacent and slack use of ratings has often been the issue. We urge more education and training for investment decision makers in this area. That is not something best tackled by regulators but by investors realising the need.

It is noteworthy that this month the ACT will be announcing a joint educational initiative which adapts one of the ACT's basic education modules for the particular needs of local authority staff in the treasury field (details will be at www.treasurers.org). The ACT makes available on its website (as a companion to another guidance note on investing liquid assets) a note on setting bank counterparty credit limits which discusses the appropriate use of credit ratings (both available at http://www.treasurers.org/investingcash ).

**Market transparency**

We support good and easily available post-trade reporting of transactions and material aggregate positions. But crucial is good disclosure of the details of any traded item and the underlying matter for complex or derivative items.

**Large banks**

We have consulted carefully with members at some of the large companies which might be most affected by the availability or otherwise of the largest financial institutions as well as more widely.

We understand that the thinking in the Turner report on large banks will be subject to further review and clearly there are some significant issues around the risks that can be created – too big/complex/interconnected to fail or too big etc. to rescue. As we said above, we think that often such too big etc. institutions are probably too big etc. to be managed efficiently, making the institutions a drag on society as a whole.

We agree that this should be approached after a proper risk assessment, but from the corporate customer point of view we can say that generally companies do not need super-large banks.

There can be minor conveniences in dealing with a very large bank that can provide a good range of service across the globe, but it is not usually the key selection criterion. Even for global cash management, companies tend to restrict a single bank to only a part/region/hemisphere of its group business and seek to ensure they have a second partner bank which could take over seamlessly from the main incumbent in case of need.

Treasurers welcome a diversity of providers in order to access a diversity of products, ideas and expertise. Competition is important too, so market dominance is not helpful, and therefore there should be some limits on size or market share.

For some super-large companies it will occasionally be convenient to be able to deal with one or two super-large banks with correspondingly large balance sheets and ability to take or underwrite significant risks, e.g. a large acquisition financing commitment, but even then the risk is normally rapidly distributed out. Companies could easily learn to transact with a group of banks rather than rely on a sole underwriter and some already do this as a matter of policy.

We discussed earlier several ways in which large institution dependency can be reduced in the system as a whole and mentioned earlier that setting a trading book relative size limit would help towards avoiding a bank (with implicit public support for at least some obligations) whose riskier assets would otherwise present a potential systemic problem.

## The Association of Corporate Treasurers

The ACT is the international body for finance professionals working in treasury, risk and corporate finance. Through the ACT we come together as practitioners, technical experts and educators in a range of disciplines that underpin the financial security and prosperity of an organisation.

The ACT defines and promotes best practice in treasury and makes representations to government, regulators and standard setters.

We are also the world's leading examining body for treasury, providing benchmark qualifications and continuing development through training, conferences, publications, including *The Treasurer* magazine and the annual *Treasurer's Handbook*, and online.

Our 3,600 members work widely in companies of all sizes through industry, commerce professional service firms.

Further information is available on our website (below).

Our policy with regards to policy and technical matters is available at http://www.treasurers.org/technical/resources/manifestoMay2007.pdf .


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