Detox regime

Executive summary

- The seeds of the financial crisis lie in the failure of the financial market to correct itself. A tighter regulatory structure will now consider whole system risk, insist that banks hold larger buffers of high-quality, liquid assets, and give the FSA the power to act early to deal with threats to financial stability.

Hector Sants, chief executive of the Financial Services Authority (FSA) and a member of the ACT's advisory board, believes that the challenge of bank regulation is a "massive topic". In a wide-ranging and masterful examination of the key issues of financial turmoil and banking regulation for the ACT Spring Paper, Sants focused on what bank regulation may look like in the future and what that may look like for banks, investors and auditors.

He began the Spring Paper by identifying fundamental structural failures which precipitated the banking crisis across the globe:

- a set of macro-economic conditions, notably global imbalances and low interest rates;
- the prevailing mindset of government and society across the globe promoting the benefits of credit and asset inflation, most notably in the housing market;
- a flawed global regulatory architecture that notably lacked macro prudential oversight and had only patchy oversight of a number of financial institutions, particularly shadow banks such as structured investment vehicles (SIVs);
- flawed prudential rules, particularly for capital and liquidity – Basel II has large elements of pro-cyclicality;
- market failure to self-correct and recognise the herd instinct;
- a pro-cyclical interaction between the accounting regime and market sentiment; and
- lack of responsible governance by market participants, in particular bank management.

Sants said he had not included in his list the operational failures of day-to-day supervision. However, he said the FSA "absolutely acknowledged" that there were operational failures within its supervisory unit responsible for the UK deposit-taking institutions, which had been well documented in the Northern Rock report. "We put our hands up very early," he said, but added: "When history comes to look at the global crisis, the operational failures in our supervisory division would not be in the top list [of reasons]. But it doesn't mean they weren't there. The FSA has had to learn lessons, and we have done."

Sants said the most pertinent failure of all in terms of thinking about the future was the recognition that we cannot rely on market discipline. The effect of the markets' failure to self-correct was exacerbated by a series of governance failures and poor business judgements by the financial institutions themselves.

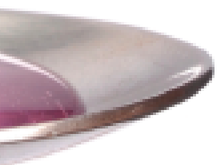
The new environment will see changes in both the regulatory and supervisory structures.

In terms of regulatory structural issues, Sants said that the lack of macro prudential oversight and the gaps in the regulations of the shadow banks would have to be addressed. The prudential approach needs to look at whole system risk rather than just on the individual institutional level. This requires regulators and central banks to work in partnership at national and international level to analyse trends in credit growth, whole system maturity transformation, institution and product embedded leverage and the interlinkage in the different parts of the financial system between banks and shadow banks.

Sants said that in his view the lead on this had to be taken by central banks in conjunction with the central regulator. Risk identification needs both bottom-up and top-down information and has to extend to institutions performing bank-like functions which have in the past escaped regulatory requirements. Regulation has to focus on the economic substance as well as the legal form. Authorities also need to understand when developments outside the regulatory boundaries threaten financial stability and be ready to act.

Capital and liquidity management also required core structural reform. More emphasis will be placed on tier 1 capital: during the crisis it has become clear that the only type of capital which is effective is that which can absorb loss while the bank remains a going concern. As Sants put it, looking at gone concern isn't very helpful: you need to look at going concern. The FSA wants counter-cyclical buffers built into the system.

Banks will also be required to increase their focus on liquidity. With hindsight it is now possible to realise banks relied too much on funding from wholesale markets and from securitisation. Maturity



BANK REGULATION WAS THE SUBJECT OF THE ACT'S SPRING PAPER, SPONSORED BY BANK OF NEW YORK MELLON AND GIVEN BY FSA CHIEF EXECUTIVE HECTOR SANTS. **PETER WILLIAMS** REPORTS.

transformation was not performed on bank balance sheets but by the non-banks and off-balance sheet vehicles such as mutual funds and SIVs. The FSA is committed to introducing liquidity regulations that will require larger buffers of high-quality, liquid assets and will create incentives for banks to extend the length of their liabilities and place less reliance on short-term wholesale deposits.

These key reforms in prudential regulation cannot happen in place of focus on conduct risk. The FSA want to ensure that banks continue to treat customers fairly and it is modifying its approach with a greater emphasis on outcome testing rather than high-level reviews of systems and controls. Product and prudential risk are intertwined.

The FSA will also need greater powers to deal with bank viability, which was a major omission in the tripartite approach. The Banking Act 2009 allows for earlier intervention by the authorities, with prompt resolution of banks in trouble; recent examples of action in the cases of Bradford & Bingley and Dunfermline Building Society are more reminiscent of the US, where banks do fail, and in simple terms there is a name change and consumers continue to bank with no disruption. Early in the crisis, the UK had no such system.

Supervision will also see changes, some of which reflect Sants' long-held views pre-dating his appointment to the FSA as well as reflecting lessons learnt from the crisis. Historically the FSA approach has been characterised by evidence, risk and principle-based regulation, but it has been a little unclear about what is meant by risk-based regulation. It should mean moving away from prescriptive rules to a higher level of articulation of what we expect firms to do. Rather than management ticking a box, the FSA wants it to make decisions knowing that it will be judged on the ultimate consequences of its actions.

That key point should also apply to the way that the FSA supervises. This is so-called outcome-focused regulation which will be applied through the FSA's new supervisory model and underpinned by the credible deterrence philosophy. Sants made it clear that the FSA continued to believe that the vast majority of practitioners were decent people and they wanted to see those people who commit offences having a reasonable likelihood of being caught and therefore being afraid. Historically, the FSA has not been in a position to deliver that message; Sants believes it now is.

IMPLICATIONS FOR BANKERS Recent events have raised questions about the competence of senior management within banks, and the FSA is no longer prepared to rely on senior managers' judgements.

However, Sants made clear that the FSA was not seeking to act as a shadow board of directors and still viewed firms' senior management as carrying primary responsibility (shared with non-executives, shareholders and auditors) for their actions and the consequences of them. A key responsibility of senior management is to understand the circumstances under which the firm would fail and ensure that plans are in place to mitigate such an event.

Banks will need to sharpen their risk management practices and their ability to manage capital and liquidity. Executives and non-executives need the appropriate degree of expertise and the FSA will ensure this is the case through its authorisation approach.

The FSA used to judge probity not competency; going forward it will do both. It has started a pilot programme of interviewing candidates for significant positions. The presumption is that anyone set to be appointed to high-impact roles such as chair, CEO, FD, or risk director will face an FSA interview. Sants told the Spring Paper audience that the process had been well received and the FSA would publish a discussion paper in the autumn on the findings. Sants said 51 interviews had been carried out so far and "in a number of cases, as a result of that interview, applications have been withdrawn".

Banks will have to think about their business models – there has already been discussions around the "narrow bank" model. The current view of the FSA is that narrowing bank activities may increase risk rather than diminish it. It is not only the rights of depositors but also the rights of the taxpayers that have to be recognised. Independent of regulation, banks will have to change their models to reflect the changed marketplace, such as the diminished appetite for complex financial instruments.

For investors, the changes mean there will be more capital in the system and that means a banking model with a slower growth profile, along with lower, but hopefully more stable, returns than seen in the years prior to the crisis. Investors need to change their appetite for risk but the intense search for yield – another driver of the crisis – must be avoided. Investors need to understand what they are buying and be aware of the risk/reward equation.

Sants said that investors had forgotten the golden rule: don't buy things you don't understand. Banks had likewise forgotten the other side of the rule: don't sell things you don't understand. Investors now need to act collaboratively to drive good governance and to challenge management to ensure plans, risk controls and audit committees are effective and credible.

Finally, Sants questioned whether there was the political will to tackle some of the big questions that have emerged as a result of this crisis. Society seems to want a regime where there is no failure, but is that possible in a system where risk is required to facilitate growth? Sants said we needed to know who picked up the tab when things did go wrong while avoiding a kneejerk reaction to taking out risk altogether.

The debate after Sants' speech confirmed the view that society, the economy and treasurers all want and need a robust and successful banking system. The reforms outlined by Sants are the building blocks deemed necessary to mend a seriously damaged edifice.

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The full text of Hector Sants' speech can be read at:
www.treasurers.org/SpringPaperSpeech