



House of Commons
Treasury Committee

**Banking Crisis: regulation
and supervision: Responses
from the Government and
Financial Services Authority
to the Committee's
Fourteenth Report of
Session 2008–09**

First Special Report of Session 2009–10

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The Treasury Committee

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First Special Report

The Treasury Committee published its Fourteenth Report of Session 2008-09, *Banking Crisis: regulation and supervision*, on 31 July 2009, as House of Commons Paper No. 767. Responses to this Report from the Government, received on 20 November 2009, and from the Financial Services Authority, received on 10 November 2009, are published as appendices to this Special Report.

The responses from the Government and Financial Services Authority are in plain text and the Committee's conclusions and recommendations are in bold text.

Appendix 1: Government response

This document contains the Government's response to the House of Commons Treasury Select Committee's report on banking supervision and regulation. The Government thanks the Committee for its report and its ongoing engagement under the Committee's Banking Committee Inquiry. The Government supports the scrutiny role of the Committee.

Today, the Financial Services Bill was introduced to Parliament and the Government's response to the *Reforming financial markets* consultation was published¹. This response to the committee therefore includes reference to primary legislative proposals covering a number of areas covered in the Committee's report, including living wills, powers for the Financial Services Authority (FSA) and the proposed Council for Financial Stability.

The FSA's regulation of banking

We welcome the speed of progress made by the FSA under the Supervisory Enhancement Programme in recruiting staff, and boosting training, in order to improve its scrutiny of UK banks. Although it is difficult, and too early, to tell what impact the SEP has had on the banks' behaviour, we are encouraged by the fact that the financial services sector has clearly noticed a change in approach. The SEP is a necessary, but not sufficient, response to the problems of the financial crisis. (Paragraph 13)

The Government welcomes the FSA's work on improving its regulation and supervision of financial services. Under the Supervisory Enhancement Programme, the FSA has significantly increased the number and quality of its supervisory staff and has adopted a more "intensive and intrusive" approach to supervision.

The Government has already taken a number of important steps to reform the regulatory and legislative framework and to address the lessons learned from the financial crisis. We remain committed to ensuring that the regulatory system is robust, keeps pace with future challenges, and supports financial stability.

¹ www.hm-treasury.gov.uk/d/reforming_financial_markets080709.pdf

By any measure the FSA has failed dreadfully in its supervision of the banking sector. But this Report is about the future not the past, and we welcome Lord Turner's candid approach to recognising the failures of the FSA and his willingness to address these failings. The arrival of Lord Turner has already had a very noticeable impact on the approach to regulation taken by the FSA. (Paragraph 22)

Lord Turner's analysis of a faulty regulatory philosophy of bank supervision, as part of a wider political philosophy is an interesting one, and seems to us plausible. But whether or not such a political philosophy had emerged, the FSA was and is an independent body, established in statute, and did not need permission from politicians to regulate financial institutions properly. Effective regulation can (and often must) require unpopular decisions in periods of economic growth, which appear at the time merely to restrain profitable activity. It is easy now for the FSA to promise to be more invasive in its supervision, because public and political opinion has swung behind such an approach. However we firmly believe that it is not the job of the supervisor to be popular and merely follow political fads. The FSA must develop sufficient self-reliance to stick to its guns in the face of criticism from industry or politicians, because ultimately, the job of the FSA may be to make unpopular decisions from time to time. (Paragraph 23)

The Government believes that strong governance arrangements are important for regulators, as well as companies and welcome's the FSA's openness and willingness to consider how it could improve its performance. The FSA's Board is conducting a review of its effectiveness and will report to the Treasury before the end of the year. The Treasury recently appointed four new non-executive directors of the FSA with a range of backgrounds, including strong consumer and financial inclusion experience, academic economics, and the Audit Commission, as well as experience in financial services. The new non-executive directors will work alongside the existing Board to provide strong internal challenge and maintain responsiveness to new risks (for more details see the Treasury press notice at http://www.hm-treasury.gov.uk/press_96_09.htm.)

In addition, as announced by the Exchequer Secretary to the Public Accounts Committee on 22nd October 2009, the FSA has decided to appoint the Comptroller and Auditor General (National Audit Office) as its financial auditor from the next financial year, 2010-11. This will enable the Public Accounts Committee to receive and investigate reports into the FSA's performance.

In addition to the FSA developing the confidence to make unpopular judgements and act on the basis of them, we are in favour of the supervisor receiving some automatic tools to put sand in the wheels of financial expansion, without having to prove beyond all doubt that its actions are necessary in the face of resistant firms. In Chapter 4 we will turn to the question of how rules-based counter-cyclical supervisory tools might be developed that make it easier for the supervisor to lean against the wind by the time the next economic boom commences. (Paragraph 24)

As set out in *Reforming financial markets*, the Government agrees with the Committee that regulatory standards should be designed to counter pro-cyclicality in the financial system. The Government believes that regulation should encourage firms to build up buffers of resources during the economic expansion in order both to dampen excessive risk taking in

the financial sector, which can amplify an economic upturn, and to ensure that banks are more resilient to economic shocks to prevent the financial system amplifying an economic downturn.

The Government is working closely with the FSA and the Bank and with international partners to develop internationally consistent regulatory tools that encourage banks to build buffers of resources in good times and to introduce a leverage ratio as a supplement to risk-weighted capital requirements. International work on addressing pro-cyclicality is being led by the Basel Committee and consists of four elements:

- dampening the cyclicity of the minimum capital requirement;
- promoting more forward looking provisions;
- conserving capital to build capital buffers at individual banks and the banking sector that can be used in stress; and
- achieving the broader macroprudential goal of containing excess credit growth and protecting the banking sector from system-wide risk.

The Government supports the Basel Committee's ongoing work and believes that a package of policy measures is likely to be needed to address the different aspects of financial markets pro-cyclicality. Any reforms to the internationally agreed Basel standards should be fully implemented in the EU through changes to the Capital Requirements Directive.

The FSA's assessment of whether senior bankers were fit and proper for their posts appears to have been little more than a tick-box formality, unless the applicant had a criminal record or gave some other evidence of a shady past. That bar was demonstrably set too low. We welcome the acknowledgement from the FSA that a candidate's competence, as well as their probity, will now be thoroughly reviewed before taking up a senior post in a bank. We recognise that there may be some dangers in the FSA assessing competence, not least because the FSA will become exposed to accusations of incompetence itself, if it makes a wrong judgement. We discuss these dangers in the next section. (Paragraph 31)

We recommend that the FSA assess whether bank executives should possess relevant qualifications. We would like to see banking qualifications become one of the core indicators against which the FSA can assess a candidate's competence. If a candidate has no relevant qualifications, the onus should be on them to prove to the FSA that they have relevant compensatory experience. To this end we recommend that the FSA work with the British Banker's Association to draw up a list of relevant qualifications, and perhaps even work to encourage academic institutes to design new qualifications tailored towards the skills required of banks' senior management. (Paragraph 32)

There are obvious potential benefits to the FSA becoming more inquisitive, and starting to ask more searching questions about firms' business models and management decisions. It is quite right that, where the taxpayer is exposed to the risk of bank failure, the regulator should adopt a proactive approach to ensuring that risks borne by banks are not excessive. However, there is a potential downside to this

approach, which is that the FSA start to crowd out the due diligence of private agents. It would be extremely dangerous if the FSA were to become the single point responsible for the identification of failure. It is important that investors and others conduct due diligence and necessary scrutiny of banks. The solution lies in making sure that the regulator does enough to insulate the taxpayer and small depositor from the impact of a firm's failure whilst avoiding treading on the toes of those with a responsibility for a firm's stewardship. It is right that shareholders should feel the pain if their firm fails, and equally it is good that small depositors are protected by deposit insurance and an active regulator. Currently bondholders and other creditors are also substantially protected from loss, because it is most unlikely that a large bank would ever end up entering administration. A balance needs to be struck by the FSA which places sufficient incentive on them to perform satisfactory due diligence. We recommend that the FSA outlines its thinking on the appropriate level of protection for creditors of banks and how it proposes to do this. (Paragraph 36)

The Government believes that the principal responsibility for the performance and management of a firm rests with its board of directors, as appointed by shareholders; the Walker Review, to be published shortly, is examining ways to address governance and stewardship shortcomings exposed by the crisis. We also agree with the Committee's belief that private agents must undertake appropriate due diligence in investing and managing investments. However, given the wider impact of mistakes made by financial firms, there is also a role for regulation. Shareholders and owners have a duty to act in a responsible manner and hold their investee companies to account. Responsible ownership involves engaging with investee boards and managers, evaluating and acting on disclosures and exercising voting rights in the best interests of beneficiaries. Improving Shareholder engagement falls within the scope of the Walker Review and we will consider carefully Sir David's recommendations on this matter.

The Financial Services Bill will ensure that the Government has the power to implement Sir David Walker's final recommendations on remuneration disclosure. Sir David will be delivering his final reports to the Government on 26 November and, the Government is taking a power to enable it to implement his recommendations. In addition, the Bill will bestow a duty on the FSA to ensure remuneration policies are consistent with effective risk management and with the Financial Stability Board's Implementation Standards. The Bill will give the FSA the power to provide that contractual provisions that contravene prohibitions on giving specified forms of remuneration are void and unenforceable. The FSA will also be given the power to make provision for the recovery of any payment made under a void provision. The Bill will strengthen the hand of the FSA in ensuring that financial services remuneration does not lead to excessive risk taking. The FSA will have the powers to fine a regulated bank that executes a service agreement with an employee that is in breach of a specific remuneration rule and force that bank to re-draft those parts of the contract that breach the rule. It will be able to make rules to force the bank to seek recovery of any payments made in accordance with the contractual obligations that breach rules.

In the light of the crisis, it is right for the FSA to strengthen its role in approving candidates proposed for "significant influence" functions, and to work with all appropriate stakeholders, including owners, as necessary. The Government welcomes the work that the FSA is doing in this area, including its extension of its Approved Persons regime in July of

this year, its plans to consult next month on the responsibilities and competence of non-executive directors, and its decision to review its “training and competence” rules next year.

Systemically significant banks

It is probably a fact of life that many banks will remain ‘too big to fail’, and will never be allowed to go bust. But there are areas where the authorities must take action. First, we are concerned that some banks would be ‘too big to save’ and the recent consolidation in the UK banking sector has only exacerbated this problem. Quite apart from competition considerations, the Government should review how prudent it is to have a banking market dominated by several banks with global balance sheets larger than the national economy. (Paragraph 43)

Second, those banks which are too big to fail must no longer be able to take advantage of that fact for private gain. Market discipline must be reintroduced in order to realign the incentives of bank investors and managers. We welcome the ideas put forward regarding a ‘tax on size’ administered through the capital regime. (Paragraph 44)

Capital requirements must tackle any incentives that banks have to grow or merge merely for the sake of becoming ‘too big to fail’. Further, and admittedly more difficult, since capital requirements are a form of insurance, they should ideally be calculated on an expected loss basis, taking into account both the probability of a bank’s failure and the potential costs of such an event occurring. (Paragraph 45)

It has been alleged that some large banks took advantage of the implicit government guarantee backing up deposits, to cross-subsidise more lucrative trading activities. In such a scenario, rewards would be pocketed by the banks, whilst risks would be largely borne by the taxpayer. Such an outcome would be intolerable. We see the debate about narrow banking as being not so much about reducing the risk of failure, or even the impact of potential failure, but more about the incentives confronting bankers. These incentives are skewed dramatically by implicit government guarantees. The FSA proposals to subject proprietary trading activities carried out by retail banks to much higher capital requirements is welcome, and the bare minimum given the failure of the concept of ‘liquidity through marketability’ that previously underpinned the relatively low capital requirements of trading books. Calculating how swingeing those capital requirements ought to be is a tricky balancing act. As they get tougher, their impact will get closer and closer to that of a prohibition on proprietary trading. A ban may not be necessary if firms are given sufficient incentive to separate their trading units from their retail banking activities of their own accord, but a ban should not be ruled out by the FSA as an option at this early stage. (Paragraph 53)

We agree with the Governor of the Bank of England that highly complex, interconnected banks should face higher capital charges than simpler banks, because they impose a greater risk on the financial system as a whole. In order to inform such flexing of the capital regulations, we recommend that the FSA initiate work to increase its understanding of the extent and nature of the interconnections between financial firms. (Paragraph 55)

The Government agrees that large and interconnected financial institutions present a challenge for the Authorities, particularly as their failure could pose significant risks to financial stability, to the wider economy and to public finances. The Government also agrees that the moral hazard problem, where such firms are perceived to benefit from an implied public subsidy, and the market distortions and misaligned incentives that this can entail, must be addressed.

The Government set out a comprehensive policy package to address the risks posed by large, complex or interconnected firms in *Reforming financial markets*, and is now taking this forward through legislative provisions in the Financial Services Bill and in driving work with international partners. This includes tougher prudential requirements on systemic firms and the preparation of Recovery and Resolution Plans (RRPs, so-called 'living wills'). The Government will continue to work closely with the FSA and the Bank of England to develop policies to address these risks. In recognition of the importance of international coordination on these policies, the Government will also continue to take an active role in international fora.

The Government agrees with the Committee's recommendation that capital requirements should be linked to the size, complexity and interconnectedness of banks, and that a deeper understanding of financial firms' interconnectedness should be achieved.

The Government does not believe that the case has been made for a Glass-Steagall style split between retail banking and investment banking activities. There are three principal reasons for this. First, it is difficult to do—a simple distinction between retail and investment banking is not possible. There is a range of market-making activities in which banks engage in order to provide important risk management services to the economy, not for proprietary trading purposes. Second, even if it were feasible, it would not be enough. The last 18 months has shown the channels of contagion in the financial system are complex. Separating investment and commercial banks would not insulate pure deposit-taking institutions from the failure of a large investment bank. Lehman Brothers has shown this most clearly. Third, it implies that all the risk lies in investment banking. However, it is not just investment banks that involve risk – the activities of retail banks, for example, Northern Rock and Bradford & Bingley, have proved to involve significant risk. In addition, unilateral implementation of such structural measures would seriously damage the UK's competitiveness.

Instead, the Government sees the combination of higher and more tailored capital requirements and RRP as achieving the same outcomes in dealing with the systemic risk posed by firms.

The Government welcomes the new International Monetary Fund/ Bank for International Settlements/ Financial Stability Board (IMF/BIS/FSB) guidelines to identify systemically important financial institutions, markets and instruments, and the agreement by G20 Leaders in Pittsburgh that prudential standards for systemically important institutions should be commensurate with the costs of their failure. The Government supports the work underway in the FSB to develop by the end of October 2010 possible measures to address the 'too big to fail' problems associated with systemically important financial institutions, including the related work by the Basel Committee to assess the merits of a capital surcharge to mitigate the risk of systemic banks. Recognising the importance of

achieving international consensus in this area, the Government remains committed to working with G20 partners and the Basel Committee on Banking Supervision Working Group on macro-prudential supervision in their work addressing systemically significant institutions.

The Government also welcomes the FSA's Discussion Paper² on the treatment of systemically important financial institutions, including its conclusions that there is a strong case for applying some form of capital surcharge to systemically important banks. The Government will continue to work with the FSA as it develops the design of the domestic policy framework.

The Government strongly supports the FSA's commitment to a trading book capital regime incorporating higher capital requirements against trading activities. To this end, the Government welcomes steps agreed by the Basel Committee to significantly increase trading book capital requirements, which will be implemented in the UK by the FSA. The Government also agrees with the FSA's initial conclusions, set out in its recent discussion paper, that a Glass-Steagall type separation is unlikely to be practical via legal distinctions, but that further consideration should be given to alternatives, including: trading book capital requirements that strongly differentiate between basic commercial bank market-making and more risky proprietary trading activities; and the use of RRPs to encourage greater clarity and simplicity of legal structures. The Government recognizes that it is the responsibility of the FSA to consider whether a ban on proprietary trading is appropriate and welcomes the further work of the FSA in this area.

The majority of consultation responses to *Reforming financial markets* supported the proposition that the nature of institutions should be considered in setting regulatory capital requirements, and that this should reflect complexity and interconnectedness as well as size. Respondents also stressed the importance of international consensus.

RRPs, for which the Government will be legislating in the Financial Services Bill, aim to reduce the probability of firm failure by requiring firms to prepare for stressed circumstances (the recovery element) and to reduce the impact of firm failure if this does occur through preparation for failure and resolution (the resolution element). By allowing firms to fail, RRPs will be a key mitigating tool for removing moral hazard and reasserting the operation of market discipline. The quality of a bank's recovery and resolution process should have a direct bearing on supervisors' overall assessment of the prudential risks borne by the firm, and the effectiveness of a firm's RRP should be considered when calibrating additional capital requirements on the basis of a firm's systemic impact if it gets into difficulty or fails. RRPs therefore create regulatory incentives for firms to become less risky.

We recommend that the FSA's advice to the Chancellor on new areas of innovation and their consequences for systematic risk should be published. (Paragraph 59)

Information on financial stability is highlighted in the FSA's Financial Risk Outlook. It is intended that the Council for Financial Stability will consider the Financial Risk Outlook in

² Financial Services Authority Turner Review Conference Discussion Paper *A regulatory response to the global banking crisis: systemically important banks and assessing the cumulative impact*, October 2009 (http://www.fsa.gov.uk/pubs/discussion/dp09_04.pdf)

one of its quarterly, strategic meetings. We envisage that the FSA would cover all areas relevant to systemic risk in its report and discussion. Quarterly meetings of the Council will also provide a regular platform for the FSA to raise concerns over innovation that may have repercussions for systemic risk. All of the above will enable the Authorities to consider the analysis and coordinate any necessary action. These discussions will be publicly minuted to raise transparency and the FRO is, of course, published.

Following discussions with the FSA, the Government has identified the need to provide the FSA with greater powers to seek information from entities which are not regulated under FSMA (Financial Services and Markets Act), where the information concerned is relevant to the financial stability either of individual financial institutions or of the UK financial system. We are introducing legislation to this effect in the Financial Services Bill. These will include the power to collect information from (i) non-regulated financial services firms, and (ii) providers of critical services to such firms (e.g. IT suppliers). In order to provide flexibility and future-proof the legislation, the Bill also proposes to confer a power on the Treasury to extend the scope of the FSA's powers to other types of institution in future.

The FSA should only permit banking activities that it understands, and that it has confidence that the bank concerned understands. (Paragraph 62)

The Government shares this view—the FSA should only permit banking activity it understands and it has confidence the bank concerned understands. The FSA is developing its understanding as follows: under the Supervisory Enhancement Programme, the FSA has significantly increased the number and quality of its supervisory staff, and enhanced its competency framework for supervisors.

Concerning the level of confidence that the FSA has in banks' understanding of their activities, the FSA has adopted a more "intensive and intrusive" approach to supervision, which includes a willingness to challenge banks' judgements about their business models. In addition, the FSA extended its regime for approving bank staff who hold "significant influence functions" (the Approved Persons regime) in July of this year. This, along with future work such as its planned consultation next month on the responsibilities and competence of non-executive directors, and its decision to review its "training and competence" rules next year, should enhance the FSA's scrutiny of, and knowledge of, the level of understanding of banks' decision-makers.

We are instinctively wary of placing too much reliance on product regulation, because it tends to be a blunt instrument. Typically it creates new opportunities for the identification and abuse of loopholes and work-arounds, and restricts some legitimate uses of the product concerned. We believe however, like the FSA, that regulators should keep an open mind and look at each product on its own merits. If, for example, a particular product has some legitimate uses and benefits, but these are significantly outweighed by inappropriate uses, the FSA should look very closely at restricting their use. (Paragraph 64)

We agree with the Committee's view that there are disadvantages to product regulation. As well as those mentioned in the Report, rigid regulation can reduce the scope for competition and innovation. However, we also agree that there may be situations in which product regulation is nevertheless relevant, and therefore it should not be ruled out in

principle. It is, however, often possible to find alternative ways of reducing the potential for harm. For example, the Government is currently looking into an alternative approach to protect retail consumers: working under the title of “Simple, transparent products” it is looking at methods for better informing consumers in order to assist their choices. This was raised in *Reforming financial markets* and the majority of respondents were in favour of development in this area. Following the consultation, the Government intends to investigate the subject further with consumers (taking a qualitative analysis approach) and to have the subject considered in more detail by a working group, formed in conjunction with the Retail Financial Services Forum. The intention is to present our findings, via a proposed solution consultation, early in 2010. By focusing on this aspect of consumer protection rather than product regulation, we hope that market innovation can be encouraged, which in turn will lead to the development of products more suited to individual customers’ needs.

We endorse the approach of the FSA that the focus of regulation should be based on economic substance rather than legal form. (Paragraph 68)

The Government also supports the approach that the FSA’s regulation should be based on economic substance rather than legal form.

As mentioned above, the Government has identified the need to provide the FSA with greater powers to seek information from entities which are not regulated under FSMA, where the information concerned is relevant to the financial stability either of individual financial institutions or of one or more aspects of the stability of the UK financial system. The new powers will help judgement of which entities outside the regulatory perimeter need regulating on substance grounds.

Improving bank resolution mechanisms is a vital component of financial services sector reform. Currently, the fact that there is no means by which large, complex banks can be resolved encourages complacency in these banks, contributing to the moral hazard dangers discussed above. The Special Resolution Regime is an important mechanism, but its usefulness is reduced somewhat by its inability to cope effectively with the resolution of a large, complex bank. That weakness derives from a lack of information about how major banks are internally structured, an issue which must be addressed. We fully support the proposal of each bank writing a ‘will’ and subjecting that will to regular evaluation by the Bank of England. Banks may not like it, they may even threaten to domicile elsewhere, but in our opinion this is a reform that is clearly needed. (Paragraph 76)

The Government does not agree that the special resolution regime (SRR) is unable to cope effectively with the resolution of a large, complex bank. The SRR provides the Government with a flexible set of tools to resolve a failing firm, including powers to transfer the firm to a private sector purchaser, to a bridge bank or into temporary public ownership, with the power to split up a failing firm. The SRR also includes a modified insolvency procedure. To complement the SRR, the Government will be legislating for RRP in the Financial Services Bill. RRP aims to reduce the probability of firm failure by requiring firms to prepare for stressed circumstances (the recovery element) and to reduce the impact of firm failure if this does occur through preparation for their own failure and resolution (the resolution element). By allowing firms to fail, RRP also aims to address moral hazard.

In addition, the Government is preparing plans for the resolution and managed wind-down of investment firms, particularly those investment firms which may be considered to pose systemic risk. A full consultation paper will be published by the Treasury shortly.

The Bill makes a number of provisions around RRP, including the following:

- a duty will be placed on the FSA to make rules requiring firms, or authorised persons of a specified description, to produce RRP. The content of RRP will not be defined in legislation, but the Bill does provide for RRP to include the preparation and maintenance of key sets of data/information. The FSA will consult on the detailed rules on RRP in the normal manner, and this will include a full cost benefit analysis;
- the Bill specifies that the FSA must make rules for those authorised firms subject to Part 1 of the Banking Act 2009;
- the Bill provides an order-making power for the Treasury to stipulate to the FSA the dates by which RRP rules must be in place for categories of firms other than those covered by Part 1 of the Banking Act 2009 (authorised firms ‘of a specified description’). The Treasury must consult the FSA ahead of making an order;
- the FSA is required to consult the Bank of England and the Treasury before preparing draft rules for both RRP;
- the FSA will be required, in drafting rules on RRP, to have regard to any relevant international standards on RRP. By requiring the FSA to take in to account international standards as they develop, opportunities for regulatory arbitrage and detrimental effects for the UK’s competitiveness will be minimised;
- the Bill requires the FSA to consider whether all recovery and resolution plans are satisfactory. In assessing the resolution plans required from firms subject to Part 1 of the Banking Act 2009, the FSA must consult the Bank of England and the Treasury. The Bank of England and the Treasury may notify the FSA of any inadequacies of such a resolution plan and can suggest remedial actions which the FSA must have regard to; and
- the Bill gives the FSA additional enforcement powers related to the collection of information in relation to RRP.

Consultation responses to *Reforming financial markets* broadly expressed support for RRP, subject to clarification of their form, content, operation and cost.

The FSA intend to consult during 2010 on the detailed rules on RRP for firms subject to Part 1 of the Banking Act 2009 in the normal manner. This will include a full cost benefit analysis. The draft rules will be prepared on the basis of evidence gathered from the FSA’s ongoing pilot project on RRP working with a small number of large UK banks.

Macroprudential supervision

The Basel capital rules are the result of over a decade of negotiations and planning. Unfortunately they do not work, or at least do not work in a crisis, which is precisely

when they are most needed. Arguably they have made things worse by distracting the attention of leading experts, and have had the effect of driving much financial activity off balance sheet altogether. There may be a place for risk-based capital requirements, but there is also undeniably a need for a minimum level of capital based on a bank's size. We welcome the steps being taken in the UK and in the international arena to introduce a leverage ratio as a backstop measure to prevent banks being able to reduce their capital levels to an unacceptable level. (Paragraph 89)

The Basel capital requirements set minimum levels of capital for banks and establish a level playing field, minimising the risk of cross-border capital arbitrage. In a number of respects the introduction of risk based capital requirements through Basel II and the CRD marks a significant improvement in the prudential regulation of banks.

However, the Government agrees that a number of weaknesses in the Basel II framework need to be addressed, and we fully support the work underway by the Basel Committee to strengthen international standards for the prudential regulation of banks. In particular, we welcome the steps that have been taken to address the shortcomings in the Basel capital framework that generated incentives for off-balance sheet securitisation activity.

The Government also agrees, as set out in *Reforming financial markets*, that risk-weighted capital requirements need to be supplemented with a leverage ratio. During good times, when risk can be systemically underestimated by the risk-based models and those who use them, a leverage ratio (total assets to capital) seeks to provide a "backstop" to ensure minimum capital levels are maintained. The Government welcomes the commitment by the G20 to implement a leverage ratio and the work underway in the Basel Committee to develop an internationally comparable tool.

On its own a leverage ratio can create undesirable incentives in that it may encourage banks to invest in riskier assets. However, this would affect the Basel II risk-weighted capital ratio by raising the amount of capital required by the banks. This is why it is important that a leverage ratio is a complement, rather than an alternative, to risk-weighted capital requirements.

There is a strong argument in favour of the introduction of a degree of countercyclicality in capital regulation. It is important that banks are forced to build up capital reserves in the good years for the inevitable leaner years that will follow. By slowing down credit growth in a boom, counter-cyclical capital rules should also prove a strong tonic to the financial markets' tendency to amplify the natural economic cycle because of irrational exuberance, which is also very welcome. There is now a burgeoning consensus that counter-cyclical capital requirements are needed; the debate has moved on to what that means in practice. We believe that such requirements should, as much as possible, be based on simple rules. This is first so that banks can know where they stand, benefit from regulatory certainty and plan accordingly. Secondly, a rules-based system would reinforce the regulator's ability to avoid succumbing to industry lobbying for lower capital requirements. Thirdly, a rules-based system could remove the need for any one organisation to call the economic cycle, a task which has proven extremely difficult in the past, and which will doubtless continue to be so. Nevertheless, there is a place for regulatory judgements, so there should be some limited flexibility in the application of the rules. (Paragraph 95)

As set out in our response to Recommendation 4 above, the Government fully supports the international consensus that regulation should encourage firms to build up counter-cyclical buffers of capital during economic expansions. The Government is working closely with the FSA and the Bank of England, and actively participating in work in international fora to develop tools to counter pro-cyclicality.

The Government agrees that this can be achieved in part through the implementation of appropriate rules-based regulatory mechanisms agreed internationally. There are clear advantages to rules-based approaches. For example, at times markets may find authorities constrained by rules more credible than authorities that are given discretion. However, given the tendency of financial markets to innovate and evolve, rules-based mechanisms are unlikely to be enough to lean effectively against credit cycles by themselves. Authorities will also need to be able to make judgments about how risks are evolving over time and to respond with discretion. This could involve varying the setting of regulatory tools to constrain the build up of imbalances in the financial system. Given the global nature of financial markets, coordination both in the development and the implementation of such tools is crucial.

Solutions to the problems of liquidity regulation need to distinguish between idiosyncratic failures of liquidity risk management at specific firms, and widespread liquidity crises caused by the freezing of entire asset markets. In the former case, the regulator's onus should be on ensuring that financial institutions are given the right incentives to manage the risk, in order to avoid moral hazard. In situations where there is systemic market freezing, liquidity should be viewed as being a public good, and be provided for by the central bank. Analysis of the maturity mismatch between assets and liabilities on a bank's balance sheet might be one angle from which to approach liquidity regulation in the future, and we would welcome the FSA's views on this matter. (Paragraph 99)

The UK has been at the forefront of work on international regulatory reform, including liquidity regulation, through its chairmanship of the G20 and membership of key bodies such as the Financial Stability Board and the Basel Committee on Banking Supervision (BCBS), and the Government will continue to work closely with the FSA and the Bank of England as well as international partners. BCBS has made encouraging progress on stronger liquidity regulation already, with the Central Bank Governors and Heads of Supervision noting as a key measure the introduction of “*a minimum global standard for funding liquidity that includes a stressed liquidity coverage ratio requirement, underpinned by a longer-term structural liquidity ratio*”³. We also welcome the FSA's recent publication of final rules on liquidity requirements, “*Strengthening Liquidity Standards*”.

We look forward to examining the FSA's proposals for regulatory reform in the area of loan-to-value ratios. (Paragraph 102)

On 19 October, the FSA published a discussion paper on its approach to mortgage regulation and a package of proposals to improve its existing regime. This is available on

³ Bank of International Settlements press release, 7 September 2009,

<http://www.bis.org/press/p090907.htm>

the FSA's website at: http://www.fsa.gov.uk/pubs/discussion/dp09_03.pdf. The Government welcomes this discussion paper.

Reform to the institutional framework of financial stability

We cautiously welcome the replacement of the Tripartite Standing Committee by the Council for Financial Stability (CFS) in respect of the publication of clear terms of reference for the new body and the fact that minutes of its meetings will now be published. We look forward to engaging with the CFS over how Parliamentary accountability might be improved. However, we view the change as one which is largely cosmetic. Merely rebranding the Tripartite Standing Committee will achieve little by itself; what is required is an improvement in cooperation amongst its members, and a simplification and clarification of responsibilities for each of its members. (Paragraph 112)

The Council for Financial Stability will put the institutional framework for financial stability on a more formal, transparent and accountable basis. The Financial Services Bill places the Council on a statutory footing, requiring it to minute publicly its quarterly strategic deliberations and the Treasury to produce an annual report on the activities of the Council. This report will be laid before both Houses of Parliament. The Government looks forward to discussing, as the proposed legislative measures are debated in Parliament, appropriate mechanisms for holding the Council to account and for scrutinising the Report on the Council. The Government notes that a significant number of respondents to consultation highlighted the role of the Treasury Select Committee in holding the tripartite authorities to account, and a belief that the Committee can effectively do so for the new arrangements.

Devising an appropriate institutional framework for macroprudential supervision is extremely important and should not be rushed. We agree with the argument made by each of the Chancellor, the Governor and the Chairman of the FSA that it is necessary to reach an agreement on the precise instruments needed in the macroprudential toolbox, before considering which organisation should wield those tools. (Paragraph 113)

Whatever the final outcome of any institutional arrangements it is absolutely imperative that responsibilities are clear. The biggest failings of the Tripartite's handling of Northern Rock were that it was not clear who was in charge, and, because the Tripartite took a minimalist view of their respective responsibilities, necessary actions fell between three stools. We are not confident that this issue has yet been adequately resolved. Where before no-one had a formal responsibility for financial stability, now many do—the Bank of England, the FSA, the Treasury, the Council for Financial Stability and the Bank's Financial Stability Committee. Where responsibility lies for strategic decisions and executive action was, and remains, a muddle. The Treasury's design of the institutional framework for financial stability must bear in mind that, when the dust eventually settles on a new system, the question that we, and others, will ask is "Who gets fired?" if and when the next crisis occurs. It is a blunt question, but one which is necessary. Only if we have such clear responsibilities can we expect good decisions to be made and the right actions to be taken. Once those

responsibilities have been clarified, the appropriate powers must be properly aligned. (Paragraph 114)

Responsibility for financial stability in the UK is shared between the FSA, as the financial services regulator, the Bank of England, as the Central Bank, and the Treasury, as the Finance and Economics Ministry. Each authority has different responsibilities and each has policy tools available to them, enabling them to perform different but complementary roles in supporting financial stability. It will be the Council for Financial Stability's role, under the Chancellor of the Exchequer's chairmanship, to ensure that the cooperation and interaction between the authorities is closely coordinated.

The Banking Act 2009 explicitly recognised the Bank's role by providing it with a statutory objective for financial stability. The FSA currently has no specific objective concerning financial stability. Although maintaining stability is a fundamental component of maintaining confidence in the financial system (an existing objective), we believe it is helpful for the FSA's objectives to contain a more explicit recognition of the role the FSA has to play in maintaining and enhancing stability. The Financial Services Bill gives the FSA a financial stability objective. This provides a more explicit recognition of the role the FSA has to play in maintaining and enhancing stability. This objective will help to clarify that the FSA's regulatory and supervisory approach should include an enhanced focus on monitoring, assessing and mitigating systemic and macro-prudential risks, and will provide overt legal authority to take action to support financial stability.

We are extremely perturbed by the statement by the Governor of the Bank of England that he was kept in the dark over the contents of the Government's White Paper on *Reforming financial markets* to the extent that he had "no idea" what it would contain, or even when it would be published, only a fortnight before publication. The Chancellor must set out why consultation papers on financial reform are now no longer jointly published, or even shared, with his Tripartite colleagues. Failure to do so will only add further cause for concern to those worried about the state of the crucial relationships between the Tripartite principals. (Paragraph 120)

The Government has a deep and broad relationship with both the Bank of England and the FSA. This includes the Chancellor and the Financial Services Secretary regularly meeting with the Governor and senior representatives of the Bank of England. *Reforming financial markets* represented the Government's view of the causes of the financial crisis, the action already taken to restore financial stability and the regulatory reforms necessary to strengthen the financial system for the future. Its development was discussed with the Bank and FSA at a number of levels, but it ultimately represents the Government's view. Furthermore, *Reforming financial markets* provides in part a response to *The Turner Review* by the Chairman of the FSA; it would not have been appropriate for the tripartite to respond as a whole to the FSA view.

International dimensions

The existence of large, complex, cross-border banks brings both benefits and dangers. Such institutions benefit the consumer by simplifying banking transactions and act as a lubricant to global capital flows. However, the risks they present to the global financial system are considerable. As the Governor has said, whilst banks may be global in life,

they are national in death, because if such a bank were to fail, the regulator in the bank's home state would have the responsibility of resolving the firm. Not only would this be an unenviable task for the home state authorities, it would also present problems for host states, as they would have very little control over the fate of the firm's banking operations within their countries. This makes all the more critical the insistence on a 'will' for any bank operating in the UK. Colleges of supervisors are certainly a good idea, as they will provide a forum through which information about large banks can be shared, but we doubt that they are enough on their own. We support the idea that the national banking units of global banks should be obliged to establish as stand-alone subsidiaries of the parent group, regulated and supervised by the host state regulator. The capital of these stand-alone banking units would need to be ring-fenced to prevent the parent group snatching it away upon failure of the global bank. We recommend that the FSA should consider how feasible such a system would be, including whether or not it could be implemented unilaterally without international agreement. Sacrifices to efficiency of global firms in peacetime would be a price worth paying for the reassurance that a possible crisis could be contained within national boundaries if the firm failed. (Paragraph 132)

With regard to resolution arrangements, the Government has been working domestically, and engaging at the European and international level, to ensure policy measures put in place minimise moral hazard, reduce the probability of firm failure while limiting the impact of actual firm failure on the wider financial system and the economy.

Within the UK, the Government will be legislating for RRPs, so-called "living wills", in the forthcoming Financial Services Bill. As set out previously, these would require firms to produce and maintain plans covering de-risking measures, and information on firm structure and other data that would assist authorities and others (such as insolvency practitioners) in preparing for and executing an effective resolution. RRPs will initially be required by firms covered by Part 1 of the Banking Act 2009, expanding to other firms to timetables set out by order. These plans would also include information to enable the swift administration and winding down of the firm concerned.

Simultaneously, at the international level, the UK is working with a variety of home and host regulatory authorities through the Financial Stability Board (FSB) to enhance cross-border crisis management preparation. The FSB will prepare templates for firm-specific RRPs, which the G20 St Andrews summit tasked firms to deliver by end2010. The UK intends to use the evidence from cross-border crisis management group (CBCMGs) discussions about issues like intra-group dependencies and structures to inform the UK's domestic implementation of RRPs. The Government believes that countries with firms that have core supervisory colleges should also establish CBCMGs for such firms.

The Government notes the Committee's comments on obliging the creation of standalone subsidiaries and capital ring-fencing. However, we would underline that, under the EU single market, a bank authorised in one EEA⁴ Member State is allowed to operate as a branch in another, with the supervision of solvency and of whole-bank liquidity resting with the home country supervisor. Financial institutions outside the EEA wishing to establish an authorised presence in the UK can either open a branch or a subsidiary. The

⁴ European Economic Area

FSA will authorise institutions as a branch once the home-regulator has been assessed for equivalence to UK and EEA supervisory standards, and once the whole firm has been assessed as meeting the FSA's threshold conditions for authorisation.

Having said that, the Government believes that the rules and safeguards for cross-border branching within the EEA should be strengthened to reduce the likelihood, and cost, of the failure of a foreign branch. As set out in *Reforming financial markets*, this could be achieved by ensuring that minimum supervisory standards are strong and applied consistently to cross-border groups; information exchange between home and host authorities is strengthened, with host supervisors having access to prudential information relating to the overall financial position of a group; and that peer review and supervisory audits of cross border supervision take place. A package of amendments to the Capital Requirements Directive (CRD) has been agreed and will come into force on 31 December 2010. The package, known as CRD 2, delivers the following measures designed to strengthen the supervision of cross-border banking groups:

- home and host supervisors will be required to reach a joint decision on the consolidated level of own funds held by a group, with a mediation mechanism in case of disagreement;
- colleges of supervisors must be established in order to foster stronger co-operation between home and host supervisors both in ordinary times and in emergency situations;
- home-state authorities will have the ability to designate a branch as 'significant' and receive more information relating to the branch and the whole firm via participation in the relevant supervisory college;
- competent authorities will be required to have regard to the implication of their decisions on the financial stability in other Member States; and
- competent authorities will be required to follow the guidelines and recommendations of the Committee of European Banking Supervisors, unless there are good reasons not to do so.

Under the CRD, the host country has powers relating to the supervision of local liquidity of branches established by institutions authorised by other EEA countries. Therefore, in addition to the above options, the FSA is also developing a new liquidity regime to apply the principle that UK-regulated firms, including UK branches of foreign (EEA and non-EEA) firms, should be self-sufficient for liquidity purposes, unless their parent company meets certain criteria. For non-EEA firms, should the FSA believe that a UK branch is or would not be subject to appropriate supervision given the nature, scale and complexity of the individual risks posed by such a branch, it has the option of recommending local subsidiarisation as an alternative form of authorisation, which would, of course, then include local capital requirements monitored by the FSA.

We believe that the Government should take the issue of over-reliance on financial services much more seriously than it currently does, and should commission a review by an independent figure from outside the financial community to consider the City's impact on the wider economy and public finances. This is not to suggest it is sensible

for any Government to decide the right size of an industry as a proportion of the economy, but rather to ensure that the risks as well as the benefits of specialisation are articulated, understood, and prepared for. (Paragraph 138)

Recent events have led some to speculate on whether there is an “optimum size” for the financial services industry as a proportion of any given economy. However, the Government believes that it would not be desirable for authorities to decide on what this “optimum size” should be, not least because it is unclear such a policy target could be achieved or enforced in practice. Moreover, the evidence does not suggest that the UK financial sector’s share of the economy in terms of output is anomalously unbalanced - whereas recent figures place the sector’s contribution at approximately eight per cent, this is significantly less than the manufacturing sector’s share of UK output, which is just under 14 per cent.

Rather, the Government agrees that the more relevant response is to ensure that the benefits and risks of the financial services industry and its numerous sub-sectors are better articulated, understood and prepared for, to ensure that the UK achieves fair, efficient and stable financial markets that can genuinely support economic growth and prosperity. A more sustainable alignment between the activities of the financial sector and the interests of the wider economy requires an informed public debate on this very subject, and we welcome the contribution of the Committee in this area.

As the Exchequer Secretary to the Treasury broadly noted in a recent Westminster Hall debate on the impact of the City of London and the UK economy³⁵, this debate involves de-bunking myths where necessary about the evidence base and nature of interaction between the UK-wide financial sector and the broader economy. At the same time, it is crucial that we continue existing efforts to strengthen the UK’s financial regulatory and supervisory framework; improve the management of systemic risk arising across financial markets; push for more effective corporate governance of financial institutions, including by making sure that investors, agents and shareholders sufficiently engage in these reforms; and to ensure that the financial services sector sustains its everyday efforts to help businesses and households.

With regard to the Committee’s proposal of an independent review, the Government understands that there are industry-led efforts underway, as a result of recommendations from a recent industry-Government report on the future of international financial services, to involve independent figures outside the financial services community in examining the benefits and impacts of the sector on the wider economy.

The way forward

This Report aims to contribute to the very important debate over the future of regulation and supervision of financial services. The debate is currently at a point where agreement is being reached, nationally and internationally, on the reforms that will be needed, but agreement is not particularly close to being reached on the practical implementation of issues such as counter-cyclical capital agreements, liquidity supervision and cross-border handling of global firms. We acknowledge that UK

⁵ http://www.publications.parliament.uk/pa/cm200809/cmhansrd/cm091014/halltext/91014h0009.htm#0_9101436000312

authorities are at the forefront of much of the agenda on the international stage, which is vital given the size of the UK financial sector. Now that immediate concerns over bank stability appear to be subsiding the temptation to relax must be avoided. Whilst there may not be an urgent need for new rules given the banks' withdrawal from some of the risky business that got the sector into trouble, there is an urgent need for momentum to be maintained towards the design of a better framework. We expect further announcements by the Tripartite bodies in the autumn, and look forward to reviewing their progress towards the establishment of safer, calmer, banking supervision. (Paragraph 143)

We are pleased that the Treasury acknowledges the useful role that the Treasury Committee can play in scrutiny of the future performance of the Council for Financial Stability and pays tribute to our work over the last two years. Such praise, however, will be no more than empty flattery if it is not supported by actions. If we are to offer effective scrutiny this must be based on our considered analysis of the relevant evidence, not on spur of the moment appraisal. We are also unimpressed that the Treasury initially indicated that the White Paper would be issued shortly after the Budget but offered no explanation for the lengthy delay leading up to its eventual appearance. (Paragraph 149)

The Government welcomes the contribution of the Treasury Select Committee and looks forward to its ongoing engagement. It is the Treasury's intention to provide it with the opportunity for effective scrutiny of the department and its work. We will look to liaise effectively with the Committee to ensure that it feels that these opportunities are provided going forward. *Reforming financial markets* contains detailed analysis and recommendations on complex subject matter; that publication was later than initially anticipated was a reflection of this.

Appendix 2: Financial Services Authority response

We welcome the Committee's report on *Banking Crisis: regulation and supervision*. In this memorandum we respond to those detailed conclusions and recommendations which are relevant to the FSA.

The issues raised in the Committee's report are high on our agenda as we work with other authorities in the UK, the EU and internationally to improve the regulatory framework for the future. We look forward to continuing to engage with the Committee on these issues.

Since giving evidence to the Committee, we have continued with our work on our supervision of firms and on the wider regulatory issues arising from the crisis. This includes:

- **Turner Review Feedback Statement:** On 30 September we published a Feedback Statement setting out our analysis of the responses we received to the March 2009 Turner Review and associated Discussion Paper, and reporting on the progress made since March in implementing change and in achieving international agreement. The feedback we received raised some important issues relating to detailed implementation, but in general supported the broad thrust of the agenda proposed in the Review and now being pursued. Our further Discussion Paper, published on 22 October (*The Turner Review Conference Discussion Paper, A regulatory response to the global banking crisis*) focuses on two issues where there is not yet a clear consensus, where debates have suggested new approaches since we published the Turner Review and where the FSA's thinking continues to evolve. These two issues are how we deal with systemically important firms and how to assess the cumulative impact of the various capital and liquidity changes being proposed. These are important questions on which we hope our paper will stimulate debate.
- **Liquidity requirements:** On 5 October we published our final rules on the liquidity requirements expected of firms. The new rules will require changes to firms' business models and will bring about substantial long-term benefits to the competitiveness of the UK financial services sector. Specifically, the rules include: an updated quantitative regime coupled with a narrow definition of liquid assets; over-arching principles of self-sufficiency and adequacy of liquid resources; enhanced systems and controls requirements; detailed and more frequent reporting requirements; and a new regime for foreign branches that operate in the UK. This integrated approach involves analysing risk at an individual firm level, with supervisors being supported by sector analysis and high quality technical advice from specialists in prudential and conduct risk. We now seek to make judgements on the judgements of senior management and take action if, in our view, those actions will lead to risks to our statutory objectives.
- **Restructuring:** As the Committee is aware, since March 2008 we have been working hard to deliver intensive supervision. This has required greater resource,

more technical expertise and a reassessment of risk. In October we implemented a new FSA operational structure designed to better align our internal operating model to our core activities of identifying and mitigating risk, supervision and enforcement.

In our response, we identify the recommendations relevant to the FSA and cite the relevant extract from the report, followed by our response.

FSA supervision

We welcome the speed of progress made by the FSA under the Supervisory Enhancement Programme in recruiting staff, and boosting training, in order to improve its scrutiny of UK banks. Although it is difficult, and too early, to tell what impact the SEP has had on the banks' behaviour, we are encouraged by the fact that the financial services sector has clearly noticed a change in approach. The SEP is a necessary, but not sufficient, response to the problems of the financial crisis. (Paragraph 13)

We welcome the Committee's support for our Supervisory Enhancement Programme. We have made clear that we cannot go back to business as usual and accept the risk that a similar crisis occurs again in ten or 20 years' time. Radical change is needed. We are confident that the Supervisory Enhancement Programme, combined with changes in regulatory philosophy and in substantive regulatory requirements (in particular, on capital and liquidity), is well designed to reduce the risk that past mistakes are repeated.

The FSA must develop sufficient self-reliance to stick to its guns in the face of criticism from industry or politicians, because ultimately, the job of the FSA may be to make unpopular decisions from time to time. (Paragraph 23)

We have acknowledged that in the past there was a strong mindset among regulators that financial innovation was always beneficial, more trading and more liquidity creation was always valuable, and that ever more complex products were beneficial because they allowed a more precise matching of instruments to investor demand for liquidity, risk and return combinations. We have had to change that mindset and we have now done so.

We are imposing at firm level a far more assertive style of supervision. We are no longer willing to assume that market discipline and incentives will always lead firms' management to make optimal decisions. We are now actively making judgements on whether business models and business strategies create undue risks for the whole financial system.

In addition to the FSA developing the confidence to make unpopular judgements and act on the basis of them, we are in favour of the supervisor receiving some automatic tools to put sand in the wheels of financial expansion, without having to prove beyond all doubt that its actions are necessary in the face of resistant firms. (Paragraph 24)

We support the development of a formula-driven ('automatic') approach to setting counter-cyclical capital buffers and/or forward-looking general provisions that would build up in periods of strong economic growth and be available to firms to use in a downturn. This would increase the resilience of the banking system and should slow down any excess credit expansion. In order to be effective, such rules should be agreed internationally, and

we are working to that end through the Financial Stability Board and the Basel Committee on Banking Supervision. We require firms to hold capital relative to the level of risk in the activities they undertake. Our capital framework already goes further than the Basel II rules and uses stress tests to calculate how much capital a bank needs in order to withstand a severe potential stress and emerge not only solvent but still well capitalised.

Approved Persons regime

The FSA's assessment of whether senior bankers were fit and proper for their posts appears to have been little more than a tick-box formality, unless the applicant had a criminal record or gave some other evidence of a shady past. That bar was demonstrably set too low. We welcome the acknowledgement from the FSA that a candidate's competence, as well as their probity, will now be thoroughly reviewed before taking up a senior post in a bank. We recognise that there may be some dangers in the FSA assessing competence, not least because the FSA will become exposed to accusations of incompetence itself, if it makes a wrong judgement. (Paragraph 31)

As outlined by our Chief Executive, Hector Sants, to the Committee, in reviewing the recent firm failures, we considered what can be done to improve the quality of decision-making by firms' management. In recent months we have taken a number of steps to improve our processes and practices for approving and supervising individual senior managers in firms.

In July 2009 we confirmed an extension of the Approved Persons regime for those that perform a 'significant influence' function (SIF) in firms. In particular we have:

- extended the scope and application of our regime to include individuals employed by a parent undertaking or holding company (which is not itself regulated in the EEA) whose decisions or actions are regularly taken into account by the governing body of an FSA regulated firm;
- extended the definition of the 'significant management' controlled function to include all proprietary traders who are not senior managers but who are likely to exert significant influence on a firm; and
- amended the application of the approved person regime to UK branches of overseas firms based outside the EEA.

In addition, in October 2009 we wrote to the CEOs of all relationship-managed regulated firms to explain how our more intensive regulatory approach applies to approving and supervising senior personnel performing SIFs. The letter reminds CEOs that it remains the firm's responsibility to ensure that the candidates they put forward for senior roles are fit and proper to perform the role in question, and that firms should, therefore, have robust recruitment, referencing and due diligence processes in place. As part of the Approved Persons process, we will undertake close vetting of appointments and will interview candidates applying to perform certain SIF roles in particular firms. In the period October 2008 to September 2009 we have conducted 172 SIF interviews, resulting in 18 candidates withdrawing their applications. This shows that there is considerable scope for some firms to be more robust in their own recruitment processes.

Events over the last two years have also raised serious questions about the role, competence and performance of non-executive directors (NEDs). In a Consultation Paper in December 2008 (*The Approved Persons regime – significant influence function review*) we set out our proposals to look at NEDs more closely where we believe they should have intervened more actively within a firm's management. Before making a final decision on this issue, we wish to consider the relevant recommendations from *The Walker Review* and the Financial Reporting Council's review of the Combined Code. We aim to publish a further Consultation Paper in December 2009 which will include further proposals to strengthen our approach to approving SIFs.

We recommend that the FSA assess whether bank executives should possess relevant qualifications. We would like to see banking qualifications become one of the core indicators against which the FSA can assess a candidate's competence. If a candidate has no relevant qualifications, the onus should be on them to prove to the FSA that they have relevant compensatory experience. To this end we recommend that the FSA work with the British Banker's Association to draw up a list of relevant qualifications, and perhaps even work to encourage academic institutes to design new qualifications tailored towards the skills required of banks' senior management. (Paragraph 32)

We strongly agree that it is important for bank executives to have the right level of skills and experience. As noted above, we have recently written to all CEOs of relationship-managed firms reminding them that it remains the firm's responsibility to ensure that the candidates they put forward are fit and proper to perform the role in question, and that firms should, therefore, have robust recruitment, referencing and due diligence processes in place.

In the course of implementing our more intensive supervisory approach in this area, we may find instances where we are happy to approve a candidate for a senior, influential role, but where the interview has highlighted areas of development for the individual concerned. In these instances we may ask the individual and firm to put an action plan in place to complete appropriate training or development in those areas. We will then follow up with the firm and the candidate to check that the action has been completed.

Our Training and Competence rules cover qualification requirements. We will review these rules in 2010, including any need for training and competence requirements for firms' senior management, and will take the Committee's views into account in that context.

Due diligence by banks' creditors and others

It would be extremely dangerous if the FSA were to become the single point responsible for the identification of failure. It is important that investors and others conduct due diligence and necessary scrutiny of banks... A balance needs to be struck by the FSA which places sufficient incentive on them to perform satisfactory due diligence. We recommend that the FSA outlines its thinking on the appropriate level of protection for creditors of banks and how it proposes to do this. (Paragraph 36)

We agree it would be undesirable for creditors of banks to believe that they could rely on the FSA to protect their interests, without them needing to undertake their own due diligence. It is important, therefore, that creditors—as well as shareholders—understand our role. The regulation and supervision of firms is based on our statutory objectives; we aim to mitigate risks to these objectives, rather than risks to shareholders or creditors. It is very important that shareholders, as owners of the business, discharge their responsibilities properly, including by scrutinising business strategies and assessing management competence.

The powers in the Banking Act 2009 are intended to increase the authorities' options for resolving a troubled bank. While there are a variety of legal safeguards and compensation mechanisms that apply when these tools are used, they are not intended necessarily to make creditors whole. As the Committee noted in its report, only certain types of deposit are protected by the Financial Services Compensation Scheme (FSCS) when a firm fails. Work is under way to support the use of these tools in all circumstances, including in relation to large banks. For instance, we have already made rules to require firms to maintain a 'Single Customer View' which will aid depositor payout if a bank enters the Bank Insolvency Procedure. As the Committee notes elsewhere in its report, work on 'living wills' is intended to prepare for the failure of a bank and we set out our thinking on that in our 22 October Discussion Paper. However, there is a balance to be struck in designing the appropriate regime in which banks should operate. An environment in which bondholders and senior creditors face greater costs is likely to affect the funding of banks. It was for this reason that the Tripartite Authorities ruled out making depositors a preferential class of creditor.

Systemically important firms

Those banks which are too big to fail must no longer be able to take advantage of that fact for private gain. Market discipline must be reintroduced in order to realign the incentives of bank investors and managers. We welcome the ideas put forward regarding a 'tax on size' administered through the capital regime. (Paragraph 44)

As we noted in our 22 October Discussion Paper, it is clear that the future regulatory regime must include effective answers to the 'too big to fail', 'too interconnected to fail' and 'too big to rescue' problems.

Our Paper aims to stimulate debate on the range of possible policy responses, and we welcome contributions to help us finalise our policy position. Our current stance is:

- There is a strong case for applying some form of capital (and perhaps liquidity) surcharge to systemically important firms, both to reduce the probability of them failing and to require them to internalise the externality costs which their systemic importance produces;
- This capital surcharge approach could be combined with an approach to global banking groups which places greater emphasis on the standalone sustainability of national subsidiaries, with an overt global understanding that home country authorities will not consider themselves responsible for the rescue of entire groups;

- Action should be taken to reduce interconnectedness in wholesale trading markets, with much OTC derivative trading moved to central counterparty clearing systems, and with collateral and margin call arrangements for bilateral trades which reduce the dangers of strongly pro-cyclical margin call effects;
- Reforms to the trading book capital regime should significantly increase capital requirements, and differentiate more strongly between basic market-making functions which support customer service, and riskier trading activities, with a bias of conservatism in relation to the latter; and
- Systemically important banks should be required to produce recovery and resolution plans ('living wills') which set out how the operations would be recovered or resolved in an orderly fashion.

While any discussion of systemically important firms will tend to focus on banks, we recognise that other firms and infrastructure providers (both regulated and unregulated) can potentially be systemic, even though the risks they pose can be very different. This means that, while our recent Paper focuses on systemically important banks, we will, in due course, consider how a framework for systemically important firms in general could be developed.

Capital requirements must tackle any incentives that banks have to grow or merge merely for the sake of becoming 'too big to fail'. Further, and admittedly more difficult, since capital requirements are a form of insurance, they should ideally be calculated on an expected loss basis, taking into account both the probability of a bank's failure and the potential costs of such an event occurring. (Paragraph 45)

On incentives for banks to grow or merge, we are taking a keen interest in the sustainability of banks' business models and are providing greater challenge to banks' business plans, including plans to grow or merge.

In the past there have been cases of mergers, especially cross-border mergers which had been motivated in large part by diversification benefits designed to reduce the overall capital requirements of the combined group. Such claims for merger-related capital relief will be subject to greater scrutiny, and there may be a case for disallowing them or imposing off-setting capital charges for the operational risk associated with business integration.

On the calculation of capital requirements, our capital framework goes further than the Basel II rules and uses stress tests to calculate how much capital a bank needs in order to withstand a severe potential stress and emerge not only solvent but continuously maintain a core tier 1 capital ratio of at least 4%. The established Basel II capital requirements were calculated to cover not just the 'Expected loss', taking into account the probability of failure, but also the 'Unexpected loss' expected to occur only with a very low probability. We recognise, of course, that the potential losses and probabilities turned out to have been estimated with inadequate data and models, and failed to capture all risks.

As outlined in our 22 October Discussion Paper, there is a strong international consensus that the global framework for prudential regulation must be radically reformed to create a more robust and resilient financial system. In future, the global banking system will hold

significantly more capital and liquidity and operate at lower levels of leverage. Within the context of this general principle, agreed by the FSB, the Basel Committee of Banking Supervisors (BCBS) has a series of work streams to design the details of:

- an overall regime of higher capital requirements, with higher quality capital (more focus on Core Tier 1 capital) and higher minimum ratios;
- a countercyclical element to capital, with capital buffers built up in good years to be drawn down in recessions;
- a possible capital surcharge for large systemically important firms;
- significant increases in trading book capital, with more rigorous definition of trading risks reflected in higher risk-weighted assets, and thus higher capital requirements even before the impact of changes in required ratios; and
- a new liquidity regime, with increased buffers of clearly liquid assets and some type of structural mismatch ratio.

We will need to ensure that the cumulative effect of this package of measures is carefully considered, identifying both costs and benefits.

Capital requirements

The FSA proposals to subject proprietary trading activities carried out by retail banks to much higher capital requirements is welcome, and the bare minimum given the failure of the concept of 'liquidity through marketability' that previously underpinned the relatively low capital requirements of trading books. Calculating how swingeing those capital requirements ought to be is a tricky balancing act. As they get tougher, their impact will get closer and closer to that of a prohibition on proprietary trading. A ban may not be necessary if firms are given sufficient incentive to separate their trading units from their retail banking activities of their own accord, but a ban should not be ruled out by the FSA as an option at this early stage. (Paragraph 53)

Trading activities appeared lucrative to bankers because of low funding cost and low capital requirements. The low funding costs can be attributed to a range of factors, including financial innovation (especially secured financing, such as Asset Backed Securities and repos), the implicit government guarantee, and arguably monetary policy. The low capital requirements resulted from capital rules for trading book exposures that were largely based on banks' own Value-at-Risk (VaR) methodology, and which failed to capture adequately key risks, including an inadequately short window for market data and omission of counterparty risk. The Basel Committee has already announced an incremental risk charge (we are proceeding with early implementation of the incremental default risk charge for 2010) and a fundamental review of trading book capital, which looks set to address more of the shortcomings (e.g. stressed VaR to cover risks of market stress).

As outlined in our 22 October Discussion Paper, we believe there must be a limit to the extent to which implicit government guarantees support unnecessary levels of risky proprietary trading. An important open issue is whether this restructuring of complex integrated groups should go as far as requiring—within the same overall group—clear

separation between the retail deposit-taking businesses and any businesses involved in proprietary trading activities. One possible approach is to recognise a trade-off, with the capital surcharge for systemically important banks lower for those groups which go further in the direction of clear legal separation of different activities.

At this stage we are not ruling out anything, including potentially punitive capital charges or outright banning of certain types of activities. But we are seeking international agreement on the way forward, to maintain a level playing field between banks in the UK and elsewhere.

We agree with the Governor of the Bank of England that highly complex, interconnected banks should face higher capital charges than simpler banks, because they impose a greater risk on the financial system as a whole. In order to inform such flexing of the capital regulations, we recommend that the FSA initiate work to increase its understanding of the extent and nature of the interconnections between financial firms. (Paragraph 55)

Our 22 October Discussion Paper addresses the issue of systemic importance and how it can be measured. In general, a firm is systemic when its collapse would impair the provision of credit and financial services to the market, with significant negative consequences for the real economy. The factors which make firms systemically important fall into three categories (although firms may combine elements of these factors): systemic by size; systemic by interconnectedness; and, systemic by herd. Measures of interconnectedness can be very challenging given the speed and extent to which they can vary, on a daily or even intra-day basis. That said, it is relatively straightforward to identify a group of large and highly inter-connected firms that are likely to be systemically important in all circumstances

We are already working on a range of possible policy measures to deal with systemic large complex financial institutions (LCFIs), including requirements for more and better capital. We are working with the Basel Committee and Financial Stability Board to determine an internationally coordinated approach to systemically important, internationally active LCFIs.

As part of the FSA restructuring referred to above, we are expanding our Financial Stability team to become a new division, focusing on macro-prudential analysis and on understanding the extent and nature of interconnectedness in the financial system.

Tripartite correspondence

Lord Myners told us that the FSA had been charged with a new requirement to advise the Chancellor twice a year on new areas of innovation and their consequences for systemic risk, and any statutory changes that would be required to take account of that. We recommend that the FSA's advice to the Chancellor on new areas of innovation and their consequences for systematic risk should be published. (Paragraph 59)

Information on any material systemic risks from new innovations are already highlighted and published in our *Financial Risk Outlook* and in the Bank of England's *Financial Stability Review*. We will consider the publication of this additional information in line with current guidelines which state that any correspondence between the Tripartite

Authorities would be subject to the deletion of any market sensitive or confidential information.

Understanding of banking activities

The FSA should only permit banking activities that it understands, and that it has confidence that the bank concerned understands. (Paragraph 62)

We agree with the Committee's view that it is important that both the FSA and firms themselves understand the banking activities that are being conducted.

As noted earlier, in March 2008 we launched our Supervisory Enhancement Programme. As part of this programme, we have significantly increased the number of specialist and supervisory staff (280 additional staff by the end of 2009) and introduced a new training and competence scheme to ensure that our staff are properly equipped to do the job, which involves a regulatory testing regime for existing supervisors. We believe we have made good progress on this and will continue to make the necessary improvements to our organisational effectiveness, ensuring we are staffed by the right people, in the right jobs, with the right infrastructure.

As to ensuring that banks make sure that they understand their own business, our work on Significant Influence Functions, outlined above, is designed to ensure that banks appoint to their boards and senior management positions individuals who have the skills, expertise and knowledge required in those roles. Our assessment of such individuals now focuses more than in the past on technical competence in risk management, the ability to understand the data and the fundamentals, and to apply that practically to the role in question.

Product regulation

We are instinctively wary of placing too much reliance on product regulation, because it tends to be a blunt instrument. Typically it creates new opportunities for the identification and abuse of loopholes and work-arounds, and restricts some legitimate uses of the product concerned. We believe however, like the FSA, that regulators should keep an open mind and look at each product on its own merits. If, for example, a particular product has some legitimate uses and benefits, but these are significantly outweighed by inappropriate uses, the FSA should look very closely at restricting their use. (Paragraph 64)

The Turner Review challenged, in particular, the idea that we should avoid regulating financial products. The term 'product regulation' encompasses a whole spectrum of possible measures, including, in extremis, pre-approving or banning products. However, we may also require firms to demonstrate that they have scrutinised the features, functionality, design processes, risk management, and lifecycle of products in the retail market and assessed the resulting benefits to consumers.

We agree with the Committee that our approach to regulation should not be overly reliant upon product regulation, but that we should keep an open mind to the utility of product

regulation in addition to our consideration of the sales and marketing of products, where disclosure alone may not be sufficient.

In deciding whether to regulate financial products we need to balance the fact that product regulation could potentially improve consumer outcomes, but it could also change competition dynamics within the marketplace and we would need to be sensitive to the economic effects and wider environment. We would also need to consider the costs and limits of product regulation which, like any other single regulatory tool, is unlikely on its own to deliver the answer. For example, our recent Mortgage Market Review Discussion Paper proposes a form of product regulation as one important component of a package of proposals to reform that market.

Living wills

Improving bank resolution mechanisms is a vital component of financial services sector reform. Currently, the fact that there is no means by which large, complex banks can be resolved encourages complacency in these banks, contributing to the moral hazard dangers discussed above. The Special Resolution Regime is an important mechanism, but its usefulness is reduced somewhat by its inability to cope effectively with the resolution of a large, complex bank. That weakness derives from a lack of information about how major banks are internally structured, an issue which must be addressed. We fully support the proposal of each bank writing a 'will' and subjecting that will to regular evaluation by the Bank of England. Banks may not like it, they may even threaten to domicile elsewhere, but in our opinion this is a reform that is clearly needed. (Paragraph 76)

This is an area we are developing further; we agree that adequate preparations for difficult times are important. We outlined our current views on living wills in our 22 October Discussion Paper. This includes the need for resolution plans to identify the actions that firms would need to take to enable the authorities to use the Special Resolution Regime (SRR) tools (or for the firm to be placed into insolvency, if the SRR is not applicable). As noted above, we have already made rules requiring firms to introduce a 'Single Customer View' by the end of 2010. This will cover, for each customer, the deposits they have with the bank and the extent to which they are covered by the FSCS.

We will require further resolution planning from systemically significant firms, falling into three broad categories:

- firms will need to be able to assure the authorities that they can provide at short notice the data that is necessary for the authorities to assess the resolution options;
- firms will need to have undertaken an analysis of the potential barriers to the authorities being able to exercise the SRR powers: implementing the bank insolvency procedure; transfers to a private sector purchaser (whole firm and partial transfer); use of a bridge bank (whole firm and partial transfer); temporary public ownership of the deposit taker; and temporary public ownership of any holding companies; and
- firms, together with payments, clearing and settlement infrastructures, will have to conduct an analysis of how the firm could 'unplug' itself from the relevant

infrastructure so that the infrastructure itself remains robust and continues to operate and so that damage to other participants is minimised.

We expect that authorities will require relevant firms at all times to have made ex ante preparations and produced plans for recovery and resolution. Once a firm has produced these plans they will be subject to review by the FSA, in consultation with the Bank of England. We will assess the risks identified by these plans and the actions proposed by the firm to mitigate them. This will form the basis for considering whether further actions are required by the firm to remove obstacles to recovery or resolution. This may include the need for structural change and/or off-setting measures such as capital and/or liquidity where the organisation of the group and its regulated activities could pose a risk to implementing the living will.

In taking forward the implementation of living wills, we will work closely with the Bank of England and HM Treasury, as well as international colleagues through the Financial Stability Board, developing common approaches where possible but also recognising that living wills will need to be tailored to the recovery and resolution frameworks in individual jurisdictions. We believe that it is important for the UK to begin its domestic implementation of living wills in parallel with ongoing international work.

Counter-cyclicality

The Basel capital rules are the result of over a decade of negotiations and planning. Unfortunately they do not work, or at least do not work in a crisis, which is precisely when they are most needed. Arguably they have made things worse by distracting the attention of leading experts, and have had the effect of driving much financial activity off balance sheet altogether. There may be a place for risk-based capital requirements, but there is also undeniably a need for a minimum level of capital based on a bank's size. We welcome the steps being taken in the UK and in the international arena to introduce a leverage ratio as a backstop measure to prevent banks being able to reduce their capital levels to an unacceptable level. (Paragraph 89)

There is now a burgeoning consensus that counter-cyclical capital requirements are needed; the debate has moved on to what that means in practice. We believe that such requirements should, as much as possible, be based on simple rules... Nevertheless, there is a place for regulatory judgements, so there should be some limited flexibility in the application of the rules. (Paragraph 95)

We set out our views on policy tools to address pro-cyclicality in March 2009 in *The Turner Review* and accompanying Discussion Paper. We are developing policy options along those lines and participating in international policy work to develop tools to counter pro-cyclicality. On 6 September international agreement was reached (in the Group of Central Bank Governors and Heads of Supervision, the oversight body of the BCBS) on the need to introduce a framework for countercyclical capital buffers above the minimum requirement. The framework will include capital conservation measures such as constraints on capital distributions. The Basel Committee plans to review an appropriate set of indicators, such as earnings and credit-based variables, as a way to condition the build-up and release of capital buffers. Many details still need to be clarified, but it appears

likely that the eventual outcome will meet the Committee's call for policy tools that have a strong basis in rules and aim to build up buffers during good times.

Liquidity regulation

Solutions to the problems of liquidity regulation need to distinguish between idiosyncratic failures of liquidity risk management at specific firms, and widespread liquidity crises caused by the freezing of entire asset markets. In the former case, the regulator's onus should be on ensuring that financial institutions are given the right incentives to manage the risk, in order to avoid moral hazard. In situations where there is systemic market freezing, liquidity should be viewed as being a public good, and be provided for by the central bank. Analysis of the maturity mismatch between assets and liabilities on a bank's balance sheet might be one angle from which to approach liquidity regulation in the future, and we would welcome the FSA's views on this matter. (Paragraph 99)

One of the key conclusions of *The Turner Review* was that, once recovery was assured, the banking sector needed more and better quality regulatory capital, capital requirements that did not exacerbate the business cycle, and stronger liquidity regulation. The main forum for agreeing global capital standards in these areas is the BCBS and, at the London Summit, the G20 asked the BCBS to work with national authorities to develop a new global framework for liquidity and strengthen prudential requirements.

The BCBS, now expanded to include all the G20 nations, has made good progress towards delivering on this commitment and in July 2009 it held its first meeting in its newly expanded form. Following this the BCBS announced it would issue a consultation by Q1 2010 which will include proposals to strengthen the quality of bank capital; build up cyclical buffers that can be drawn down in periods of stress; and introduce a leverage ratio as a backstop to Basel II. Further, Governors and Heads of Supervision have publicly announced that we will 'introduce a minimum global standard for funding liquidity that includes a stressed liquidity coverage ratio requirement, underpinned by a longer-term structural liquidity ratio'.

As well as taking part in international discussions, we have also made significant progress on domestic implementation of our reformed liquidity regime. Consistent with commitments to implement the new regime from Q4 2009 onwards, we have completed our consultation on our new liquidity framework. Our Policy Statement 'Strengthening liquidity standards', published on 5 October, contains our new rules on the liquidity requirements expected of firms.

Loan-to-Value ratios

We look forward to examining the FSA's proposals for regulatory reform in the area of loan-to-value ratios. (Paragraph 102)

On 19 October we published our Discussion Paper on the future regulation of the mortgage market, in which we set out our views on how we can ensure a sustainable mortgage market that works for consumers. A question that had already generated considerable debate was whether we should cap loan-to-value (LTV) or loan-to-income

(LTI) ratios. We have also considered the case for specifying debt-to-income (DTI) ratios. We already use LTV thresholds for prudential purposes. These thresholds are not hard limits beyond which no lending can occur, but are used to set capital requirements which rise as the LTV increases. This is because LTV remains an important indicator of risks to a firm.

Our analysis suggests that LTI ratios do not take into account individual expenditure, therefore do not accurately reflect affordability, and would therefore be a blunt and also ineffective policy lever to ensure responsible lending. We therefore see no case for imposing an LTI cap. With regard to LTV caps, in turn, our analysis shows that high LTV ratios appear to be much less a determining factor for individual defaults than factors such as the level of the applicant's credit impairedness. For example, standard mortgages of 95-100% appear less likely to default than self-certified mortgages of 75-90%. Also, average LTV ratios have actually not increased over the past decade or so but slightly decreased. From this, we believe the case for imposing an LTV cap on consumer protection grounds is not clearly proven.

We do not, however, rule out the application of LTV, LTI or DTI caps in future as tools that could be employed as part of a wider counter-cyclical macro-prudential framework (a discussion which is out of the scope of the review) or in light of further analysis of the pattern of arrears and repossessions as the current downturn continues. Also, there are some products that combine several borrower and/or product risk characteristic in a single mortgage transaction, and we are currently assessing which of these combinations are so inherently unsuitable for an applicant that they should be banned (e.g. a 95% LTV mortgage on an interest only basis to a credit impaired applicant).

Macro-prudential supervision

Devising an appropriate institutional framework for macro-prudential supervision is extremely important and should not be rushed. We agree with the argument made by each of the Chancellor, the Governor and the Chairman of the FSA that it is necessary to reach an agreement on the precise instruments needed in the macro-prudential toolbox, before considering which organisation should wield those tools. (Paragraph 113)

In its paper on reforming financial markets, the Government set out a variety of tools that could be deployed to reduce macro-prudential risks. Following this, the government plan to introduce a Bill this autumn, which will lay out how they will work with us, the Bank of England and international partners, both to develop a framework for monitoring and assessing macro-prudential risk and for analysing fully the impact of the range of macro-prudential tools on the wider economy. We will participate actively in these discussions.

Cross-border banks

The existence of large, complex, cross-border banks brings both benefits and dangers. As the Governor has said, whilst banks may be global in life, they are national in death, because if such a bank were to fail, the regulator in the bank's home state would have the responsibility of resolving the firm. Not only would this be an unenviable task for the home state authorities, it would also present problems for host states, as they would

have very little control over the fate of the firm's banking operations within their countries. This makes all the more critical the insistence on a 'will' for any bank operating in the UK. Colleges of supervisors are certainly a good idea, as they will provide a forum through which information about large banks can be shared, but we doubt that they are enough on their own. We support the idea that the national banking units of global banks should be obliged to establish as stand-alone subsidiaries of the parent group, regulated and supervised by the host state regulator. The capital of these stand-alone banking units would need to be ring-fenced to prevent the parent group snatching it away upon failure of the global bank. We recommend that the FSA should consider how feasible such a system would be, including whether or not it could be implemented unilaterally without international agreement. Sacrifices to efficiency of global firms in peacetime would be a price worth paying for the reassurance that a possible crisis could be contained within national boundaries if the firm failed. (Paragraph 132)

As outlined in *The Turner Review* we recognise this is a difficult issue and something that has to be considered carefully. Since the publication of the Review, the EU Commission and Council have agreed the broad outline for reform of the EU's regulatory architecture. The existing Level 3 advisory committees will each be transformed into European agencies called European Supervisory Authorities (ESAs). In addition to the existing Level 3 responsibilities of advising the Commission and promoting supervisory convergence, the new ESAs are likely to be given the following further competences:

- powers to develop binding technical standards for adoption as Commission rules, in areas to be specified and subject to Commission endorsement;
- supervisory powers over entities with pan-European reach, initially confined to including CRAs;
- powers to take binding decisions addressed to national authorities, in order to settle certain disagreements between supervisors;
- powers to take binding decisions addressed to firms where the requirements are directly applicable and the national supervisor is failing to apply them; and
- crisis powers to take decisions binding on national supervisors and firms.

It was also agreed that the exercise of these powers should not impinge in any way on the fiscal responsibilities of Member States.

However much we improve confidence in supervisory processes across Europe, it can never wholly exclude the risks created to host country depositors by cross-border operation, nor the dangers to the system in the case of large banks headquartered in smaller countries which might lack the resources to rescue them. As we said in *The Turner Review*, we have to recognise that in addressing it there are only two intellectually pure ways forward. One would be to accept full supervisory integration, underpinned by one pre-funded European deposit insurance scheme and by a shared European fiscal responsibility for a rescue if ever required and appropriate. The other would be to remove branch passporting rights, with host countries free to demand separate subsidisation of potentially stand alone national operations. Each of these intellectually pure answers

would achieve an alignment of responsibility with power, but in two radically different ways.

The one certainty in the debate has been that there is no support for either of these intellectually pure solutions. Instead we will continue to seek to combine a single market with a still national approach to ultimate fiscal responsibility, and with supervision delivered by national authorities which are close to the operations of the regulated firms. That compromise can be made to work and deliver stability; however, it will also require greater coordination and cooperation through the ESAs, and ensuring that legitimate host country national interests are recognised by making it clear that host states have the right to receive all prudential information about entire groups.

This approach will also require allowing host states to take proportionate and measured steps to restrict the activities of branches in response to clear prudential weakness not adequately addressed by the firm or its home supervisor ahead of any. We appreciate that there may be concern that powers of this sort could be abused and used for commercial or protectionist measures (rather than for market confidence or consumer protection reasons), and we are willing to debate how best to reduce the possibility of abuse, for example through the ability of home states to appeal to the ESA.

Throughout all this we continue to be committed to working with our international colleagues to ensure that entities for which we have responsibility are effectively regulated and where we have either home or host responsibilities that we carry out these functions properly. This will include working to develop the effectiveness of supervisory colleges.