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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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 published[1]. 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.hmtreasury.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 cyclicality 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 RRPs 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 Paper[2] 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 RRPs in the Financial Services Bill. RRPs 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 their own failure and resolution (the resolution element). By allowing firms to fail, RRPs also aim 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 RRPs, 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 RRPs. The content of RRPs will not be defined in legislation, but the Bill does provide for RRPs to include the preparation and maintenance of key sets of data/information. The FSA will consult on the detailed rules on RRPs 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 RRPs;

- the FSA will be required, in drafting rules on RRPs, to have regard to any relevant international standards on RRPs. 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 RRPs.

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

The FSA intend to consult during 2010 on the detailed rules on RRPs 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 RRPs 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