

LIBA Response to FSA Discussion Paper 09/02
A regulatory response to the global banking crisis
18 June 2009

Introduction

LIBA appreciates the opportunity provided by the Turner Review and associated Discussion Paper DP09/2 to discuss regulatory, supervisory and structural issues. We welcome the clear expression of regulatory thought contained in these documents. We share the FSA's concern to identify issues that have contributed to recent instability and to determine what can most sensibly be changed to provide greater security in the future without sacrificing the essential features which make London and the UK home to a thriving innovative and competitive financial industry.

In considering the questions raised in the Discussion Paper and the Review document the following clear themes emerged as of critical significance. Our full response to the questions is attached in the Annex to our response.

International coordination and consistency is essential.

The FSA is one of the major global supervisors and contributors to global and EU regulatory policy, and in the UK market also acts on occasion directly as a regulator (in the formal sense of "rule-maker"). London is home to one of the most significant international financial centres. In this context it is crucial to ensure to the greatest extent possible that the UK supervisory and regulatory approach is consistent with global and EU agreements, and that it does not move ahead into areas where other regulatory bodies may not agree to move at all. We are glad that the FSA is acting as a thought leader, but the timing of its contributions needs to be carefully managed so that its proposals mesh properly with the global processes and influence the global consensus effectively. Although there may be times and issues where a more nationally based approach is suitable and necessary, these occasions are rare. There are more gains to be made from the perspective of global financial stability, as well as for the effective risk management of globally active firms, from international consistency than from a patchwork of idiosyncratic regulatory regimes.

Competitiveness matters

Closely allied to the importance of international consistency is that of retaining competitiveness. London's status as a major financial centre means that due weight

must be placed on this as well as financial stability concerns. HM Treasury has recognised this through its sponsorship of the "Bischoff Report." While high quality supervision and regulation is an essential part of London's strength, unnecessarily onerous local regulation and poor quality of supervision will drive business away. The UK is not the only credible base for financial services in Europe.

The health of London as a competitive market place rests not only on prudent and sensitive regulation but on market innovation. In this regard the sometimes disapproving note directed at innovative approaches and attitudes in the Review and Discussion Paper is a concern. Innovation brings challenges but without it there will be sterility and contraction. Harnessing innovation, while examining its developments critically, is the most constructive approach.

Prudential issues

In the context of specific prudential discussions we would like to draw attention to areas of particular concern: the trading book environment, VaR Models, valuation and procyclicality.

As a preface to our more specific comments on the trading book, we would make the general point that the trading activities of firms have performed and continue to perform useful functions, including the facilitation of client business whether it be accessing capital markets, or hedging or mitigating the risks of clients' (or the firm's own) business. The boundary of 'socially useful' activity must not be drawn in a way that would limit firms' ability to serve the market's legitimate needs. Clearly there are issues that need to be addressed to ensure that the standards surrounding trading practices and the health of the market can be fully maintained, and we commit to working with the regulatory community to identify the most effective solutions.

More specifically, we agree that a review of the trading book regime is reasonable and fully understand concerns with respect to the treatment of illiquid assets and "boundary" issues between the banking and trading book environments. In the context of this work, however, it is important to recall and build on the strengths of the trading book, namely the enhanced environment it creates for risk management including the ability it offers firms to manage positions through offsetting and hedging. Naturally it is essential that the boundary be policed effectively by firms and regulators and we strongly advise against any return to simplistic lists of eligible instruments to manage this boundary.

In progressing the international work, however, we stress that changes to the trading book treatment should not unduly focus on credit risk or assume that remedies suitable to the banking book environment (where credit risk is the primary risk) will be suitable to the trading book. We also consider that regulators should not turn their back on the use of models either in the trading book, or banking book environment. It is important to understand the limitation of models and not place

undue or unfeasible reliance on their output as this will lead to imprudent outcomes. For example, firms would note that Value at Risk models are not designed for tail risk per se and firms apply other techniques to capture tail risk. Thus if VaR is taken to be a good proxy for tail risk, then problems will inevitably emerge. The art is ensuring that tools are fit for clearly defined purpose.

The discussion paper also addresses valuation and procyclicality. The FSA appears to conclude that both fair value accounting and cost less impairment accounting as currently implemented have a procyclical impact. Although we understand the basis of this argument, we think it needs to be further developed and the evidence more fully assessed as we feel that there are numerous elements within the existing capital regime that dampen the cyclicity of the trading book capital requirements (eg Through the Cycle ratings, stress tests and add-ons and fair value accounting). In particular we note that the use of fair value accounting has facilitated the early identification of problem assets, enabling firms to take quick action: it did not create the problem assets. Moreover accounting and prudential regimes each have a different focus and care will be needed to ensure neither is compromised.

Policy formation

The Turner Review and Discussion Paper represent an intensive and welcome effort by the FSA to showcase and communicate its thinking. More broadly, we encourage the FSA to continue to ensure it has in place high quality policy formation functions so that it is able to act vigorously, communicate successfully and persuade the global regulatory community of its views when international and regional agreements are being developed. It is vital that the FSA is fully capable of successfully influencing the regulatory standard setters.

Better Regulation

The disciplines of good policy formation, rule making and enforcement need to be maintained, at national, EU and global levels. The Turner documents represent a good example of this as they contribute significantly to a reflective policy debate. We encourage the FSA to continue to champion the principles of Better Regulation domestically and in the international arena. For example, the international regulatory response to the crisis has shown considerable activity, including the creation of new structures, and expansion of resource and participants, ranging from G20 governmental summits to an ever faster pace of legislation in the EU, not all of which has been congruent with broader global thinking. What has been noticeable in all of these international initiatives is the haste. Policy initiatives are decided upon and delivery targets set very quickly indeed. A "medium term" time horizon for a set of major policy decisions can be as short as 6 months. We are concerned, particularly now that the immediate volatility of the crisis has now subsided, that this rate of progress is too rapid, and gives insufficient time to assess the range of likely outcomes and consequences of these policies, given that measures that are being put into place will be permanent and not temporary.

In our view there is a critical need for the regulatory community to analyse clearly and assiduously, including with full impact analysis, how initiatives interact and support (or even conflict with) each other. This analysis is necessary to prevent the build up of systemic risks or instabilities in the future. There remains a need for a focus on the most proportionate way to solve problems which are identified. In this context, we broadly support the concept of an "outcomes focused" regulatory approach on the understanding that the concept is consistent with and intended to deliver the same effect as FSA Handbook, General Provisions, (GEN 2.2.1): "Every provision in the Handbook must be interpreted in the light of its purpose."

Aggregate Impact

There is now an international consensus on the importance of identifying and assessing macro economic and macro prudential trends. There remains a significant gap, however, in assessing what the cumulative effect of the many individual micro prudential proposals can or will be. We strongly encourage the FSA to remedy this in conjunction with its global colleagues, but also to begin to put resource in place to assess this issue.

Taking the level of regulatory capital as an example, the calibration of regulatory proposals needs to be analysed carefully. To date there appears to be an embedded assumption that a whole sequence of major reforms are needed to ensure the financial services sector can withstand extreme tail events and that the (unquantified) lost output to the UK and global economies will be a fair trade for such stability. This may be the correct answer, but as yet the analysis supporting this view has not been performed and the policy choices are not being made on an informed basis.

We look to the FSA for an indication of how the regulatory programme will be taken forward and how it will be communicated to the industry. We hope that the FSA will take a lead in G20 and EU debates to identify clearly what the prudential regime should deliver, and, consequently, what are the right tools to deliver it. In this context, it is important to be aware that there will be a limit on the number of binding constraints that can be applied to firms without severe restriction of business and damaging flow through into the wider economy. Supplementary monitoring measures with clearly defined trigger points for further supervisory intervention would be a constructive approach to explore. Undertaking such analysis should lead to clarity on which of the range of possible regulatory initiatives will be pursued and which will not, as well as, importantly, identifying a likely range of consequences on the micro and macro scale.

Supervisory Approach

The optimal model for the supervisory relationship with industry is based on proportionality of approach and should foster trust, mutual respect and rigour. The dialogue needs to be constructive and needs to flow in both directions. We wholly support the FSA in its identification of the need for raising standards in supervisory

practice and agree that an intensification of supervision is appropriate. At the same time, we are concerned that intensity of approach will be confused with “penal” or “punitive approach” which would be damaging both for the recovery of firms active in London and specifically damaging to the openness and health of the regulatory relationship. The FSA is keen to shift from review of systems and controls into assessing the judgements of senior management. Setting aside potential concerns relating to shadow management if this brief is wrongly interpreted, it is critical that the FSA recognises that challenging a firm’s business strategy requires a very elevated skill set. Considerably more resource would be needed within the FSA, both in number and quality, to deliver this shift in approach effectively.

Colleges and the group dimension

Although the Discussion Paper debates several aspects of group issues, on balance, the FSA’s thinking seems less developed in these areas. We would welcome further discussion with the FSA over time on these issues, particularly in respect to the branch passporting framework in the EU (ie right of establishment) where we are anxious to retain the strengths of the single market while recognising that there are practical issues to be faced in terms of risks and resolution practices. It should be possible to work within the spirit of EU legislation and avoid any need to press for the “subsidiarisation” of EEA branches in the UK.

We think that much progress can be achieved on a purely pragmatic basis. Information sharing, cooperation and coordination between supervisors can deliver shared insight and risk analysis and identify issues that would be otherwise invisible at a domestic entity level. We welcome the fact that the FSA is a supporter and proponent of the college of supervisors system and we ask that the FSA put ever greater efforts into advocating and facilitating an efficient global delivery of these mechanisms.

Macro Prudential and Macro Economic issues

It is clear that there is a strong global consensus that attention must now be given to creating a macro prudential overview. The definition of “macro prudential” is, however, less agreed. This uncertainty means that vigilance will be needed in several areas.

First, there is the risk that practical implementation or enforcement of supervisory activity arising from macro prudential data gathering and analysis might be inefficient or duplicative. It is important that the boundaries between the roles and activities of the supervisor and the central bank (not only at national level but internationally also) remain clear. On a practical basis firms are keen to ensure that there will be maximum coordination (including meetings, information gathering, data reporting etc) between the relevant authorities, whether at domestic level, for example between the Bank of England and FSA, or internationally.

Second, there appears to be an implicit assumption in many current regulatory communications that macro prudential oversight and initiatives will provide the “missing piece” of the jigsaw and act as a panacea or an effective safeguard against any future instability or build up of localised or system wide risks. We think that any such assumption is too bold. Much macro prudential analysis will lead to an ambiguous conclusion and it is therefore not merely difficult, but potentially highly unwise to build a system that will rely on a mandatory regulatory response to a particular macro prudential signal. The appropriate response may be regulatory, but it may also be fiscal or monetary and we caution against the “macro prudential authorities” limiting their possible range of actions.

We look forward to continuing to engage with the FSA on the important issues of regulatory reform.

Capital and Liquidity – Chapter 3

Q 1 Are there shortcomings in the international prudential framework not already identified in the DP that are relevant to the analysis?

A major thread of the international regulatory debate, irrespective of whether the debate focuses on policy content or regulatory structure, is the absolute need for international coordination and consistency of approach. We understand that this principle is of high priority for the FSA also, but we can only reiterate that it is absolutely essential for coordination to take place. The benefits to this are not merely pragmatic efficiency for firms, but enhanced understanding of group dynamics and the strengths and weaknesses of international financial stability.

Q 2 What are the measures supervisors should take to mitigate the risks to depositors and other unsecured senior creditors of secured funding, taking account of the benefits of such funding where used to an appropriate degree?

We recognise that the FSA has identified secured funding/encumbrance of assets to be an important area to analyse in its prudential assessment. We support the FSA’s statement that it wishes to take any such analysis forward in the context of an international debate and consensus and we think it important that the FSA consider in their analysis very clearly what risk they are seeking to mitigate and thus what the most appropriate response will be. International agreement will be essential to prevent fragmented approaches applying to internationally active groups that may cause distortions in patterns of business.

In launching any review of secured funding we would like the regulatory policy makers to bear in mind that there are a number of intertwined practical and policy

issues, which we seek to identify below, and it is essential that there is careful analysis of potential impact, consequences and behavioural incentives before any changes are brought forward.

It is commonly agreed that the scale of pledging collateral or encumbering assets has increased greatly over the last 10 or 20 years. Typical manifestations include: Central Bank provision of liquidity (with the most vigorous debates surrounding which items are eligible as collateral), other lines of credit, and of course the repo and secured finance markets. Inhibiting or damaging these markets would obviously have direct consequences for firms' funding and liquidity needs.

We accept that pledging or encumbering a large proportion of an institution's assets, particularly of its best quality assets, will impinge on the residual security that will be available to depositors and other unsecured creditors of an institution in the event of winding up. However, prior to winding up, an institution's access to funding and liquidity will be central to its continued viability. It will be crucial to find a balancing point so that considerations of how to ensure an equitable outcome for depositors in the event of a bank failure do not promote an outcome that is more likely to lead to that bank's failure in the first place. A regulator-driven self-fulfilling prophecy would be unhelpful.

Moreover, it is important to recognise that the existing regulatory prudential framework encourages the provision of collateral/encumbrance of assets as good risk management/risk mitigation practice. Not only is the practice of pledging collateral often intrinsic in obtaining funding (as noted above), but capital adequacy, credit risk mitigation and large exposures frameworks each take account of and reward the practice of encumbrance to a greater or lesser extent whether globally or within the EU. Three examples are: covered bonds (an asset class that is backed by mortgages and which attracts a very low regulatory capital charge in the EU); capital relief for exposures to a counter party that have been collateralised (the credit risk mitigation framework in both Basel and the EU) and finally exemptions to large exposure limits in the EU framework where an exposure has been collateralised.

By granting these more lenient treatments the capital adequacy and concentration risk frameworks both at global level and in the EU have sought to give regulatory capital recognition for a range of sound industry practices in risk mitigation. On balance, this was appropriate because, of course, a major motivation of the Basel 2 revisions was to remedy the agreed weakness of Basel 1 which had failed to give much if any regulatory capital incentive to a firm to adopt a balanced risk profile. Instead, under Basel 1, firms had strong incentives to remove assets from their balance sheets or simply to seek assets of higher risk profile which might deliver higher returns.

Although we fully appreciate that it is not easy to identify the right balancing point between regulatory incentives, not least in view of the range of individual and systemic needs that seek to be met, we make the points above in order to stress the fact that changing encumbrance patterns (whether driven by regulatory incentives or otherwise) are likely to have system wide repercussions and on an individual institution basis could have negative and self reinforcing effects and it is therefore essential to have clarity on the intended purpose of any regulatory approach. For example, a higher risk weight might mean that funding institutions insist on higher levels of encumbrance in order to maintain funding lines to the firm. But if the firm seeking funding was at a hard limit then it would be at risk of loss of funding, leading to a liquidity squeeze or possibly restriction of business. Hence any change to policy on encumbrance would need to be handled carefully and phased in over a period of time in order to avoid damage to firms and to the wider market.

In practical terms we note that a proportionate first step might be to ensure greater transparency of the degree of encumbrance of an institution's assets. This might be achieved through a Pillar 3 approach. We anticipate that regulators could obtain full details on levels of encumbrance of assets through liquidity returns and we would expect the regulator to monitor information from firms in relation to encumbrance. The FSA might also consider reviewing whether firms are monitoring the degree of encumbrance in their counterparties (eg whether IRB firms reflect the information in their LGD figures) and whether firms factor into account (eg through credit risk stress tests) the fact that in a severe downturn encumbrance of assets in a counterparty might increase. In the context of liquidity management the FSA might also want to review whether firms monitor and manage funding concentration risk (eg over-reliance on the securitisation market).

Micro Prudential measures – Chapter 4

Q 3 Do you agree with the proposals to redefine what counts as capital with a stronger emphasis on going concern loss absorbency?

Before commenting on the composition of regulatory capital, we would note that we agree with the FSA that, overall, there is a need to ensure that firms have a stable and secure capital base. This may mean increased levels of capital, but it is imperative that increases in required regulatory capital are subject to careful calibration and impact analysis before they are implemented. Moreover, we are strongly of the view that regulators need to continue to focus on the adequacy of capital at the group level. We understand that there is a need to identify minimum levels of capital within subsidiaries, but it is also vital that groups retain surplus capital resources that can be mobilised throughout the group to wherever there is need. It is not necessarily in the interests of industry or the regulators for capital to be immobilised in a particular

jurisdiction when it might be mobilised effectively to meet stresses elsewhere within a group.

With respect to defining eligible regulatory capital instruments, first and foremost we are anxious that any new agreement on definition should be reached on an internationally consistent basis to avoid anti-competitive effects. We recognise that tier 1 capital ratios are likely to be increased and that regulators have concerns around the composition of hybrid and core capital.

Nevertheless, we think that there is a grave risk that lower tiers of capital, in particular upper tier 2 which has non-cumulative features, will be given insufficient weight. We support the view that lower tier 2 capital is appropriate to sustain a subsidiary entity where the subordinated debt is provided by the parent entity and provided that the Group is adequately capitalised and subject to equivalent supervision. None of the subsidiary's senior creditors would incur a loss in this instance. The FSA might propose to reintroduce a rule from the former regime applying to investment firms which is that such subordinated debt would have to be provided by the parent or controller only.

Furthermore, with respect to tier 3 capital we remain of the view that this stratum of capital is peculiarly suited to the trading book regime and the shorter holding periods of the assets in this book. We note that in paragraph 3.24 of the Discussion Paper, the FSA argues that due to the illiquidity of some positions it was not always possible for firms to reduce the size of the trading book on a timescale within the duration of the Tier 3 instruments. However, we would also note that the scenario described by the FSA encompasses not only individually illiquid positions, but also a time when there was profound market illiquidity. This means that there may be a risk of recalibrating capital needs on the basis of the experience of the most extreme market conditions. Separately, and in relation to illiquid positions it is possible that some firms may have had inadequate governance of the trading book/banking book boundary. These firms may, further, have had inadequate capital add-ons to cover liquidity. In this context, we have stressed elsewhere in our response that we believe in the importance of adequate policing by firms and regulators of the boundary. Finally, it is important to recall that many of the illiquid positions would not have attracted higher capital if placed in the banking book environment.

Q 4 Should IRB banks be required to use a system such as variable scalars, or equivalent, whose effect is to limit the potential for procyclicality in capital requirements to a level that would be produced by a TTC ratings system?

We support the objective as iterated by the FSA, and the optional use of variable scalars. However, we would caution against the mandatory introduction of further sets of variable scalars.

Q5 Are there any other key issues that the review of trading book capital should cover?

We agree that a review of the trading book regime is reasonable but at the same time we note that there is already considerable activity in this area by the Basel Committee and paralleled in the EU, relating to the treatment of incremental risk and adjustments being brought in to the treatment of Value at Risk models (specifically the stressed VaR component of the capital charge).

The FSA has identified the banking book/trading book boundary definition as one of the crucial aspects of any forthcoming review. This is a topic with a long history and, as regulators know, there are no easy answers. There are some points we would like to make to orientate the discussion:

- While recognizing the concern that some items in the trading book have been illiquid we do not agree that the primary risk faced in the trading book is that of credit risk and therefore changes to the trading book treatment should not unduly focus on credit risk or assume that remedies suitable to the banking book environment (where credit risk is the primary risk) will be suitable to the trading book.
- We would caution the regulators against creating an incentive for firms to reallocate items to the banking book (which is primarily a credit default treatment) as this will lead to the loss of the governance procedures and risk management standards that overlay the trading book regime. Equally we advise against any return to a fixed list of eligible items for the Trading Book, which was a regime that brought unhelpful rigidity to regulators and industry alike when it was imposed via European legislation (ie the former Capital Adequacy Directive and Investment Services Directive).
- The development and use of models attracts much criticism in the Turner Review, in particular with respect to “complexity” of the models. However, criticism of the design of the models misses the more pertinent and important question which is whether or not the user of the model understands what function a model can and (maybe more importantly) cannot perform. Implicit in the use of models and modelling is the over-arching point that models can only function according to the quality of their design, base assumptions and input data. A model, of itself, is not safe or unsafe, but the use to which the model is put, including the degree of unquestioning reliance placed upon its output information, can of course be safe or unsafe. Hence criticism of a design for being too complex or conversely too approximate an estimate of “reality” is misplaced. The challenge is to identify whether or not the model is fit for purpose and what safeguards may need to be taken in “non-normal” conditions that the base assumptions of the model did not cater for. Understanding the possibilities and limitations of

information derived from models is therefore more appropriate than deriding models for failed complexity and banning future use. Fundamentally a complex situation or problem is unlikely to be susceptible to simplistic remedies and to insist on a non complex solution is, in all likelihood, to create the possibility of risks being poorly understood and weakly managed.

- Moving forwards, therefore, we think that FSA should conduct a careful analysis of what models/aspects of models functioned as they were expected to do, and which failed, as this will yield important information on the design successes and failures of models to approximate reality, and provide greater understanding of the limitations of the models and potential safeguards to their regulatory use that may be necessary.
- Additionally it is important to recall that firms do not use VaR techniques alone to manage their trading book positions. Used properly and with understanding, VaR is a critically important risk management tool within a suite of comprehensive risk management tools. It is important to recognise that VaR was not designed to address all elements of risk (eg tail risk). There are a range of other techniques firms use including capture and analysis of tail events and creating capital buffers. It is necessary for firms to identify all material risks not captured in VaR models and agree and develop suitable add-ons with regulators. However it is important that regulators assess and challenge the adequacy of risk management on an ongoing basis. We recognise that the FSA already does this as part of its Pillar 2 process.
- Crucially we do not think that there are any regulatory “rules” or adjustments that could substitute for stronger supervisory practices to ensure that firms are policing the trading book/banking book boundary internally. We believe that the supervisory review process needs to be an important component of any regulatory development. Arguably, the present definition of the boundary between the banking and trading book, which is based on trading intent, remains suitable provided that it is adequately policed by firms and regulator alike.

Questions 6 and 7

How should the leverage ratio capture (i) off-balance sheet exposures and (ii) derivatives?

Should the numerator of the leverage ratio be Core Tier 1 capital or should a broader measure of capital be used?

If a leverage ratio were to be introduced, we believe it is essential first to identify the purpose of the ratio and clarify what such a tool can reasonably achieve. These considerations will naturally inform the key design and calibration decisions.

In our view it is critical that the leverage ratio (if adopted) should be designed as a supplementary prudential measure and should function as a “back stop” rather than as a punitive restriction on the growth of the institution either in terms of scale or direction of business.

There is a real risk, which must be avoided, that the ratio could act as a brake on the revival and development of economic activity. This risk is more likely to be a function of calibration than design, but both components are important in this matter. The macro economic impact of this tool must be examined carefully and adverse outcomes avoided, not only on a domestic but on a global scale.

Scope of Application:

- First we strongly advocate that any decision on leverage would need to be taken at an international level and consistently applied across jurisdictions globally.
- It is essential that double leverage within groups is avoided, ie that any leverage constraint applies at group level and not at each subsidiary level. We recognise that the EU legislative processes may find some challenge in drafting text that would avoid a separate leverage constraint being applied to the EU parent company that was a subsidiary within a global group, but it is a challenge that would need to be met in order to avoid competitive distortions. We are also conscious that the European Commission has indicated that it intends to bring forward proposals sooner rather than later in this area so we would like the UK authorities to be particularly mindful of this risk.

Regulatory response to breaches:

- If leverage ratios were to be agreed upon internationally, we think it would also be important for there to be agreement on the regulatory response in the event that leverage ratios were breached by an institution. Would there be an increase of supervisory attention, or mandatory downsizing of activity, or raising of capital? We assume that supervisors would ensure that a firm had sufficient time available to manage its affairs and that the regulatory response would be proportionate in any case.

Design of ratio:

- We strongly disagree that any leverage ratio should be designed on the basis of a simplistic gross measure. This is for several reasons:
 - No differentiation for different accounting standards
 - Failure to account for netting, hedges, off balance sheet and funding risks.

- Poor measure of cash available to meet short term liquidity needs, and may not back test well using the recent stress scenario.
- Treatment of off balance sheet exposures and derivatives: We agree that a leverage ratio, if introduced, would only be meaningful if it incorporated off balance sheet items and derivatives. The challenge is in identifying the correct measures of exposure and we suggest existing regulatory measures of exposure (for example, potential future exposure (PFE) /exposure at default (EAD) as relevant) should be used. We also note that in an economic downturn an EAD component (where it is used) would typically rise so there could be an element of procyclicality introduced here also.
- Numerator of leverage ratio: If the primary concern for the regulators is loss absorbency, then the numerator should be composed of core tier 1 capital. Moreover, tier 1 acts as a leverage constraint on other tiers of capital irrespective of the creation of a leverage ratio. We would not, however, expect the calibration of a leverage ratio using only core tier 1 to be as restrictive as one that permitted the use of other tiers.

Macro Prudential Policy – Chapter 5

Q 8 Should these reforms be applied to smaller and domestic banks, building societies and investment firms? If so, how can this be achieved in a proportionate manner?

We do not believe that there are grounds for excluding firms on the basis of their size, or because they are purely domestic in their focus. Firms can be small (on an individual basis) but loss of confidence in their sector can lead to risks of contagion. The liquidity crisis of the early 1990s demonstrated this phenomenon clearly. It would be appropriate to ensure that the authorities had full powers of information and intervention so that worrying trends could be identified earlier rather than later.

It is not clear that there are any greater challenges (or new specific challenges) in applying macro prudential tools in a proportionate manner to smaller firms than already exist in applying risk based supervision in a proportionate manner.

Q 9 Do you agree with the FSA's reasons for favouring a range of policy measures to deal with macro-prudential policy issues rather than adjusting the Basel II risk-based capital requirement?

Yes we support the FSA's view that a range of policy measures will be necessary to deal with macro-prudential policy issues. We agree that it is not possible to adjust a single figure (eg the risk based capital requirement) by a factor that itself is a product

of multiple inputs and achieve a meaningful policy tool. Furthermore we note that the Basel 2 framework itself has yet to be transposed in all major jurisdictions globally and there has not yet been any opportunity to assess its effects. Adjusting the framework prior to understanding its operation is not desirable and should only be contemplated in the case of compelling analysis of deficiencies.

Q 10 What should be the focus of the FSA's initiatives on valuation and disclosure in UK banks' accounts so as to maximise their impact on market confidence?

The Discussion Paper highlights a number of issues with the current accounting framework including the existence of a mixed attribute model, conceptual issues and practical concerns surrounding valuations.

Our overriding concern in this area is that any FSA initiatives should not impede the IASB/FASB programme of convergence towards a single global set of accounting standards. It follows that we believe the FSA should focus on supporting the IASB and, where relevant, the UK Accounting Standards Board in developing a considered and comprehensive response to these issues.

In the context of continuing moves to create a globally consistent framework the IASB has already started to address a number of the issues highlighted in paragraphs 5.20-5.25 and box 5.1 of the discussion paper.

For example, in relation to the issues highlighted by the FSA in Box 5.1 of its discussion paper, the IASB established a technical Expert Advisory Panel in 2008 which produced recommendations on valuation techniques in illiquid markets and best practice fair value disclosures. The IASB is currently incorporating the Expert Advisory Panel's recommendations into IFRS through appropriate guidance and/or modifications to existing standards. Although the impact of these recommendations has not yet been seen in the market place, we believe that they could help to alleviate some of the concerns raised by the FSA.

In general, we believe that where additional disclosure requirements are considered necessary, as suggested in Box 5.1, these should be developed in a thoughtful and risk-focused manner, to ensure that they require firms to disclose details of their key risks and positions rather than producing boilerplate disclosures which may be of varying relevance to individual firms and focus solely on those issues identified in the present market turmoil. In our opinion, the development of new disclosure requirements is therefore best achieved through the due process operated by the accounting standard setters rather than a piecemeal approach involving various interested parties.

Notwithstanding the above, we would support any efforts of the FSA to ensure consistent application of the guidance/standards issued by the accounting standard setters.

In addition to the above mentioned work on valuations and disclosures, the IASB has an urgent project on financial instrument accounting in progress with the aim of producing a replacement for IAS 39 before the end of 2009. This project is focused on simplifying and improving the overall model for financial instrument accounting.

Finally, to the extent that prudential filters or other adjustments may be applied to a firm's financial statements for regulatory (or other) purposes, these should be applied separately so as not to compromise the financial statements or undermine investor confidence in the numbers reported.

Q 11 Do you agree with the FSA's analysis of the implications of accounting standards for procyclicality?

The FSA appears to conclude that both fair value accounting and cost less impairment accounting as currently implemented have a procyclical impact. Although we understand the basis of this argument, we think it needs to be further developed and the evidence more fully assessed. In particular we note that:

- Virtually all markets in which regulated firms operate are inherently cyclical, and any accounting model (such as fair value accounting) which purports to mirror faithfully the market would mimic this.
- The procyclical effect is at most indirect through the use of financial reporting valuations etc for regulatory purposes. Financial reporting is not immediate enough in itself to impinge on short term trading decisions.
- A large part of the dislocation of the markets is triggered by liquidity concerns and not directly by valuation issues.
- The use of fair value accounting has facilitated the early identification of problem assets, enabling firms to respond quickly: it did not create the problem assets.
- Cost less impairment accounting also has a procyclical impact which is amplified in "bad times" as loan loss provisions are only made once a loss event has occurred. This effect could be reduced by moving to an expected loss model.

Q 12 How best should prudential regulators address the problem of procyclicality through counter-cyclical reserves/buffers?

We do not believe that procyclicality should be addressed by regulators through requiring any additional provisions to be made in the Income statement.

Any such reserve would not be a provision in the accounting sense of the word and thus has no place in the Income statement. Inclusion would undermine the validity of the Income statement and may undermine investor confidence, as the purpose of

financial reporting is to inform investors, potential investors and other stakeholders. It could potentially introduce an artificial smoothness to the results enabling firms to hide true volatility. Investors and other stakeholders should be able to access unbiased accounting numbers in order to be able to assess them appropriately and compare results globally.

In terms of devising a counter-cyclical reserve (ie not through provisions in the income statement), we hold the following views:

- The formulaic approach: this approach offers the benefits of consistency, transparency and relative simplicity. There are, however, limitations as such an approach would be unable to respond or be sensitive to the risk profile of a firm, how it was run or its ownership structure.
- The discretionary approach: this approach offers converse virtues and restrictions when compared with the formulaic approach. Under a discretionary approach there would be less transparency or straightforward comparability between firms. However, a discretionary approach could be more tailored to the profile of a specific firm. For example, a buffer could be set by stressing the behaviour of individual business lines (ie clearly not all business lines are equally sensitive to the cycle). A discretionary approach could be embedded in the existing Pillar 2 framework and could thus efficiently utilise the mechanisms devised for delivering "Individual Capital Guidance." As such a discretionary approach could be more integrated into a firm's capital management processes and decision making.
- We note that the FSA proposal of a buffer of 2-3% of Risk Weighted Assets "at the top of the cycle" relies, clearly, on a public authority identifying this point in the cycle. It is not, however, clear how the FSA proposes to signal when this stage of the cycle has been reached. We have yet to encounter any meaningful or compelling response from the authorities to suggest that either accounting or supervisory or central banking authorities have identified how to do this or are prepared to do so.
- We appreciate the FSA's recognition that capital buffers are typically treated as a de facto regulatory minimum and we welcome the FSA's attempts to find a regulatory response that will avoid this outcome.
- We would, though, appreciate more debate with the FSA to understand how and when banks would be able to draw down on buffers, including whether there would be constraints imposed by the regulators and whether the regulator has factored in the possible market reaction to such draw down.

Q 13 Do you agree that serious consideration needs to be given to establishing some form of global supervisory architecture for international audit firms?

We do not offer a view on whether this issue needs to be addressed, but we would observe that any new architecture would have to take account of the needs of global firms.

Q 14 What macro-prudential policy tools should be considered other than those mentioned in this DP?

We strongly support the FSA statement that the central bank and the supervisor need a high degree of coordination. It is essential that firms are not subject to duplicative, much less conflicting, approaches from the authorities. From the authorities' perspective, such coordination can only support the effectiveness and coherence of oversight.

We have no additional suggestions to make in terms of alternative or additional macro-prudential tools that might be considered.

Questions 15 and 16

What are your views on the effectiveness of a core-funding ratio as a measure to constrain excessive asset growth?

What types of institutions should be exempt from such a core funding ratio? How would any exemptions limit the effectiveness of the measure?

It is not wholly clear whether the FSA sees a leverage ratio as supplementary to a core funding ratio (CFR) or an alternative to it. Clearly an adjusted leverage ratio would negate the need for such a tool. Moreover we question whether an active constraint would need to be put in place, or whether it would be more constructive to use a range of metrics as indicators, that would permit the regulator to increase its level of supervision or intervention if necessary. Other important related metrics might include monitoring concentration of funding or maturity schedules.

In any case, if a CFR were to be introduced, as with the leverage ratio itself, much would depend on the detail of how the CFR were to be designed. For example, we note that there may be a significant impact on subsidiaries and the cross border dimension. Therefore it is critical that the FSA should not adopt such a supervisory tool on a unilateral basis.

We note that hard definitions of acceptable high quality funding may be susceptible to change over time. For example the inter-bank market or the securitisation markets may, at one time or another, have been seen as high quality valuable funding sources. Hence we would oppose any hard coding of a limited range of funding sources.

In common with our views expressed in response to Question 8, we see no arguments in favour of excluding a segment of the banking/investment firm sector from such a ratio should one be introduced (following careful analysis and international consensus).

Q 17 To what extent would market discipline and the convergence of supervisory practices be improved by the disclosure of information relating to Pillar 2 assessment? What information would be most useful?

In principle, we support greater transparency. There are two elements to this. On the one hand we support the disclosure of relevant information at an aggregate level which will give both industry and regulators access to benchmark information. On the other hand we believe it is important for there to be greater transparency with respect to the tools and actions taken by the regulator, not simply in terms of the formal powers of the supervisor but in terms of how the powers are exercised (eg processes that are put in place) and whether the powers are used. This transparency should not simply be confined to the domestic arena but should apply more broadly through the EU (where there is already a framework to support supervisory transparency in place) and on a more international basis also.

Nonetheless, we believe it is essential to move with caution in the field of Pillar 2 transparency. There are two significant adverse consequences that we can identify and that we know have been of regulatory concern in the past. These concerns remain valid and must be fully respected in determining the content of whatever information is disclosed.

First, Pillar 2 transparency on an individual firm basis will contain too much proprietary and market sensitive information, hence disclosure could be counterproductive and create market instability and scope for market abuse. In these circumstances, firms would be more likely to be inhibited in their discussions with regulators, and the openness of dialogue that Pillar 2 is intended to foster would be lost. Furthermore, even at an aggregate national level, care must be exercised, to ensure that significant firms cannot be individually identified. This risk would be particularly acute in any jurisdiction where there was only a limited number of major firms.

Secondly, and more damaging from a stability perspective, we perceive a significant risk that Pillar 2 information would be seen as akin to the "regulatory rating" and could therefore encourage adverse effects. It could be argued that in order for Pillar 2 information to be interpreted meaningfully by the market, the market would first have to adopt a regulatory outlook. In practice we think this is unlikely and we believe that the market discipline incentives will, at best, be ineffective and at worst stimulate adverse consequences and would be at risk of substituting a (potentially not fully understood) regulatory view in place of an independent market analysis of a firm.

Finally we note that the current form of the Pillar 2 regime is relatively new and there is a notable lack of consistency in application across the EU and internationally. We note that not all countries are willing, or apparently constitutionally able to apply additional capital requirements under a Pillar 2 approach and therefore we do not think that international comparisons (driven at regional or global level) could be meaningful. At a minimum, before any Pillar 2 transparency were to be required, it would be essential to ensure transparency by regulators in terms of how the national Pillar 2 approach is implemented.

Scope of Regulation – Chapter 6

Our responses to the FSA questions are noted below. However, we would like to preface our remarks by identifying some key issues that are critical to effective regulation in this area.

Resources: Resource questions are critical and the FSA (indeed regulators globally) will need clear criteria to identify what information they are seeking and to consider why they are seeking it. We see a high risk that the FSA will, in practical terms, swamp itself with information that it is unable to absorb. Hence, there will need to be a rigorous assessment of the regulator's data needs and the resources (both in numbers and skills) it will also need to interpret and analyse such data.

Data and information needs: As noted above identifying data needs will be important for the regulators. A clear focus on criteria to filter information requests will be important.

A piecemeal or scatter gun approach to requesting information is not only inefficient (on both sides) but is more likely to lead to an incomplete and potentially misleading picture of the risk of a group (whether over or understating risk). Hence, and to emphasise the point made above, resources are needed at the FSA to assess and analyse data that the FSA is seeking. It would, in our view, be very easy for the FSA to become overwhelmed.

Macro prudential analysis: the quality of analysis of the data will necessarily be vital. In identifying the institutions and the information that is sought we encourage the FSA to focus on the substance of economic activity as opposed to the form it takes. We also note, as the FSA is aware, that risk evolves into new areas and new forms. Hence rigidity in the analysis of what the regulators are looking for will be counterproductive and the regulatory approach needs to remain nimble.

Regulatory relationships with other regulators: As a part of the process of identifying information needs, the FSA needs to work in partnership with other regulators in the international fora. We do not think it possible for the FSA, or any regulator, to

conduct this analysis unilaterally but would strongly encourage and support a cooperative approach. On a related point, there needs to be sensitivity shown towards other regulators in the wider group (including issues around access to information from third country supervisors). This is an area where the quality of relationships fostered by the college arrangements could yield considerable benefits. From the group's perspective requests for information should be efficiently handled through the regulatory network rather than by allowing each regulator to address requests to any local entity.

Regulatory relationship with firms' management: We would like to support and encourage a full and effective engagement with senior management in firms. A strong relationship, based on questioning, challenge and understanding is a prerequisite for effective risk analysis and oversight of a group and an identification of evolving new areas of risk. There is no substitute for "in the field supervision" which can be supported by but not substituted with the supervisory rule book (ie the FSA cannot rely on its rule book alone for an understanding of the risk management of the industry and an identification of new areas of risk as they evolve). A closer and enhanced understanding of management will support the FSA in awareness of growing risks that are not currently captured within rules/data sets as new activities emerge and gain critical mass.

Q 18 Are there other considerations that are relevant to the assessment of the issues and risks posed by the boundary question?

We support in principle the identification and capture of large systemically important firms within the scope of regulation – provided there is a consistent and global approach. Furthermore, we agree that broadly the "regulatory boundary" is in the right place and believe that the FSA needs to be careful to utilise its current powers effectively.

Q 19 Is the escalating response set out here the right way to deal with the threats to financial stability and consumer protection posed by unregulated financial activities and institutions? Or should the FSA, along with other regulators, develop an alternative approach?

We do not think that there is compelling evidence to suggest that there are major regulatory gaps. In many cases the resolution of regulated/unregulated boundary questions may lie in better macro prudential analysis of the information that supervisors already have rather than the absence of important information. We believe that concerns posed by the presence of unregulated entities within groups can be addressed effectively from the supervisor's point of view and agree with the escalating approach to non-regulated entities.

Q 20 What are the implications of subjecting parent holding companies for financial services groups to direct powers to comply with the requirements of the prudential framework?

We see no direct benefit arising from the solo supervision of unregulated entities. Conversely we are concerned by the potential of restriction of fungibility between group entities. On balance therefore our view is that the FSA's case for more, wider or stronger powers is unproven.

Systemically Important firms – Chapter 7

Q 21 Are there other issues which regulators should take into account when assessing their response to the evidence from the current crisis that some financial institutions have been deemed too big to fail fully? If so, what are they?

We agree that the regulators have already identified the issues that need to be taken into account. The FSA seems to have drawn the conclusion that it would be inappropriate to attempt to draw artificial boundaries around types of firms and we support this analysis. Industry would have no appetite for artificial caps on business or measures that would restrict the efficient operation of the market. In this context it is important to remember one of the key messages from the recent Bischoff Report which emphasised the need for London and the UK to ensure there continues to be space for innovation to flourish in order to benefit economic activity and broad based systemic resilience.

Q 22 What are your views on the balance between varying the intensity of supervision according to the impact and risk that an individual firm poses, and having policy frameworks and approaches that differentiate across-the-board according to a firm's systemic significance?

In our view the FSA already implements a system that differentiates between the impact or risk that a firm could pose to the financial system. This concept is fundamental to the ARROW supervisory system. We would strongly support greater and higher quality of supervisory resource to the supervisory programme and believe this would have benefits for all.

We would not support the proposal that large or systemic firms should be subject to a separate policy framework or rule book. There are two reasons for this.

First, the policy framework (eg the capital adequacy framework) already allows for differentiation of risk in that the firms who are willing and capable of meeting the higher associated standards are permitted to use the more complex methods of capital calculation, which permit a more realistic estimate of the factors affecting the

risk profile of the exposure. To overlay this system with one that categorises between systemic and non-systemic firms runs the risk of forcing firms to use either more or less appropriate regulatory risk metrics for their business. We would not agree that this outcome would represent an acceptable overlay of supervisory judgement.

The second reason is one of practicality, as we believe it would become impractical and inefficient to distinguish between the systemic and non-systemic firms over time as businesses morphed, grew or contracted. The boundary would be hard to police for all the reasons that the FSA cites in the Discussion Paper. It may be worth noting in this context that in the 1980s the Bank of England supervision attempted to differentiate to a degree between full “banks” and the more limited “licensed deposit takers.” The practical conclusion was eventually drawn that it was not possible to maintain a clear bright boundary line. In the ever more complex financial relationships that exist 30 years later, it seems less likely still that it would be possible to separate out the systemic firms on a reliable and continuing basis.

Groups and intra group exposures – Chapter 8

Questions 23 and 24

Are there other aspects of group structures that the FSA should be taking into account?

Is the increased focus on group structures and intra-group relationships and increased supervisory cooperation the right way to deal with the threats to financial stability and consumer protection posed by large, international group structures? In what circumstances would a greater focus on individual legal entities be warranted?

It is not possible to understand, much less manage, the risks potentially posed by large internationally active groups without two fundamental requirements being in place. One of these is global coordination between the relevant regulators and the other is an understanding of the consolidated group as a whole as well as of its constituent parts. We believe that the FSA agrees with this view and wish to do all we can to support the delivery of global coordination and comprehension of the whole group structure.

In practical terms we see much to support in the FSA's expressed policy on the significance of international coordination, information exchange, analysis, and cooperation on supervisory activities. It is still the case, however, that numbers of firms have failed to experience the fruits of the international relationships. While accepting that such relationships and understanding of information needs grow over

time, we strongly encourage the FSA to put greater effort into ensuring that the UK presences of international groups are supervised in the context of the whole group. It is neither efficient nor in our view meaningful for there to be a routine “piecemeal” acquisition of information on cross border groups. On occasion it will be important for the regulator to seek more information in relation to a particular business area/legal entity, but there should be a high quality operational fabric of information gathering and flow across the group if the FSA and its peers are to understand the risks that the large international groups with multi-faceted intra group relationships may pose. An individual group entity and its relationship to the wider group can only be understood if there is already a meaningful understanding of the consolidated group.

When there is a greater focus on an individual entity within a group it is also important to understand that there will be consequences to the overall group structure and behaviour/dynamic if restrictions are placed on the individual entity. This could, clearly, include migration of business to other entities. This is not to argue that there should be limited or no focus on an individual entity but it is important to understand whether restrictions placed on a local entity would weaken or strengthen the ability of the group to ensure continued flow of funding and liquidity (for example). Broadly, where the FSA wishes to focus more on individual entities we consider that the large exposure (concentration risk) framework would provide a fruitful basis from which to start.

International Architecture – Chapter 9

Firms would like to stress in the context of the debate on international architecture that it is the outcome of the quality and effectiveness of supervision and the supervisory relationship that is crucial from the industry perspective.

In delivering a new supervisory architecture, the industry seeks an increase in the quality of supervisory standards and the delivery of a greater consistency of approach on an international basis. Firms support the FSA approach to supervisory activity as a positive model from which London has benefited as a financial centre and which should be preserved and enhanced further (See also discussion on Chapter 11 re Supervisory Approach, below).

We appreciate that for the supervisory authorities the question of crisis resolution and the related potential for burdens to be placed on the national tax payer will be fundamental not only to domestic supervisory arrangements but also to the scope and design of international structures. The objective is to ensure that there is appropriate high quality supervision in the UK, effectively and efficiently integrated with equally high quality cross-border arrangements, that will deliver orderly markets

and financial stability but that will also permit the free flow and growth of financial activity. We encourage the FSA to support architectural developments that will foster this financial activity in London.

Q 25 How can the international architecture be arranged to provide the most effective early warning of threats to financial stability and challenge to national authorities and in an apolitical way?

We broadly support the FSA analysis and discussion as set out in Chapter 9, especially the emphasis on globally coordinated arrangements.

To consider the practicalities, careful organisation will be necessary to avoid the undesirable outcome whereby firms at national or group level receive overwhelming requests for data from national, regional and international authorities. Information flow needs to be governed so that it can support coherent analysis at domestic or international level. We note in the recent European Commission Communication on EU supervisory structures that there is a reference to liaison between the ECB, the ESRC and the IMF. This is insufficient as there needs to be a requirement to coordinate. The analysis of the EU bodies and UK authorities should feed up into the regional and global bodies. Similarly, within the UK there needs to be smooth coordination between the FSA and the Bank of England.

We remain conscious, however, that there seems to be a lack of solid consensus with respect to the definition of macro prudential responsibility, including the related definitions of *macro-supervisory supervision* and *oversight* and that this will naturally affect any discussion on the appropriate international architecture. It could, indeed be validly argued that financial stability management cannot be done apolitically.

As a form of regulatory challenge process we believe that a strong peer review system, as described by the FSA, will have much to offer and will have the capacity to drive up international supervisory standards.

We would, though, like to draw attention to one aspect of the likely structure/tool kit – which is that of the “early warning system”. It is by no means clear that macro-level data is capable of yielding consistently unambiguous signals. It is therefore a difficult and delicate issue to design actions associated with such triggers, other than increased intensity of monitoring, which would be appropriate to the circumstances and not be vulnerable to the risk of unintended consequences.

The UK, as a financial centre, has more to lose than gain from unfocused reform. Many foreign banks locate an office in London in order to passport across Europe. Care must be taken that the implications of reform in aggregate on the UK's competitive position are fully understood. Furthermore, solutions should not be implemented in the UK ahead of the rest of the world not least as this may result in the UK being out of line with the global agreements.

Q 26 Is this the most effective way of organising colleges on the one hand and crisis management groups on the other?

We support the FSA analysis with respect to colleges of supervisors. The college process for day to day supervisory activity is clearly different from that which will be required in a crisis situation, albeit that it would be desirable for crisis arrangements/relationships to be well established and understood prior to being needed. The college arrangements clearly provide a basis on which the crisis arrangements can build.

Q 27 Do these options represent the right approach to the problems posed by EEA branching?

Industry welcomes and supports and wishes to protect the benefits of the single market in the EU/EEA. The “right to establish” under EU legislation, namely the use of the passport to branch, is a significant benefit of membership of the EU. Branches spur competition and innovation and these are necessary conditions for a competitive financial centre to thrive. We strongly discourage the FSA from pursuing a route of “subsidiarisation” as a default position for incoming EU branches.

At the same time, the industry recognises that the FSA has identified a real problem and it is important to address such issues openly to ensure that the single market will be preserved. To question the conditions under which the single market may be accessed is not to question the validity or the benefit of the single market itself. Hence we welcome the debate that the FSA has launched.

We support the FSA analysis that crisis management and resolution procedures require attention. Supervisory responsibility cannot be divorced from fiscal responsibility. Nevertheless the issue needs to be analysed step by step and we do not think that the appropriate response to these issues lies either in sweeping new supervisory architecture applying across the EU, or in sweeping new powers for the host state supervisor.

In the first instance we think it is essential to identify, with far more clarity than exists at present, exactly what powers a host state supervisor possesses in case of an incipient crisis or emergency. We strongly believe that the host supervisor should be willing and able to use existing powers.

However, we also agree that it is appropriate for the host supervisor to have comfort with respect to the overall risk profile and supervision of the group. There are three stages at which the host supervisors position will need to be considered:

- (a) at the point where the branch establishes itself in the host jurisdiction;
- (b) ongoing monitoring or supervisory issues related to the branch/its wider group; and

(c) in the event of crisis management.

With respect to (b) and (c) recent amendments to Capital Requirements Directive already provide some strengthening of arrangements. For example a host supervisor will have right of access to and participation in an EU college of supervisors. This ought to be an efficient method of yielding access to relevant group wide information and risk analysis by the home state supervisor without creating undue burdens on other supervisors or on the group itself. In the case of crisis management, again the arrangements have been enhanced within the CRD.

Where the host supervisor has no direct power in respect of whether a branch has unimpeded right of establishment in a host territory in all circumstances, (ie stage (a) noted above) it may appear, at first, that only major legislative or even treaty changes could amend the host supervisor's powers of action. If, for example, a host state were to be aware of the intention to branch of an institution over which it had reason to be concerned, the host state could notify the home state of its concerns, (indeed we would assume that the host would share such information as a matter of course) but the host would have no right to insist that the home state vetoed the branch establishment in the host state. To amend the respective supervisory powers in such cases may well require treaty changes and would hardly be a straightforward objective, but the issue merits analysis.

Supervisory challenge process: One potential approach which might not require any further legislative (much less treaty) change might be for the home state supervisory decision to permit branching to be notified to the host state in advance of notification to the supervised entity and if the host state had concerns, the decision could be taken to a peer review/dispute resolution mechanism established by the relevant level 3 committee (or successor structure). Similarly, if a host state had concerns about a branch on an ongoing basis it might seek an explanation from the home state as to why remedial measures had not been put in place. Again, the peer review/dispute resolution mechanism would provide a framework for the issue to be considered if the supervisory authorities differed in their analysis. Although the home state decision would be, by definition, subject to challenge and possible change via the peer review mechanisms newly introduced, from the institution's perspective the decision would be delivered by the home state authority only. There would clearly be strong pressures on timing in the current iteration of the Directive.

Depositor protection focus: An alternative approach could be to focus on the practical impact on customers/depositors in the host state, were the institution to fail. There are important caveats to taking this approach as there would be practical challenges to be faced and industry would not support a pre-funded deposit protection scheme as this would be unduly onerous and would have damaging impacts on the EU economy. However, in this scenario, branching could be restricted or challenged where the host state had reason to believe that the development of the depositor base in the host jurisdiction had grown beyond the

capacity of the home state's depositor protection and overall resolution and compensation schemes to cover the host state deposit base. One difficulty of this scenario would be that there could not be a "once for all" determination as a deposit base would be expected to develop over time and although the initial branch presence might pose no threat, it may do so at a later date. It is also important to note that this approach would not depend only on an assessment of the depositor protection scheme in the home state, but of the overall resolution and compensation arrangements in that jurisdiction. The strength of building an approach on this form of analysis is that it has a practical focus on outcomes for the EU citizen and tax payer; and that it would create an incentive to keep the home state regulator focused on potentially unsustainable growth in the host jurisdiction and to utilise its supervisory powers within the existing parameters of the EU legislative framework. In doing so it would support and promote confidence in the single market that crisis management and resolution would not be over stretched to the detriment of the consumer or the tax payer.

Authorisation criteria: Clearly the specific reasons why a host state might wish to resist or obstruct a branch establishment will be similar to the considerations it would have if assessing a direct application for authorisation. These concerns can be summarised at a high level as whether the institution has fit and proper and effective management. The host state may have concerns (eg with respect to reputation of management, source of capital funding, relevant skills and capacity to manage risk) but again any approach based on host state assessment could not be a once for all assessment but would need to be continuing. Hence it would create a de facto systematic "double guessing" of the home state's supervisory decisions and judgement. Even with a peer review mechanism this would be a cumbersome approach to make operational and may create too great a level of supervisory uncertainty for the institution.

Ultimately, any restrictions on existing passporting freedoms must be proportionate to the problems identified. There needs to be a proportionate response which appropriately distinguishes between different sectors of the market, and restricts existing passporting freedoms as little as possible, consistent with systemic risk management.

Q 28 Are the functions of rule-making capability and supervisory oversight the right ones to be given to a European institution that has the characteristics described here?

In considering the FSA's proposed description of a European institution we would like to reflect on three aspects.

First, it is important that any new European institution is capable of supporting the raising of standards of supervisory practice. We are concerned that some of the debate with respect to peer review processes could evolve into an enforced

compliance regime, as opposed to a “comply or explain” regime. In principle, and as stated above, we are strongly supportive of a peer review mechanism globally but we would not wish to see it misused so that it simply became a tool to enforce uniformity of behaviour throughout the peer group. In the event that there were to be a reserve power for the EU authority to direct the outcome of a dispute and intervene if peer review were to uncover difficulties then it might be seen that uniformity as opposed to legitimate difference of approach were being imposed. Whilst we accept that there may be occasions when it is important to challenge supervisory decisions and outcomes, uniformity of itself offers no guarantee of improving standards. Where it is clear that a difference exists due to a failure to comply with or to have correctly transposed the underlying legislation, the Level 4 enforcement procedures are remedies that are available to the Commission and which could be brought into play.

Secondly, in respect of rule making we find there to be some ambiguity in the FSA’s description. It is not clear whether, under FSA’s proposal, the new institution would be responsible for formulating the proposals that would deliver Level 1 or Level 2 legislation. The level and nature of the rules that are proposed to be made at the EU level are vitally important as there is a danger that an EU authority would abandon outcome-focused rules in favour of something much more detailed and prescriptive that would limit the scope for supervisory discretion and hence the ability of the FSA to conduct its supervisory practices in accordance with its own local assessment. There is also uncertainty surrounding the FSA’s view of where to draw the line between “European” rule making and “national” interpretation and application.

Closely related to the question of what rule making the FSA precisely means, is the third area, that of policy formation. The FSA has stated that it is supervisory practice and decision making as opposed to rule making that it wishes to prioritise and protect at national level. Nevertheless the focus of supervision necessarily follows the direction set out in the “rules.” It would be inappropriate for the UK authorities to resign influence in the development of the underlying policies. In the EU context, the European Commission and a range of EU Member States authorities, including the UK, sit on the international standard setting bodies (eg Financial Stability Board, Basel Committee and IOSCO) and a global/G20 commitment to international consistency of approach should ensure that there should be no significant difference between policy agreed at global level and the policy that is translated through regional EU rule making processes. In order to ensure that this happens, it is important for the UK authorities to participate and collaborate fully in the formulation of policy that is enacted into EU rules.

However, it is also the case that the international standard setting bodies do not address all conceivable areas of regulatory policy. There are areas where the EU already has a body of legislation that is not mirrored globally (eg concentration exposure rules) and this is likely to remain the case. Therefore there is the strong

prospect of EU policy development and micro regulation that will not exist outside the EU. For globally active firms the ability of the UK authorities to influence positively the overall quality of supervisors and policy makers in the EU in these areas becomes of critical importance.

This leads to the conclusion that there is a major risk to the strength and competitiveness of the EU and London if the FSA, as a representative of the UK authorities, steps away from policy influence within the EU. It is essential that all the relevant UK authorities, including the FSA, engage wholly with the EU processes and are prepared to commit time, resources and, as necessary, staffing to these processes. The risk otherwise is of rule making that delivers stifling and anti competitive outcomes. It is not sufficient to rely on influencing global policy-making and assuming that its outcome will flow through directly to EU level. To avoid competitive distortion between EU-based and third-country-based groups, the arrangements must ensure that there is no significant divergence between EU rules and global rules.

Markets Issues – Chapter 10

Remuneration

The discussion paper touches briefly on the topic of Remuneration in this chapter. We do not offer further comments here on this issue as Remuneration has been subject to very recent consultations by the FSA and European Commission in May to which LIBA responded. Our views, therefore, can be found in our response to FSA Consultation Paper 09/10 : Reforming remuneration practices in financial services of 18 May, which we submitted jointly with SIFMA; and also in our submission of 7 May to the European Commission working document on remuneration proposals within the Capital Requirements Directive.

Q 29 Does the DP highlight the correct issues concerning the role of CRAs and the use of their ratings?

We agree that ratings play a significant role in the market (they have a role to play in reducing information asymmetry) and in the regulatory requirements. Given recent events it is appropriate to review the framework in which they operate. From the perspective of users of ratings, it is very important that market confidence in the rating agencies is restored and maintained going forward. We agree that the FSA has identified most relevant issues that impact the quality of ratings. We would note that the IOSCO Code and EU regulations are addressing the issues that the FSA has identified.

The Discussion Paper, however, did not reflect upon the CRAs' severe reaction to the widespread criticism that they have received. The CRAs have both issued some

severe downgrades of securities and have amended their quantitative analysis almost entirely on the basis of negative factors (eg. hypothetical default of entire sectors). Although the default rating denotes the likelihood of some loss of principal in a security, there is a cliff effect as all ratings below BB- or equivalent result in a capital deduction.

We would agree that some market participants over-relied on or misinterpreted the information content of ratings, using them as a proxy for other risks and not just as an opinion on credit quality. Ratings are not a substitute for proper risk assessment and due diligence. We support both industry and regulatory initiatives to improve both transparency and due diligence.

In light of the potential moral hazard associated with the regulation of rating agencies, it is appropriate that the capital framework does not encourage over-reliance on ratings. However, we continue to believe that ratings do have a role to play in the capital adequacy framework. One of the purposes of Basel 2 was to introduce a more risk-sensitive framework for credit risk. For those firms not able to meet the exacting standards of the IRB Approach, ratings offer an independent assessment of credit risk and will therefore continue to have a role. Indeed, in the case of securitisation, we note that the Basel Committee's decision not to allow full credit risk modelling meant that an independent measure of credit risk was essential, because such structures are essentially based on credit risk models. In keeping with the broader desire to limit reliance on ratings, however, we recommend that firms with the capability and governance processes to analyse their structured finance exposures should be permitted to use an Advanced IRB approach.

Q 30 Are the approaches outlined to address these issues appropriate and proportionate?

Assessment of the current regulatory proposals and their likely effectiveness/Regulation of CRA conduct of business. We encourage FSA to continue to work, at EU and international levels, to promote consistent regulatory standards for CRAs, and consistent decision-making between the authorities on their registration and the availability of their ratings for use for regulatory purposes. From a users' perspective it is vital that early certainty is given on whether existing ratings, eligible under the recognition process of the CRD, can continue to be used either through 'endorsement' or 'equivalence'. Given the extra-territorial nature of the EU Regulation, co-ordination of supervisory views both within the EU and globally will be essential. Although the EU Regulation includes essential provisions allowing grace periods, firms will also need early clarity on the approach to be taken to withdrawal of registration, suspension or withdrawal of ratings. With respect to transparency we would note that it is more important to users to have additional information on the factors that would result in volatility of the rating than, as the EU Regulation requires, a designation based on the type of product.

Regulation of methodologies: we support the FSA analysis that it would not be appropriate to supervise the CRAs' methodologies. Greater transparency would be a more fruitful tool. Were the CRA methodologies themselves to be subject to regulation it would not be possible to limit the moral hazard of implicit government guarantee in the performance of the rating and redress in the event that ratings did not perform as expected.

Use of ratings by market participants: we support the conclusions drawn by the FSA in paragraph 10.45 relating to the need for market participants to re-evaluate the extent to which their internal controls and procedures remain appropriate. An over-reliance on ratings is, of itself, a systemic risk and we regard a stronger emphasis on investor due diligence as essential for a healthy market place. We support initiatives to ensure that market participants have access to relevant information but also have incentives to perform due diligence. In this context we have already welcomed those aspects of the revised Article 122 of the Capital Requirements Directive that have enhanced investors' responsibility for their due diligence.

Re-engineering the IRB approach: Paragraphs 10.33 and 10.34 suggest that the FSA might prescribe parameters that are more in line with those implied by the standardised approach, because of the use of ratings in the calibration and benchmarking of the IRB approaches. However, the discussion paper highlights that the performance problems for ratings have been in the structured finance sector (we would note that in Europe the level of downgrades is low) rather than other areas where there is a longer and richer data history. Therefore we do not understand why a problem is perceived in the use of ratings as part of the IRB process, which is not available to securitisation exposures. In addition such a change runs counter to the core principle of the IRB approach, which is to base capital requirements on firms' own assessment of credit risk. It is certainly true that the IRB approach results in less capital for higher quality exposures than that of the standardised approach, but conversely it also requires more risk capital for lower quality exposures. If the FSA is concerned by the procyclical impacts of the IRB approach compared to the standardised approach then as noted in other sections of the Discussion Paper there are other means by which these pressures can be addressed. Alternatively if the concern is driven by divergences between firms' internal assessments, as suggested by paragraph 10.33, then it would be more appropriate to undertake further benchmarking exercises and determine what is driving the differences before deciding to amend the regulatory framework.

Government guarantees: Paragraph 10.35 indicates that the FSA believes that implicit government guarantees should not be reflected in the measures of risk that drive regulatory capital calculations. We would note that the IRB approach already includes a floor for PD (parameter specifying probability of default), which provides a measure of protection against implicit support.

Q 31 What options should a review of the use of structured finance ratings in the regulatory framework consider?

It is appropriate to reconsider the calibration of the capital adequacy framework for securitisation as the present calibration, clearly, predates the market turmoil.

However, we would note that the rating agencies have been reassessing and updating their methodologies and assumptions as a result of recent events and it is important that the capital framework does not introduce double counting as a result. And, as the FSA noted at the recent ESF Global ABS conference, not all securitisation transactions are the same and the level of downgrades in Europe is actually relatively low.

We agree that recent events have shown up the deficiencies in the ratings of some structured transactions, such as CDO of ABS or CDO² where double or higher leverage has been introduced through multiple tranching sequences that significantly increase the correlation and default risk and where credit analysis of the resulting securitisation position is based on the package of pooled securitisation risk rather than exposure by exposure analysis. We would note that both the Basel Committee and the European Commission have put forward proposals in this area. There are two issues we would highlight here: international consistency between Basel and the EU is essential; and, given the capital implications for EU firms of requiring deduction will be very significant and are likely to damage recovery, the scope of transactions captured by the EU's proposed re-securitisation definition needs to be carefully and more narrowly defined.

We would agree that the cliff effect of deduction where a transaction is downgraded can have a significant impact and should be re-considered.

With respect to the proposal that firms should use the SFA approach, we would note that this would only offer a partial solution because the information requirements necessary for firms to undertake this calculation are such that it is currently difficult for third party IRB firms to meet the requirements. Although we note that the advances in transparency may help address these issues, we believe that a review of the ability of firms to use internal assessment methodologies should be undertaken, for example expansion of the scope of the Internal Assessment Approach. For standardised firms, allowing the use of the SFA would require a significant change to the CRD/Basel 2, as this methodology is not currently available to them.

Implications for the capital adequacy framework

In examining the discussion presented by the FSA in relation to the use of ratings, we are concerned that the FSA's analysis appears to give an imperfect representation of the intentions and design of the existing Basel 2 capital adequacy framework. In order to engage in a constructive and well-informed debate with the FSA, it is

important that the regulator and industry are not at cross purposes with respect to the purpose of the framework and the assumptions on which the existing framework is founded. As noted above (Question 30, “re-engineering the IRB approach) we have observed that the FSA now seems to question whether firms should be permitted to calculate their own probabilities of default (PDs). The calculation of PDs is a basic precept of the Internal Ratings Based Approach and to amend this would be to signal a significant shift in the capital adequacy framework. We would like to discuss these points further with FSA to ensure a coherent understanding of each others’ views.

Q 32 Is this the most appropriate framework for post-trade transparency or are there other aspects we should be considering?

As FSA is aware, increasing transparency comes at a cost – typically of market liquidity. Hence any increased transparency arrangements in non-equity markets need to be well considered, and taken carefully (and slowly) to avoid abrupt diminution of liquidity.

As FSA says in paragraph 10.55, there is a need to tailor any measures proposed to address particular identified problems in the relevant market. Post-trade transparency might not be the most suitable regulatory tool. Proposals which might better increase market confidence include: better issuer transparency; product disclosure; or reporting on average price/high/low of liquid side of the market with appropriate time delay. We cross-refer to our response to CESR on post-trade transparency on these topics.

Furthermore, it is also important to consider mechanical issues associated with any requirement to report trades publicly to non-equity markets based on the current disclosure requirements for equities. In a number of respects, the equity requirements are not suitable for bond and other markets, for example they do not take account of trading almost exclusively on a principal basis.

The criteria in paragraph 10.55 are important. It is important not to focus too much on post-trade transparency where it would be inappropriate or unnecessarily damaging to liquidity. In an area where there are no global standards and a range of approaches around the world, and where US approaches are not necessarily well adapted to EU circumstances, it is particularly important to proceed carefully. We welcome FSA’s continuing commitment to working with the industry, and we urge it to continue to press for a proportionate approach in the EU that meets the liquidity needs of market users.

We note that some asset managers favour more post-trade transparency to help them in daily valuation. Nevertheless, post trade transparency does not necessarily assist in valuation. When trades are infrequent, and prices have become stale, or

there have been developments in the market not reflected in the last trade, it is clear that post trade transparency cannot be a panacea for valuation.

Q 33 Are there other measures which the FSA should be considering or promoting in international fora?

We encourage consistent international efforts, through IOSCO and CESR, to promote disclosure of the characteristics of non-equity instruments in a way that encourages due diligence by investors.

Within this context of global coordination, we encourage FSA to continue its efforts to persuade CESR to make EU markets more attractive. It is essential to retain the ability to continue to innovate so that the London market can continue to meet the needs of market users worldwide.

It is also important, when considering whether regulation is needed, to take account of the measures that market participants, working through trade associations, have taken on product disclosure.

Q 34 What other considerations should the FSA take into account with respect to OTC derivatives infrastructure?

We support the position articulated by ISDA's response to the Discussion Paper in respect of this issue, but for ease of reference, the key points we would like to emphasise are:

- We are conscious that the continued development of OTC derivatives infrastructure is subject to considerable industry and regulatory attention at present.
- We confirm our commitment to reducing systemic risk in the OTC derivatives market, and agree that it is essential for firms to ensure they have in place adequate counterparty risk management systems. However, we would note also that in our view the capital adequacy framework provides sufficient incentives for firms to seek to clear trades in a central clearing system. We do not agree that there is any need for penal capital requirements to be applied to derivatives which are not centrally cleared.

Q 35 Are any (other) changes to clearing arrangements needed? If so, what should they be?

We support the concept that client business should be held in segregated accounts and that the proprietary trades of brokers' affiliates should be held separately. However, we note that the requirements of MIFID and UK client asset rules are that firms should hold, segregated together, both client monies and the proprietary positions of firms' affiliates. This is a fundamental flaw which requires remedy and we believe should be addressed in the forthcoming review of the MIFID. The regulatory

framework should ensure that there is clear segregation between, on the one hand, clients' funds and, on the other hand, firms' own positions including that of a firm's affiliates.

We do not, however, support the options identified by FSA in paragraph 10.75 for all client business to be held in individual client specific accounts. Such proposals are not pragmatic and would increase operational risk substantially as well as driving prohibitive processing costs. In particular we need a risk-based cost and benefit analysis before taking forward segregation in the case of centrally cleared cash markets business. We do not see a customer benefit and a change of this sort would be expensive to develop and implement.

Finally, we welcome the work that is being taken forward on the UK insolvency regime, in particular HMT's consultation on Investment Banking Insolvency. This is an area where it is essential that the tripartite authorities work in close cooperation with each other.

Q 36 Are any changes to settlement arrangements needed? If so, what should they be?

LIBA and its members continue to be actively engaged in a wide range of activities in the UK and Europe in relation to improvements to the efficiency, safety and soundness of settlement arrangements. As these develop, it remains essential that we continue to learn from recent experience.

In this context, we note that work is being taken forward both in relation to the proposed 'OTC protocol', which, if adopted, would provide greater operational clarity in certain circumstances; and in the context of HMT's preparation for a possible special insolvency regime for investment banks. Clearing and settlement questions are the subject of a chapter in HMT's Discussion Paper dated May 2009.

Supervisory approach – Chapter 11

The FSA does not seek direct comment on its elaboration of its supervisory philosophy and practices but firms consider that as part of a beneficial wider dialogue it would be useful to offer reactions and reflections on the FSA's stance.

Support for the FSA approach

Firms place a great priority on their relationship with the regulator and consider that the FSA delivers a high quality approach to supervisory practices which we hope will be influential in the global community of regulators.

We welcome and support the high standards that the FSA sets itself and we think it is worth highlighting some of the areas in which we have particularly appreciated the FSA's approach. These areas include the openness of the FSA to direct industry contact, regulatory transparency (notably in the case of its enquiry into the supervision of Northern Rock); and the quality of the FSA's consultative (and pre-consultative) processes which encompass industry standing groups and panels, consultative papers, and fully articulated policy feedback statements.

Quality of regulatory relationship

In keeping with the value placed on firms' relationship with the regulator we endorse the FSA decision not to turn to the bank examiner model. The optimal model is based on and will foster trust, mutual respect and rigour. The regulatory dialogue needs to be constructive and needs to flow in both directions. Openness of communication needs to be encouraged so that firms will readily come forward and share potentially complex or difficult issues at early stages, rather than having a concern that the regulator will react disproportionately to smaller issues of less consequence.

In terms of the tone the FSA intends to adopt in its regulatory relationships firms expect the FSA to be challenging but to avoid an adversarial approach which would be counterproductive not least as it would erode or significantly diminish the quality of openness that is necessary. The FSA itself has noted that it is seeking to encourage its supervisors to be "brave" and "decisive". While agreeing that decisiveness is a virtue, when compared with vacillation, we believe that the concept of "bravery" should be interpreted in the sense that supervisors should have the confidence of their experience, skill set and judgement on which to base supervisory decisions. We also consider that "bravery" should encompass listening and understanding when a judgement is outside one's skill set. Dialogue must be at the heart of the regulatory relationship. Supervisory staff should also benefit from the support and trust of the senior FSA management. We agree that an over reliance on seeking legal opinions and third party advice would, however, be interpreted as nervousness by the supervisor and should be avoided.

Business strategy

One important dimension of the FSA's stated approach to supervision is its stance in relation to a firm's business plan and strategy. This is a highly sensitive area as there can be a fine line between (1) identifying and challenging potential oversights in a firm's analysis, or unrealistic assumptions; and (2) directing the course of business in the firm, which would amount to shadow management. If, however, there is a regulatory desire to be close to strategy and models of business (in particular global business) then there is a practical need to broaden the range of expertise the FSA has access to and to ensure the highest calibre of staff. Additionally the FSA will need access to quality data on a global basis as it will not be possible to assess strategy for

global groups in domestic isolation. We believe it is important that the FSA's approach in this area should not undercut the key principle of predictability of regulation. Firms should be judged on the reasonableness of their actions at the time, not with hindsight.

Staffing and Recruitment

Firms seek a sophisticated, relationship-based approach from the FSA but fully recognise that this is a challenging demand that cannot be achieved without significant resource and further recognise that the necessary quality of resource implies expense. We already welcome progress that is being made in raising expertise in certain areas, notably that of liquidity risk management. We look forward to this continuing. Currently the FSA is at an early stage of its focus on staffing issues but firms would like to stress the importance of developing and nurturing experience within the regulatory organisation. Quick staff turnover in post (eg of two years or less) is not conducive to building the reservoir of understanding and skills that the FSA needs. Moreover a failure to nurture such experience detracts from the goal of delivering "outcome focused" supervision as opposed to a more expedient tick box mentality. We would further like to encourage an outward focus in staff at all levels within the organisation.

Data and information technology

The FSA has launched some significant projects on regulatory reporting and data retrieval and management within the organisation. We strongly encourage the FSA to continue in these efforts so that it will have the tools for timely analysis of the information, whether to identify broad industry trends or to press individual firms with further necessary questions. On a related point, we would also encourage the FSA to consider closely the cumulative effects of data disclosure given the many and wide ranging requirements to publish and disclose, whether Pillar 3 reports, FSF disclosures, ESF good practice disclosures or other requirements. It would seem a good moment to have a debate on the volume and granularity of data being exposed and whether it is supporting or overwhelming those it is supposed to serve.

Limitations of Regulation

We support the FSA's iteration of the limitations of regulation (paragraph 11.10). We would ask the FSA to bear these limits in mind when considering whether to superimpose a supervisory judgement upon a firm's business strategy. However, we welcome the FSA support for the role of Non-Executive Director which should indeed be one of a "critical friend" to the firm. Neither the regulator nor the corporate governance mechanisms should act to stifle the responsible taking of risk, business activity and innovation.

On a related topic, another limitation that regulation can suffer from on occasion is that of burdensome process. Although firms fully acknowledge that due process

must be observed, in a number of areas (notably market abuse) greater regulatory ability to be responsive would be welcomed. Given that the FSA itself has to work within a legal framework, the question is therefore whether the framework has been sensibly interpreted and implemented and not subject to over cautious interpretation (perhaps to achieve a high degree of confidence that there could be no legal challenge) or whether reforms are needed to that legal framework.

Other regulated sectors – Chapter 13

Q 37 Which of the issues set out for discussion in this DP are most relevant to other regulated sectors?

We do not offer a view on this issue.

Question 38

Are there any lessons which have been learned in other sectors which could be applied to banking?

We do not offer a view on this issue.

Open Questions posed in Turner Review Document

Should the UK introduce product regulation of mortgage market Loan-to-Value (LTV) or Loan-to- Income (LTI)?

Our members do not consider that this question is directly relevant to their activities. However, we note that if such a policy were implemented we do not believe that it would be appropriate or suitable, much less practical to insist that wholesale counterparties (eg to securitised products backed by mortgages) were to be responsible for ensuring that the underlying mortgage contracts complied with any LTV or LTI requirements.

We also observe that this regulatory approach would be based not on regulation of the firm or institution but of the client and could be seen as a measure to constrain leverage (and thus potentially procyclicality) within the general population. This would therefore represent a major political decision, not one purely based on regulatory considerations.

Should financial regulators be willing to impose restrictions on the design or use of wholesale market products (e.g. CDS)?

We consider that placing restrictions on the design or use of wholesale market products would be wholly counter to the principle of fostering a thriving, competitive, innovative financial centre. Innovation of itself is not harmful or dangerous and without it, over time, the financial markets will become moribund and cease to perform their function.

Does effective macro-prudential policy require the use of tools other than the variation of countercyclical capital and liquidity requirements e.g.

- **Through the cycle variation of LTV or LTI ratios.**
- **Regulation of collateral margins ('haircuts') in derivatives contracts and secured financing transactions?**

We consider measures of the nature set out here by the FSA to be primarily a matter for firms' own discretion. Given robust regulatory structures and incentives that are already in place we do not consider it helpful that the regulator should seek to set such detailed parameters.

Should decisions on for instance short selling recognise the dangers of market irrationality as well as market abuse?

No, we do not agree.