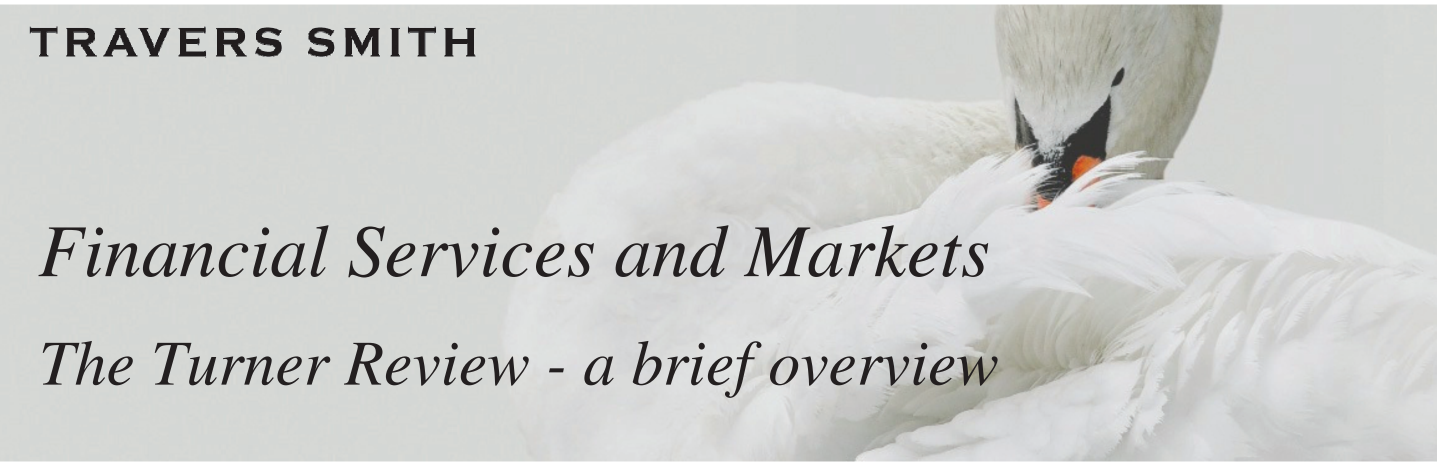

TRAVERS SMITH

Financial Services and Markets

The Turner Review - a brief overview

"There is growing recognition that the dispersion of credit risk by banks to a broader and more diverse group of investors, rather than warehousing such risk on their balance sheets, has helped make the banking and overall financial system more resilient.

The improved resilience may be seen in fewer bank failures and more consistent credit provision. Consequently the commercial banks may be less vulnerable today to credit or economic shocks."

(IMF Global Financial Stability Report, April 2006)

Introduction

The Turner Review describes the global failure to foresee the causes of and prevent the current financial crisis. It recommends changes to regulation and supervision with the aim of creating a more robust banking system. Its publication was accompanied by FSA Discussion Paper 09/2 which provides more detail on the FSA's own thinking on the issues. Many of the proposals, if adopted, would be of direct applicability to banks, but their impact will be wider as banks are so pivotal in the financial community. There are other proposals which will be of direct wider interest as they have implications for other investment firms and for the markets generally.

This note summarises some of the key elements in the Turner Review and the FSA Discussion Paper.

The Banking sector

- Banks will be required (i) to have more capital; (ii) to maintain a capital buffer to draw down in recession years which will be shown on the profit and loss account; (iii) to comply with a gross leverage ratio (total assets to capital); (iv) to comply with both tailored liquidity requirements and a core funding ratio. Many banks will be permitted only Tier 1 capital.
- There will be a comprehensive review of trading book capital and other trading book requirements. Proprietary trading activity (particularly that which is unrelated to market-making to support customer services) will become more expensive in terms of capital required.
- Bank governance requirements should be reviewed and the skill levels and time commitments of non-executive directors of banks must be improved.
- The FSA will continue to adopt a more challenging and intrusive regulatory style, including into risk management and oversight. It will challenge management judgements and be closely involved with banks and their auditors in reviewing accounting approaches, including to fair value estimates and loan impairment provisions.
- Passporting of bank branches in the single market is flawed and host supervisors need more powers, including the right to demand local subsidiaries. Further work must be done on compensation scheme cover for passporting banks.

Unregulated entities and activities

- The risk of regulatory arbitrage using unregulated entities or jurisdictions which do not recognise higher standards should be combated by international regulatory agreement and co-ordination and by bringing offshore centres into internationally agreed regulatory standards.
- Regulators need to have more information on the activities of hedge funds and other investment intermediaries in order to assess if their activities have systemic importance. They may collect this from authorised firms who deal with unregulated entities.
- There is a strong case for legislative change so that regulators have direct powers to ensure that parent holding companies for financial services groups comply with the requirements of the prudential framework. The FSA proposes there should be measures to enable supervisors to assess the risks posed by unregulated activities that are conducted within a regulated financial services group.

Credit ratings

- Market participants should assess the extent to which they rely on ratings and whether this is appropriate, understand the limitations of ratings and stress test the effect of any contracts which have ratings downgrades as trigger events.
- There should be a fundamental review of the use of structured finance ratings.
- Turner expects that the securitised credit market will return, but that the impact of the various regulatory policy changes will mean that it will do so in a simpler form, more in line with the original concept of securitisation, and that highly complex structures, such as CDO^2, will be unlikely to find an investor market in the future.

Market Regulation

- Retail and wholesale product regulation is under active consideration. Retail product regulation could, for example, include limits on mortgage loan to value or loan to income ratios.
- Wholesale financial product regulation is being discussed in the area of structured credit and credit derivatives and could extend more widely.
- The Financial Stability Committee of the Bank of England should become a joint committee with the FSA to make judgements as to macro-prudential conditions and policy responses.
- There should be a new independent European regulatory authority to set standards and oversee supervision, with primary responsibility for actual supervision remaining with national regulators.

Accountancy firms and standards

- There are general accounting issues for the banking sector, in particular whether the financial statements provide transparency about a bank's financial position at a sufficient level of granularity. The FSA is already engaging in an intensive dialogue with banks and their auditors on valuation procedures and assumptions used for some complex asset classes.
- Serious consideration must be given to establishing some form of global supervisory architecture for all significant activities of the major accountancy firms. This would consider their risk management systems and their ability to meet financial claims.

Comment

Regulatory approach

- It is important for <u>all</u> firms to appreciate that there has been a significant shift in regulatory mood. Regulators will no longer assume that managers are better placed to understand and judge the risks inherent in their business, that professional institutions understand the instruments they deal in or that regulation should not restrain innovation. Whilst much of the Turner report is about banks, these themes have much wider relevance. Key elements of future regulatory philosophy will be:
  - a general shift to a supervisory approach which is proactive and which challenges the judgement of senior management on business models, risks, etc.;
  - more detailed scrutiny of the organisational and funding structure of international groups and the responsibilities and conflicts of managers in respect of the local firm and the group as a whole;
  - that more liquid markets are not always better and innovation in the financial markets is not automatically a good thing;
  - that theories based on self-correcting and rational markets are wrong - financial markets are susceptible to irrational herd effects;
  - that wholesale participants are not always as sophisticated as they think they are, and in particular must make improvements to their understanding of capital markets structures, of risks and their use of credit ratings.

Impact of proposals

- The overall effect of the capital, trading book, liquidity and other proposals for banks may be to:
  - reduce the amount of proprietary trading by banks so that it takes place to support customer business rather than as a stand alone profit centre;
  - reduce reliance on short term wholesale funding, having a knock-on effect to the wholesale funding market;
  - incentivise banks to attract a higher proportion of retail term deposits;
  - reduce rapid growth in lending by banks and increase lending from non-bank sources (which will need a regulatory response);
  - lead to more resources being required for accounting and risk management functions and greater involvement by senior management in accounting judgements;

- lead to an increase in the cost of non-executive directors and in the demands made by them for information, training and adequate insurance cover;
- encourage shareholders to be more questioning of corporate strategy.

- Other implications for market participants include:
  - hedge funds and other unregulated investment vehicles will be subject to requirements (imposed directly and indirectly) to provide information on their activities to regulators and central banks, irrespective of where the particular fund is located, or its assets based. Offshore centres will come under significant pressure to ensure that entities based in their jurisdictions comply. Regulated firms which deal with such entities may expect to be asked to provide information on the activities of their unregulated customers and counterparties;
  - the possible introduction of some level of direct regulation to hedge funds (in addition to the regulation of their managers and advisers). It is principally envisaged that the regulation would extend to capital, liquidity/leverage and other prudential rules where the activities have become either bank-like in nature or are otherwise systemic in importance. As above, no territorial limit is stated at this stage;
  - enhanced regulatory capital requirements and modified risk models may affect the business models of market participants, such as prime brokers; permitted leverage is likely to be lower; and increased proprietary trading book costs are likely to lead to higher costs for customers, particularly when trading illiquid assets;
  - clearly there may be implications for the valuation of shares in banks and other affected entities. There may also be a market impact if, as seems probable, banks become heavier purchasers of gilts and other high quality liquid investments;
  - there will be more emphasis on training and competence standards in the wholesale markets;
  - there will be greater emphasis on truly comprehensive consolidated supervision and international groups can expect their regulators to want to understand the implications of their business operating model in the context of the legal entities involved. Complex management structures will come under scrutiny;
  - there will be more focus on bank-like activities carried out by non-banks, and the role of money market mutual funds may come under examination.

Timing Issues

Many of the proposals require international agreement to be truly effective. The FSA has signalled that if international standards are not agreed it may take unilateral action in some areas, although there would be further consultation and cost benefit analysis. There is clearly a strong preference for international agreement and a desire for this to be reached as a matter of urgency. The timing emphasis is therefore on the need to reach agreement quickly. It is recognised that implementation is a different matter.

In particular it is accepted that that the transition to the future capital regime for banks will be a lengthy one because of the current economic crisis. The increases already planned for trading book capital increases will be implemented by 2010 but any other changes need careful management because of the severe recession affecting all the major developed economies and the fact that increasing capital ratios for banks would constrain their ability to lend. The FSA notes that the gradual exit strategy from government involvement will lead to the need to balance the desire to maximise government proceeds in a privatisation with the pace at which a capital buffer can be built up.

Not all of the proposals will necessarily be adopted, either at all or in the form suggested. On some of the issues, for example the concept of "capital buffers", the opinions of different central banks and regulators may vary. There will therefore be a vigorous debate on some of the issues raised.

If you would like further information or advice on these matters, please contact Margaret Chamberlain, Jane Tuckley, Mark Evans or Tim Lewis in the Financial Services and Markets Department or your usual contact at Travers Smith.

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2 April 2009

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