New High Level Principles for Risk Management

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5. New Product Approval Policy and Process

There is nothing much in this section apart from a requirement for a new product approval policy and new product due diligence.

Conclusion

I am sure we will not be alone in thinking that the CEBS could have provided more useful guidance in such an important area. It is perhaps the issues that they have failed to address - in particular the development of an enterprise risk management framework and the role of the non-executive director - that provide us with the greatest disappointment.

There are however a few key messages, perhaps the loudest of which is that ***risk management is now central to the way that a institution operates and can no longer be relegated to a more junior level***. The elevation of risk management as a principle driver must be welcomed and the CEBS therefore generally applauded for their added impetus.

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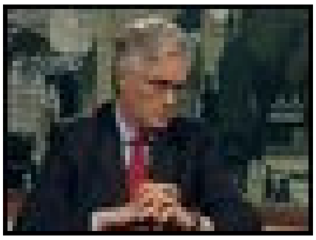
The Turner Report Reviewed - The FSA's Response to the Credit Crisis



What is the Turner Report?

Lord Adair Turner, Chairman of the FSA, has recently published his much heralded report on the credit crisis. He examines in sometimes tedious detail the causes of the failures leading to the crisis and then sets out his recommendations for the future.

It is worth noting that the UK's FSA is the first major regulator to publish such a detailed report although its release just before the G20 Summit in London may be seen as both timely and pre-emptive. Some might argue that it actually was presumptuous. It is clear that Lord Turner and the FSA are hoping that their proposals will be both taken up in the UK and internationally. Many of the changes recommended by Turner go to the heart of the Basel Accord and impact on the international regulatory and supervisory frameworks.

Indeed, given the international and global nature of so many of the key market participants, really effective regulation can only work if it is implemented across each of the key financial jurisdictions on a consistent basis. Only by achieving this can regulatory arbitrage be avoided.

Turner's View of the Causes of the Crisis

Turner identifies three underlying causes of the crisis:-

- Macro-Economic Imbalances
- Financial Innovation is 'of little social value' and
- Important Deficiencies in Key Bank Capital and Liquidity Regulations

These, Lord Turner says, were underpinned by an exaggerated faith in rational and self-correcting markets. He makes an obvious observation in stressing the importance of regulation and supervision being based on a system-wide "macro-prudential" approach rather than merely focusing solely on specific firms.

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'If Lord Turner's suggestions are taken into account this will probably result in the demise of the ratings agencies as businesses.'

Readers of previous Risk Updates will know that the first two issues were actually nothing to do with the crisis and to blame them in our opinion suggests faulty analysis working from an invalid hindsight perspective. Given that we disagree with the analysis conducted by Lord Turner, it is perhaps unsurprising that we have reservations about his recommendations.

In his report Lord Turner added that "The financial crisis has challenged the intellectual assumptions on which previous regulatory approaches were largely built, and in particular the theory of rational and self-correcting markets. Much financial innovation has proved of little value, and market discipline of individual bank strategies has often proved ineffective".

He identified the "fault lines in the regulatory approach", due to the globalisation of banking activities, which led to "global finance without global government". This is an issue that has been recognised for many years and appears within the Basel Sound Practices paper from 2003. Indeed the Basel Accord and subsequent papers were specifically designed to deal with such matters. However, was Northern Rock really caught because it was a global institution? What about Fannie May or Freddie Mac? Almost all of the institutions that had difficulties – these were problems of liquidity not problems of international regulation.

Unsurprisingly Turner calls for more and improved regulation supported by a more intrusive approach by supervisors and the end of 'light touch' regulation. Whether a more heavy handed rules based approach would be more effective is not necessarily an automatic consequence - as the SEC has demonstrated so very recently. ***It is clear to us that the detailed rules approach*** – which actually has been followed by the FSA and other regulators (specifically those adopting Germanic approaches) – ***does not work***. The focus on detailed pointless rules stifles innovation and prevents banks from appropriately managing their business. Worse than that, the regulators stop focusing on what really matters and instead look towards death by a thousand cuts. It never happens.

The Turner Proposals

Lord Turner proposes major reforms in the regulation of the European banking market, creating a new European regulatory authority together with increased national powers to constrain risky cross-border activity. In our view this is will be a challenge to make happen due to the problems of national rules and the certain disagreement as to where it should be housed. The threat could of course lead to some institutions leaving Europe, which would hardly be in anyone's interest.

Similarly predictable, Turner proposes major increases in regulatory capital to levels 'significantly above existing Basel rules'. He does not really justify this because it cannot be justified. The problem that the banks faced was a failure of liquidity, not a failure of capital. Northern Rock did not run out of capital – it just could not get the liquidity it needed at any price it could afford. Lord Turner also calls for a fundamental review of the trading book capital regime not just with a view to increasing capital 'by several times' but to addressing the shortcomings of the current VaR approach. Our view is the current VaR regime is a problem and does need to be addressed, but whether capital is the answer is open to debate.

This would, of course, affect banks' profitability and, particularly in the current climate, would have a strong political impact too since it would reduce banks' ability to provide credit, which in turn will impact economic growth. What is clear is that everything that Turner is recommending will have the effect of ensuring that the recession is longer and deeper than would otherwise be the case.

More controversially, he recommends counter-cyclical capital buffers, to be built up in good economic times so that they can be drawn on in downturns. As mentioned earlier, this is something that we agree with.

What Turner Did Not Recommend

Interestingly, there are several areas where recommendations were expected but were not made in Lord Turner's recommendations.

1. Turner has rejected the idea of a Glass Steagall separation of banking and securities businesses as being impractical.

2. Contrary to many expectations Turner has not called for a major review of or changes to the Accounting Standards which so many felt were at the heart of the problems leading to the credit crunch.

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3. Similarly Turner highlights areas where he believes it is premature to recommend specific action, but where wide-ranging options need to be debated. These include product regulation in retail (e.g. mortgage) and wholesale (e.g. CDS) markets.

4. While Hedge Funds might expect some greater interest from supervisors Turner did not call for wholesale new regulation for them.

Really the accounting rules are not within the remit of the FSA, which could be the only reason for Turner to keep clear. Were hedge funds the cause of the crisis? Was it derivatives? It is our belief that derivatives have been the savior of the global financial services industry this time and, had they not been available, currency would have failed by this stage.

Dumb or Dumber?

However, amongst his other proposals, Lord Turner has recommended a number of specific changes, including the following:

- Regulation of "shadow banking" activities on the basis of economic substance not legal form: increased reporting requirements for unregulated financial institutions such as hedge funds, and regulatory powers to extend capital regulation;
- Regulation of Credit Rating Agencies to limit conflicts of interest and inappropriate application of rating techniques;
- National and international action to ensure that remuneration policies are designed to discourage excessive risk-taking;
- For the UK he also proposes major changes in the FSA's supervisory approach, building on the existing Supervisory Enhancement Programme, with a focus on business strategies and system wide risks, rather than internal processes and structures.

Was shadow banking at the heart of the crisis? Not really – where is the evidence to support such an increase in costs? The ratings agency issue needs to be covered much more carefully and is an issue we shall return to. If Lord Turner's suggestions are taken into account this will probably result in the demise of the ratings agencies as businesses.

Basically the increased costs will result in an unexciting volume business becoming unprofitable and we would suggest that some or all will close. Now that would really be an achievement for Turner to take to his grave.

The report also calls for improved risk management and governance and the up-skilling of the regulator's own staff. As one of the causes for the crunch, Turner refers to a *'misplaced reliance on sophisticated maths'* which made it *'increasingly difficult for top management and boards to assess and exercise judgment over the risks being taken'*. We have much sympathy with this point of view and do consider that misplaced reliance on inaccurate modeling is a problem. However once again Lord Turner must be stopped from throwing the baby out with the bath water. What we need is better modeling and better trained boards, perhaps including non-executive risk specialists. What we do not need is prejudiced ignorance.

'What we need is better modeling and better trained boards, perhaps including non-executive risk specialists. What we do not need is prejudiced ignorance.'

Perhaps, with all the change and fresh thinking that is now being debated, it might be sensible for regulators and bankers alike to reflect carefully on the enormous reliance we do place on models and statistics to the exclusion of good old fashioned common sense. The Accord itself sets very clear objectives for any model – how often it should be tested and validated and the importance of understanding assumptions. The rules are already there – they just need to be applied in practice.

What will be interesting is to see how the global regulators agree or disagree to proceed. There was the appearance of broad agreement at the April G20 meeting in London. However when we move from the discussion stage to the 'development' and 'implementation' stages will the approach really be a united and integrated one or will it be local and, dare we say, protectionist. Let us hope that the Turner report is not the blueprint that he hopes it is. We do not believe it is the answer to the problems of the current world and also are concerned that the next crisis can be seen in the inappropriate responses being suggested to this one!