

D Cook Esq.
Financial Services Authority
25 The North Colonnade
Canary Wharf
London
E14 5HS

18 June 2009

Dear Sirs,

DP09/2 A Regulatory Response to the Global Banking Crisis (Turner Review)

Thank you for providing us with an opportunity to respond to the Turner review and the discussion paper.

The IMA represents the asset management industry operating in the UK. Our Members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes.

They are responsible for the management of around £3 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles.

Our response is given in two sections. Please contact me if you have any questions arising from this response, or wish to be provided with any clarification. We welcome further involvement as you develop the ideas raised in your paper.

Yours faithfully



R B Saunders
Chief Executive

Encs.

Index

Section I of the IMA paper	5
Future architecture of the banking sector	5
Summary	5
Introduction	5
Background: an overwhelming financial crisis	6
Too big to fail?	7
How to secure capital market liquidity?	7
The investor standpoint	8
Competition and consolidation	10
The structure of financial regulation	11
Conclusion of Section I	12
Section II of the IMA response	13
Section 3: The role of inadequate capital and liquidity in causing instability	13
Q1: Are there shortcomings in the international prudential framework not already identified in the DP that are relevant to the analysis?	13
Q2: 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?	13
Section 4: Solutions through micro-prudential measures	13
Q3: Do you agree with the proposals to redefine what counts as capital with a stronger emphasis on going concern loss absorbency?	13
Q4: 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?	13
Q5: Are there any other key issues that the review of trading book capital should cover?	13
Q6: How should the leverage ratio capture (i) off-balance sheet exposures and (ii) derivatives?	13
Q7: Should the numerator of the leverage ratio be Core Tier 1 capital or should a broader measure of capital be used?	13
Section 5: Macro-prudential policy	14
Q8: 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?	14
Q9: Do you agree with the FSA's reason for favouring a range of policy measures to deal with macro-prudential policy issues rather than adjusting the Basel II risk-based capital requirements?	15
Q10: 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?	15
Q11: Do you agree with the FSA's analysis of the implications of accounting standards for procyclicality?	16
Q12: How best should prudential regulators address the problem of procyclicality through counter-cyclical reserves/buffers?	17
Q13: Do you agree that serious consideration needs to be given to establishing some form of global supervisory architecture for international audit firms?	18
Q14: What macro-prudential policy tools should be considered other than those mentioned in this DP?	18

Q15: What are your views on the effectiveness of a core-funding ratio as a measure to contain excessive asset growth?	18
Q16: What types of institutions should be exempt from such a core funding ratio? How would any exemptions limit the effectiveness of the measure?	18
Q17: 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?	19
Section 6: Scope of regulation	19
Q18: Are there other considerations that are relevant to the assessment of the issues and risks posed by the boundary question?.....	19
Q19: 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?	19
Q20: 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?.....	20
Section 7: Systemically important firms	20
Q21: 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?	20
Q22: 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?	20
Section 8: Groups and intra-group exposures	20
Q23: Are there other aspects of group structures that the FSA should be taking into account?	20
Q24: 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?.....	20
Section 9: Responding to events – international architecture	20
Q25: 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?	20
Q26: Is this the most effective way of organising colleges on the one hand and crisis management groups on the other?	21
Q27: Do these options represent the right approach to the problems posed by EEA branching?.....	21
Q28: 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?	22
Section 10 Markets Issues	23
Remuneration	23
Credit rating agencies	23
Q29: Does the DP highlight the correct issues concerning the role of CRAs and the use of their ratings?	23
Q30: Are the approaches outlined to address these issues appropriate and proportionate?	23

Q31: What options should a review of the use of structured finance ratings in the regulatory framework consider?	24
Market regulation	24
Q32: Is this the most appropriate framework for post-trade transparency or are there other aspects we should be considering?	24
Q33: Are there other measures which the FSA should be considering or promoting in international fora?	25
Q34: What other considerations should the FSA take into account with respect to OTC derivatives infrastructure?	25
Q35: Are any (other) changes to clearing arrangements needed? If so, what should they be?	26
Q36: Are any changes to settlement arrangements needed? If so, what should they be?	27
Other.....	28
Section 13: Implications for other regulated sectors.....	28
Q37: Which of the issues set out for discussion in this DP are most relevant to other regulated sectors?	28
Q38: Are there any lessons which have been learned in other sectors which could be applied to banking?	28

Section I of the IMA paper

Future architecture of the banking sector

Summary

- While there are attractions on both investment and public policy grounds for a clearer separation between “utility” retail and commercial banking on the one hand, and trading and other capital markets activities on the other, seeking to enforce this by statutory separation on the lines of the former US Glass-Steagall legislation is unlikely to be practical or effective.
- But much of the benefit could be achieved by better calibrated – and therefore prospectively higher – capital requirements for trading activity undertaken by universal banks. The purpose of such an adjustment would be to address the reality that large banks continue to run the risk that failure in their capital markets business could infect their traditional banking arm. This would potentially result again in a need for taxpayer support, and so they should be subject to more demanding requirements as regards their balance sheet. This would leave choice in the hands of the banks. It would also put a price on excessive leverage which, within the banks, helped to create the crisis.
- Capital requirements should also encourage business models which limit risk in other ways, for example by isolating certain activities in separately constituted and capitalised subsidiaries, with transparent and limited cross-default arrangements. This needs to be allied with full consolidation in published accounts to ensure transparency for investors.
- The banking crisis has already seen a greater reluctance by banks to commit capital to market-making in the capital markets; it should therefore be an objective of policy to have low barriers to entry to encourage new types of intermediaries to enter those markets.
- The banking crisis has left the sector more concentrated than before. In due course the authorities need to address this.
- Action on regulatory standards needs to be co-ordinated internationally, although supervision will always be located primarily at the national level.
- Regulatory conflicts need to be addressed in any future structural reform of the regulatory system.

Introduction

We have addressed issues relating to the future architecture of the banking sector in this first section of our response. The second section, addressing the questions as posed, deals with some additional points.

The Investment Management Association and its members, who comprise the buy side of the capital markets, have a number of direct interests in the future architecture of the banking sector:

- The industry's clients have an overarching interest in a stable investment environment, with a robust financial infrastructure;

- It requires efficient and liquid capital markets in which to invest, which are in turn largely dependent on a healthy banking system; and
- Both these need a thriving private sector banking system, in which the industry can invest its clients' money with confidence and for the long term.

A healthy market needs to deal with moral hazard. If banks are able to trade secure in the knowledge that if things go wrong they will be bailed out by the taxpayer – whether because they are too big to fail or because consumers need to be protected from the consequences – that is profoundly unhealthy.

This section discusses a number of questions which follow from this. It does not at this stage seek to put forward a detailed policy prescription. But we believe the asset management industry can help to shape a new regime. Investors and regulators have a strong common interest in transparency and stability. The market can be expected to shape the banking industry in different directions from that before the crisis. It will be important for regulatory reform to go with the grain of those changes.

Background: an overwhelming financial crisis

The financial crisis that engulfed the USA, continental Europe, the UK and many other countries around the world was primed by low interest rates, excessive leverage, and imprudent lending and trading activities undertaken by the banking industry. The Turner review provides a particularly compelling analysis of the causes of the crisis.

The consequence of the seizure in the markets was to bring many banks to the brink of collapse; and a few did so. To prevent systemic collapse of the banking system, governments stepped in to provide support while bank balance sheets were shored up. The process of shoring up is far from over, and deleveraging has some way to go.

We agree that the authorities were right to step in to support the banking system. But by doing so, other essential elements of a free market economy, such as competition, were largely set aside. Moreover this action made it explicit that the Government stands behind the banking system. This is right and proper, because a functioning banking system is an essential public utility in a market economy. What has become clearer is the nature and extent of the Government guarantee, applying as it does to all UK depositors and, in a slightly less direct way, the availability of credit to the commercial and to the housing markets, and the amount of the support that taxpayers have had to make available. It is less clear what is the price paid for that guarantee.

UK financial services have never operated solely within a free market economy. Woven into the structure of the commercial life of the financial services industry are regulatory restrictions that are intended to guard the interests of customers. Conduct of business rules protect customers, and set some market conventions. Capital rules should have guarded the utility roles provided by the banks; but they failed in the crisis. Whilst taxpayers may just be persuaded of the need in future decades to support a failing utility, they will not wish to support a bank because

those utility functions were hobbled to unfettered risk-taking activity. We therefore suggest structural change based on the need to:

- reduce the likelihood of failure by large banking institutions ;
- protect the utility services offered by the banks from contamination by other activities, particularly in the event of failure in another part of the business;
- strengthen competition;
- improve efficient regulation.

Too big to fail?

A Government guarantee of the banking system needs, in the interests of the taxpayer, to extend no further than necessary. It is also in the interests of the taxpayer that the risk of the guarantee being triggered by events outside the mainstream banking system itself should be minimised. This suggests a clear public policy interest in developing a clear working distinction between “utility” and other banking.

It is important to be clear about the terms used here. By “utility” banking we mean those without which a market economy cannot function effectively. This encompasses retail deposits and lending to companies and households, as well as custody and money transmission, which is why the new resolution procedures introduced by the Banking Act 2009 are so important. This is distinct from product origination and most of the proprietary trading functions undertaken by banks, the loss of which in an individual bank should not, in a properly competitive and well constructed market, cause undue problems.

Large universal banks, which in the UK are significantly concentrated for retail and clearing business, may therefore constitute a significant risk to the taxpayer. This may be exacerbated by the presence of extensive and poorly diversified trading and product origination activities. The more concentrated the sector, the greater the systemic risk. As it has sometimes been put, “if it’s too big to fail, it’s too big”. “Too big to fail” may also be “too big to save” – as the collapse of the Icelandic banks demonstrated.

How to secure capital market liquidity?

It is essential that the capital markets continue in the future to provide depth and liquidity for investors. Recent events have called this into question and investors have suffered, particularly in the cash fixed income markets. Research commissioned by the IMA¹ demonstrates clearly the extent to which dealer liquidity disappeared in the sterling market. This was made more difficult by the absence of alternative mechanisms for trading. In these markets, it should be a regulatory objective to encourage the emergence of new trading platforms, agency broking, “bulletin board” facilities and the like, covering the whole liquidity spectrum in terms of underlying securities.

¹ *The Impact of the Credit Crunch on the Sterling Corporate Bond Market*, Board, Sutcliffe, Wells (April 2009)

A central recommendation of the Turner Review is that there should be a large increase in the capital requirements associated with proprietary trading by banks. We agree with this. There must however be a concern that this will further affect liquidity and make it more difficult for the dealers to provide a market in the future. And to the extent that higher capital requirements result in increased trading costs, that will reduce returns for end investors.

In OTC markets it should therefore generally be a regulatory objective to encourage new participants into the markets where these may improve access to pools of liquidity. In addition to dealer-provided liquidity, the emergence of new trading platforms, agency brokers, “bulletin board” facilities and the like should be supported so that all forms of liquidity, including “natural” liquidity from the investor base, is made more accessible. In markets that can provide central clearing, it should be possible for confidence to be rebuilt quickly amongst investors. This is however contingent upon regulators ensuring that investors can benefit from protection against counterparty default through the central clearer; and upon stringent governance arrangements within the clearing house to ensure that risk management decisions are not subject to interference. But where bi-lateral trading and settlement arrangements continue to be used, intermediaries should expect a higher capital charge to support the undiversified nature of the risk that is carried.

It should also be a regulatory policy objective to keep barriers to entry low for new market intermediaries.

The investor standpoint

Investment managers in the UK remain cautious about investing in the banking sector as currently constituted. This is of particular importance to the Government when it comes to considering the re-privatisation of the stakes in UK banks managed by UKFI.

This caution is rooted in the following factors:

- The complexity and opacity of banks with multiple business streams can be difficult to disentangle to understand the potential risks and rewards. This is an issue for investors themselves to consider: the clock cannot be turned back, and they will need the relevant analytical skills in the future.
- The loss of shareholder value since the crisis took hold in the summer of 2007, and the subsequent dilution suffered by investors in many banks.
- Uncertainty about whether bank balance sheets are fully “cleaned up”, and whether they continue to hold assets which could lead to significant future losses. There are attractive UK equity opportunities outside the banking sector which may be a preferable investment for their clients’ money.

These concerns have abated somewhat in recent weeks, as the sector has appeared to stabilise. HSBC and Lloyds HBOS recently completed successfully significant equity raising exercises, and the recent recovery of a number of bank shares has encouraged buying. But further bad news could reverse that.

There is a widespread view among investment managers that the market will drive banks to become simpler and more transparent in future. If this view is correct, and

if the market were to reward this through the rating of the stock, then boards can be expected to respond. When it comes to investing in the sector in future, for example when the Government seeks to sell its stakes in UK banks, they are likely to attach importance to clarity about the assets and the nature of liabilities, and will be expecting to see lower returns on equity than before the crisis.

This reflects the difference between “utility” banking, which is relatively low growth but with a strong and steady dividend yield, and investment banking, which has higher growth potential and more volatile earnings. Both types of investment have a legitimate place in many investment portfolios. The problem with the way banking has developed in recent years is that it has become much more difficult to discern which of the two, or in what proportion, one is buying when one buys bank stock. Greater clarity about that distinction should make the eventual return of private capital to the sector easier.

Separation?

Thus both public policy and investment considerations would seem to point to the desirability of greater separation.

Against this it has been argued that a number of recent banking failures in the UK – for example, Northern Rock, Bradford & Bingley, London Scottish and Dunfermline Building Society – have involved retail banks with essentially no capital markets business. That is true, but irrelevant. The purpose of separation would not be to prevent the failure of retail banks. It would be to prevent a failure within a capital markets business infecting an otherwise sound retail bank. These banks failed as a result of imprudent business practices, as they should have. The Banking Act 2009 is an important step forward, because it allows such banks to fail without causing undue disruption to the system, thus avoiding moral hazard for banks. It is for this reason that IMA supported the new banking legislation from the outset. The argument about the failure of retail banks in no way diminishes the case for separation.

The approach of the 1933 legislation in the US was a simple prohibition on deposit-taking banks carrying out securities business. It is doubtful whether such a measure today would be desirable or effective. The financial system has moved on and, even before Glass Steagall was repealed, was many times more complex and interconnected than in the 1930s. A significant problem of Glass Steagall was that it diminished any significant diversification of the business model. The resultant concentration of activity thus undermined the main purpose – bank stability – for which the legislation was intended. It would seem a backward step to reintroduce this model as it would almost certainly inhibit reasonable practices and stifle innovation in unforeseen and undesirable ways. And a statutory split might not achieve its objectives because securitisation could undermine it quickly and, as the Treasury point out in the Budget Report, counterparty exposure would remain.

We conclude that an attempt to introduce Glass Steagall type legislation now would be neither practical nor effective.

The role of capital

Nevertheless the case for a clearer distinction between the different types of banking activity remains strong. If it is not enforceable by a statutory split, other means should be explored. The most obvious is through capital requirements. The Turner Review, as noted above, already proposes higher requirements for proprietary trading. We endorse this approach. But where those activities are carried out in a bank with a significant business in retail or commercial banking, the risks of cross-infection and potential for taxpayer intervention would require significant levels of capital to offset them.

Stability could be further reinforced by requiring certain activities to be carried out in separately constituted and capitalised subsidiaries. At a basic level this would permit the separation of utility businesses from more speculative trading activities. The capital treatment of separate legal entities would then have to be carefully adjusted to take account of cross default commitments and guarantees made within a banking group, to the extent that these act to diminish the detachment of the separate legal entity. It would be important however for fully consolidated published accounts to be presented to ensure full transparency for investors.

It is also in the interests of both investors and regulators for banks to be positively discouraged from routing business through offshore or off balance sheet vehicles purely to reduce capital requirements. There are of course legitimate reasons for such structures. Investment banks would be expected to have many separate subsidiaries established to trade in markets around the world. Many exchanges, for example, will require members to be domiciled in the same jurisdiction. But in addition many banks operate subsidiaries and affiliates that do not provide services, but are used as a means to maximise tax efficiency and to transfer regulatory and client obligations away from the domicile of the utility entity. These affiliates should be transparent to the regulator, so that appropriate capital requirements can be agreed. Explicitly, they should not be attached to any utility function, but should operate purely to maximise the efficiency of the proprietary trading function.

Regulators have already sought to control the proliferation of off balance sheet activity, including securitisation, by introducing requirements for banks to retain a portion of the issuance. Further work should be done to establish the efficiency of this measure as a proxy for risk management.

At the same time, again as noted above, there is a need to encourage new intermediaries into the capital markets to support user activity, particularly if dealer liquidity may not be available at the same levels as before.

Competition and consolidation

One consequence of the response of the authorities in Europe and North America to the crisis has been significant consolidation in the sector. For the moment the emphasis needs to be on restoring the health of the system, a process which still has some way to run. But, in the long term it has created more concentration in an already highly concentrated sector. This is the case in respect of both clearing banking operations and capital market activities. Moreover in the UK, the *de facto* government guarantee of the banks is unhealthy in terms of customer service and

choice. Nor is it healthy from the perspective of these institutions having become “too big to fail”, or from the distorting effects on competition of the implicit government guarantee.

Early action will be required by the competition authorities to consider the degree to which competition is impaired within the banks and to take steps to remedy this in the usual way. It is not beyond question that the competition authorities will, or should, require a degree of break-up of existing bank businesses where these have come to dominate too large a share of the market. For regulatory and systemic purposes a form of break-up may also assist other objectives. It would be beneficial if the authorities were to work together.

The structure of financial regulation

A financial crisis has very few benefits; but one (perhaps the only one) must be to test out the regulatory arrangements put in place for the financial services industry. The credit crisis showed that the regulatory structure for banks was not fit for purpose in most parts of the world, including the UK. Regulation will not prevent all problems, but it should act effectively to mitigate them and at times pre-empt them. This did not happen.

Although in principle we support the need for international co-operation, information exchange and the setting of standards by regulators, we also note that there were already extensive arrangements of this kind in place before the credit crisis began. These did not prevent the credit crisis either. In practice, it is the national regulator who will do most of the regulating.

Regulation in the UK has two distinct, and to an extent conflicting, objectives. The first is to ensure stability of the system and concerns financial firms that present balance sheet risk. (It may be noted in passing that firms that do not use their balance sheets for proprietary business, for example agency brokers and investment managers, do not pose systemic risks to any significant degree.) The second is conduct of business regulation, which is largely intended to protect consumers and ensure confidence in the integrity of the system. Market regulation is not attached explicitly to either of the aforementioned objectives although implicitly it should sit with the second objective in terms of purpose and effect. It should be noted that market regulation carries a significant risk of being misapplied if it becomes subordinate to balance sheet regulation.

The two can sometimes be in conflict. For example, to take two instances that arose in the course of the crisis:

- The FSA operates the Official List for publicly quoted companies. When the banks were facing substantial write downs of business lines, little information was provided to the market by virtue of the listing requirements. Meanwhile, during the same period, the regulator had substantial information by virtue of its role as bank regulator. How does the regulator decide that it was appropriate for less information to be made available for the market?
- Many banks securitise assets through a regulated covered bond programme. When a bank is short of capital, the regulator has powers to order the bank to shore up its balance sheet; at the same time, the regulator (the same

authority, but for covered bonds) has powers to order the bank to keep the programme fully capitalised. These two activities are mutually incompatible: how does the regulator decide which should come to the fore?

These issues need to be kept to the fore when considering the future role of the regulator. In our view, when the two are in conflict the requirements of financial stability will almost invariably prevail, for example the recent waiver of competition law in the Lloyds TSB/HBOS merger. But the implications for other public policy objectives need to be weighed carefully. This points to the importance of full co-operation among the authorities.

Conclusion of Section I

The financial crisis has revealed weaknesses in the business models of many banks and in the way they were regulated. A good start has been made with the Banking Act 2009 to reform in the light of that experience, but more is required. The new regulatory architecture needs to adopt as a specific objective a more transparent industry for both regulators and investors. This must involve a much greater appreciation of the distinct roles of "utility" and "commercial" banking and recognition of its implications for the future regulation of the sector.

Section II of the IMA response

Section 3: The role of inadequate capital and liquidity in causing instability

Q1: Are there shortcomings in the international prudential framework not already identified in the DP that are relevant to the analysis?

Q2: 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?

(1 and 2) Section I sets out our views and thoughts on the international prudential framework.

Section 4: Solutions through micro-prudential measures

Q3: Do you agree with the proposals to redefine what counts as capital with a stronger emphasis on going concern loss absorbency?

Q4: 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?

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

Q6: How should the leverage ratio capture (i) off-balance sheet exposures and (ii) derivatives?

Q7: Should the numerator of the leverage ratio be Core Tier 1 capital or should a broader measure of capital be used?

(3 – 7) We are supportive of any attempts to improve the adequacy of banks' capital and to reduce the risk and severity of future periods of financial instability. In particular, we support the recommendation that there is an increase in capital requirements associated with proprietary trading by banks. Inadequate capital and excessive leverage were key factors behind this crisis. We agree that there is a need for careful consideration of both the costs and benefits of any proposals. We consider that this is a fundamental necessity, and must include an analysis of the availability of capital to facilitate the effective functioning of the financial markets in the light of any proposals. Whilst few would argue against an increase in the capital requirements applicable to banks, an increase in minimum capital requirements and any associated increase in the cost of capital will reduce the amount of money circulating in the financial system. This could potentially have adverse consequences for the broader economy.

We also support the intention to reduce the cyclicity of the credit risk related capital requirements. In our opinion, any regime which addresses procyclicality

should provide for a mechanism which increases the size of the capital buffer at all instances when that buffer is not being utilised. This seems to be the only threshold which can be actively monitored and managed by both the firm and the FSA.

We have previously shared our views on some pre-funding of compensation. Given that banks will fail and compensation will be needed, pre-funding will have benefits, not least in that it may help to address procyclicality and might be seen as part of the capital buffer approach.

Section 5: Macro-prudential policy

Q8: 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?

The discussion paper addresses the response to the global banking crisis. Part of that response must be to recognise the variety of firm types that are subject to FSA prudential supervision, and to impose additional requirements where they can be demonstrated through detailed analysis to be necessary.

In this regard, there must be recognition that the activities that a limited licence investment management firm is permitted to undertake do not extend to lending, deposit taking or dealing on own account. Any client money received must be segregated from the assets of the firm. The purpose of prudential regulation in the context of investment management firms is therefore fundamentally different to that relating to banks because:

- systemic risk is considerably less evident than in banking (and often does not exist at all);
- contagion risk is less likely because of the nature of the contracts involved;
- there is no potential for disruption to the payment system;
- with no lender-of-last-resort, there should be no problems of moral hazard;
- funding is primarily long-term whereas banks rely on potentially volatile, unsecured short-term deposits; and
- most assets of non-bank financial institutions are marketable, with little variance between their value on a going-concern basis and that in liquidation.

Consequently, the risks presented by limited licence investment management firms to the statutory objectives of the FSA are significantly different; consumer protection is essentially provided through the segregation of client assets and market confidence is unlikely to be adversely impacted upon the failure of an investment management firm. The risks presented by these firms do not therefore warrant the imposition of the detailed proposals for the banking industry contained within the discussion paper.

To impose such requirements could further incentivise the relocation of the investment management industry away from the UK, resulting in an adverse impact on the broader economy.

For these reasons, we do not consider it appropriate to impose the requirements which are being drafted to realign the banking industry with the risks that it faces upon the investment management industry.

Q9: Do you agree with the FSA's reason for favouring a range of policy measures to deal with macro-prudential policy issues rather than adjusting the Basel II risk-based capital requirements?

We are supportive of those measures which increase the robustness of the banking industry but only if this achieved in a manner which is both proportionate and substantiated by thorough analysis.

Any proposals from the FSA must have regard to the international arena; we do not consider it appropriate to impose requirements which are inconsistent with that in operation internationally if this would reduce the competitiveness of the UK financial system when compared with either other parts of Europe or the US. In addition, the proposals from the FSA must not inhibit the effective functioning of the financial markets, and detailed consideration must be provided to all elements of the markets before any implementation.

Q10: 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?

As major investors in companies whose securities are traded on regulated markets, IMA members are interested in the requirements governing how such companies prepare their accounts and the information disclosed to them as users. Investors increasingly seek to diversify their portfolios and invest not just in UK companies but globally – the annual IMA Asset Management Survey shows that in 2008 over half of UK asset managers' holdings in equities were outside the UK. Thus we support the development of high quality accounting standards that are applied consistently internationally, and which maximise the transparency and comparability of financial reports, and the work of the International Accounting Standards Board (IASB) in this area.

The DP raises the possibility of the FSA introducing mandatory enhanced disclosures for UK banks. The IASB recently introduced changes to International Financial Reporting Standard (IFRS) 7, *Financial Instruments: Disclosures*, to require enhanced disclosures about fair value measurements and liquidity risk which are not yet effective². It is also undertaking a review of IFRS 7 and the controversial International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement*, with an Exposure Draft due to be published in July. We consider these initiatives should be given time to take effect and do not believe that the FSA should act unilaterally in this area. Users invest globally and such a move by the FSA would lead to inconsistencies in financial reports internationally. In addition,

² Effective for annual reporting statements beginning on or after 1st January 2009.

market confidence is not just a UK but an international issue and as noted in our answer to question 9, any proposals from the FSA must have regard to the international arena. In conclusion, we would be very concerned if the FSA expanded its role into the interpretation and application of financial reporting standards and consider this is an area which should remain firmly within the remit of the accounting standard-setters.

That said, as noted in paragraph 221 of the Treasury Select Committee report, the Banking Crisis: reforming corporate governance and pay in the City,³: “the FSA’s piecemeal approach to garnering auditor knowledge about individual banks indicates to us a wasted opportunity to improve the effectiveness of bank supervision. In future, the FSA should make far more use of audit knowledge, on a confidential basis”.

We agree and would welcome the FSA reinstating the “tripartite” meetings between the management of systemically important financial institutions, their auditors and itself. Auditors learn much about individual banks in the course of their audit and are likely to develop an understanding of issues affecting the banking sector as a whole. In addition, in the current illiquid markets, banks frequently mark to model instead of market but the valuation procedures used and assumptions applied can vary from bank to bank and there are inadequate disclosures in the financial accounts. More dialogue between these parties on these issues could help address these points and go some way to help restore market confidence.

Q11: Do you agree with the FSA’s analysis of the implications of accounting standards for procyclicality?

We agree with the analysis in the paper that fair value accounting and the mixed attribute model are somewhat procyclical. Also we agree that the cost less impairment based on incurred losses when there is objective evidence that there is likely to be a reduced cash flow has a similar impact. In this context, we consider the primary audience for accounts is the holders of ordinary shares, as the providers of the risk capital and bearers of the residual risk. Other stakeholders, such as creditors – including purchasers of traded debt - employees, bankers, customers and suppliers, are protected by contractual and other rights that are not shared by shareholders.

Although we recognise that IAS 39 is overly complex and welcome the IASB undertaking a review, investors support the mixed attribute model and the use of fair value, mark to market or mark to model, for financial institutions’ financial assets and liabilities where it is not intended that they are held to maturity in that:

- there is no satisfactory alternative to fair value - historical cost reflects an arbitrary moment in history when the assets were initially recognised and in any event, requires them to be recognised at the lower of cost or net realisable value which, of itself, would have necessitated write downs in the current economic climate;
- market confidence will only be restored when the “bad news” is exposed by marking such assets down to realistic prices – otherwise the markets are likely to apply their own more exaggerated discounts; and

³ <http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/51902.htm>

- requiring all liabilities to be marked to market under the full fair value model would be counterintuitive. Thus a company would downgrade its debt as its credit rating declines and take a credit to profit and loss meaning that it could buy back its own debt at below par so shareholders benefit ignoring that:
 - the debt is not transferable and is normally settled; and
 - it could pay a dividend when defaulting on interest payments.

To address the issue of procyclicality, we consider a distinction needs to be made between the financial reporting requirements of listed companies to the market and the prudential requirements of financial institutions as required by the regulator. It is the role of the regulator to determine capital adequacy requirements from the reported numbers and these should operate to smooth cycles - tighten requirements when conditions appear benign and credit in the system has grown and ease them when the pain has been taken. Otherwise, regulatory requirements which force banks to have "adequate capital" at the trough of the cycle could lead to their being over-capitalised as soon as there is any recovery. Investors, on the other hand, want to know what a company is worth today and value transparency.

Q12: How best should prudential regulators address the problem of procyclicality through counter-cyclical reserves/buffers?

IMA supports the concept of prudential regulators requiring a dynamic or economic cycle reserve to address procyclicality provided it does not detract from the integrity and transparency of financial reports. Accounting requirements should ensure that the performance of the business is reported to the market. They should not be set with the objective of achieving financial stability in that this is the preserve of the regulator.

Such a reserve needs to be transparent to investors but we do not agree that it should be taken through the profit and loss account/income statement or reported as an economic cycle reserve on the balance sheet – two of the suggestions in the DP.

One of the reasons put forward in the Turner Report for taking the provision through the profit and loss account is that "incentive-based pay systems which refer to profit and EPS would then be based on distributable profit and distributable EPS⁴". We consider that if the FSA wants to influence the manner in which remuneration or dividends are calculated, it should not change the financial statements themselves but develop separate requirements. In this context, in the UK, dividends may only be paid out of 'distributable reserves' – which are not the same as 'accounting reserves' and are not disclosed in consolidated accounts. Also, tax in the UK is assessed against taxable profits, which are not the same as accounting profits.

Investors want transparency and neutrality of information to be able to assess the quality of the assets that the entity holds and to be able to look at the performance of the entity and compare it across time and with that of other entities. The suggestions in the DP could impair the investor's ability to do this. However, there should be disclosure of the effects of regulation in a way that that does not distort the numbers (for example, because their basis of calculation is different), say in the notes to the accounts.

⁴ Page 67

We do consider, however, that in its review of IAS 39, the IASB should look at the relative merits of the incurred and expected loss approaches to impairment and whether there is a case for changing the basis of numbers reported. As for our answer to question 10, this should remain firmly within the remit of the accounting standard-setters.

Q13: Do you agree that serious consideration needs to be given to establishing some form of global supervisory architecture for international audit firms?

Some years ago, the large audit firms underwent a series of mergers resulting in the Big Five, and due to the loss of Andersons, the Big Four today. We understand that one of the key reasons for these mergers was that they were a response to the increasing globalisation of companies and sought to minimise the risks and costs of using firms from one network to audit a large multinational company.

Despite these mergers, the audit market still appears to be fragmented in that there are different regulations and qualification requirements in different countries. We consider it would be helpful if this was addressed and agree with the DP that "serious consideration should be given to establish some form of global supervisory architecture". That said, it is important to maintain high quality standards and to guard against a reduction in those standards and a "rush to the bottom" in the interests of harmonisation.

Q14: What macro-prudential policy tools should be considered other than those mentioned in this DP?

IMA has not identified any other macro-prudential policy tools apart from those set out in this response. However, we consider that there needs to be scope for further discretionary interventions should the need arise in the future.

Q15: What are your views on the effectiveness of a core-funding ratio as a measure to contain excessive asset growth?

Q16: What types of institutions should be exempt from such a core funding ratio? How would any exemptions limit the effectiveness of the measure?

(15 and 16) A core funding ratio will directly correlate asset growth to the ability of a firm to secure core funding. The more successful a firm is at securing core funding, the more scope the firm will have to grow assets in an aggressive manner. If the aim is to reduce the risk of incremental asset growth being achieved through funding of deteriorating quality, this proposal will certainly limit the usage of lower quality capital.

However, any question of to whom this may apply must give sufficient consideration to the varying nature of the funding profile of the variety of firms subject to the FSA's prudential regime. There must be recognition that the core funding of institutions will and does differ. Not all financial institutions are permitted to accept

deposits; therefore any definition of core funding that places reliance upon retail deposits will severely limit the ability of a large volume of firms to be compliant with that requirement.

The discussion paper recognises that the proposed core funding ratio could require significant structural changes for many institutions and could make many institutions unviable.

The proposed core funding regime should apply only to those institutions that acquire funding through assets that are deemed to be of deteriorating quality, or where the quality is reduced through the use of swaps. To relate the core funding ratio to the underlying instruments will ensure that the aim of the regime is achieved, i.e. that there is a restriction on the issuance of (and therefore the reliance placed upon) lower quality assets.

Q17: 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?

Supervisory convergence is unlikely to be achieved if only one jurisdiction requires additional disclosure. The amendment of the disclosure obligations would need to be coordinated across national boundaries, and should therefore be considered as part of any amendments to Basel II.

If the aim is supervisory convergence, this could be achieved through more – and better aligned – communications between supervisory authorities. Supervisory authorities could ensure like-for-like comparison; there would be no need for any interpretation as there would be if supervisors relied upon the public disclosure of firms. In addition, under Pillar 3 there is an ability for firms to not disclose where the data is considered to be either confidential or proprietary. Direct and non-public communication between supervisory authorities would bypass this ability and achieve supervisory convergence.

The discussion paper identifies that disclosure did not prevent the current crisis, albeit that the Pillar 3 regime was only recently established. It would therefore be prudent to conduct additional analysis of the impact of the disclosure of Pillar 2 information and its usage by firms and supervisors before any regulatory amendments are implemented.

Section 6: Scope of regulation

Q18: Are there other considerations that are relevant to the assessment of the issues and risks posed by the boundary question?

Q19: 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?

(18 and 19) Since the discussion paper was published, the proposal for an Alternative Investment Fund Manager Directive has been published by the European Commission. We shall naturally engage with HMT, the Commission and yourselves, on this issue.

Q20: 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?

No comment.

Section 7: Systemically important firms

Q21: 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?

Q22: 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?

Our response in Section I describes our approach to the "too big to fail" and to what factors FSA's focus should be applied.

Section 8: Groups and intra-group exposures

Q23: Are there other aspects of group structures that the FSA should be taking into account?

Q24: 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?

(23 and 24) Our response in Section I provides any comments on these questions.

Section 9: Responding to events – international architecture

Q25: 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 recognise the need for adequate macro-prudential supervision and effective early warning mechanisms. Therefore, we welcome the creation of a European Systemic Risk Council and we share the de Larosière Group's view that "*to be effective macro-prudential supervision must encompass all sectors of finance and not be confined to banks, as well as the wider macro-economic context.*" We also welcome the G20 conclusion to reinforce the role of the Financial Stability Forum as it becomes the

Financial Stability Board. A good coordination between the two bodies will be essential as the stability issues do not recognise continental borders.

We want to stress that in gathering the data needed by the new body, a duplication of reporting requirements, i.e. that the same information has to be provided to various bodies in various formats, must be avoided, and that existing information sources should be exploited fully before imposing new requirements. The efficiency and success of the ESRC will depend on the information flow between the ESRC and the micro-prudential, i.e. the future European Authorities and national supervisors. Asset managers should not be required to report the same information to various authorities, instead authorities should agree to exchange this information amongst them. This implies that reporting requirements should be streamlined both in terms of format and content, while being proportionate and tailored to the specific characteristics of the entities required to report. Indeed, the reporting requirements should not place an unreasonable burden upon market participants in terms of costs and efforts, and an obligation to report each and every transaction should be avoided.

Finally, we believe that a proper and permanent representation of the asset management industry must be ensured in a future "European Systemic Risk Council". We welcome Recommendation 16 of the de Larosière report stating that "high-level alternates to the central bank Governors should take part in the discussions, in particular when insurance or securities markets issues are discussed". However, we are concerned that the permission of the high-level alternates to take part only in specific discussions (and not on an ongoing basis) will not sufficiently take into account the importance and needs of the asset management industry as the buy-side in financial markets. We see the risk that macro-prudential supervision will be exercised from a purely banking perspective, which should be avoided.

Q26: Is this the most effective way of organising colleges on the one hand and crisis management groups on the other?

No comment.

Q27: Do these options represent the right approach to the problems posed by EEA branching?

The UK is a global financial services hub, which takes by far the greatest benefits of passporting rights in the Single European Market on financial services. In this context home country control, and thereby limiting the powers of host Member States, has for many years been a clear aim for the UK in areas similar to investment management. Extensive host Member State powers risk diminishes the benefits of a Single Market, if national regulators have the freedom to burden foreign service providers with requirements which are not defined or harmonised in European legislation. The UK should therefore be very careful when suggesting any changes to the passporting regimes. The single case of Icelandic banks, despite its severity, should not lead to an overreaction by UK authorities regarding EU passporting rights, throwing the baby out with the bathwater.

Q28: 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?

IMA's members provide asset management services, distribute investment funds and act as investors in the securities markets of all the 27 EU Member States. A harmonised regulatory and supervisory framework is therefore of crucial interest to us. *It is very expensive and inefficient to operate under 27 different sets of rules/differing interpretations of the EU rules.* So far in many areas of financial markets regulation and especially supervision national differences remain strong beneath a thin layer of European harmonisation.

There has also been unwelcome gold-plating of the EU rules, with national regulators adding requirements on top of the EU requirements as they see fit. There are a lot of examples on this, for instance in the area of the MiFID and UCITS Directives. The simplified prospectus for UCITS funds is a good example where the benign intentions of European legislators to achieve a short, harmonised document to be used across Europe failed completely because of the diverse implementation and gold-plating by national regulators. This necessitated a review of these requirements in the UCITS IV package and again expectations are high that Europe gets it right this time, but only national implementation will tell whether the aims will be achieved this time around.

The 3L3 Committees (CEBS, CEIOPS and CESR) have reached their limits, not only in terms of resources, but also legal powers. Therefore, we strongly support the strengthening of the 3L3 Committees and transforming them into European Authorities (European Banking Authority, European Insurance Authority and European Securities Authority) as suggested in the de Larosière Group's report, with real powers, while leaving day-to-day supervision to national supervisors, thus making full use of their local knowledge. This will help to reduce significantly the huge compliance costs faced by IMA members who operate on a cross-border basis in the securities markets of all 27 EU Member States.

In particular, we welcome the proposal that the future authorities should be able to adopt binding technical level 3 interpretation and supervisory standards. This will help to prevent Member States and national regulators from gold-plating of EU rules. In this context, we stress the need for timely interpretation of EU rules, meaning that for each project, deadlines should be fixed by which binding technical level 3 interpretation and supervisory standards have to be issued in order to ensure coherent interpretation across Europe, legal certainty and a smooth functioning of the internal market.

We strongly support the European Commission's proposed actions to introduce a more consistent set of supervisory rules. We also support the proposed overall supervisory structure, establishing a European System of Financial Supervision, with national supervisors still responsible for the day-to-day supervision but with a strengthened coordination at the European Level. Local knowledge is needed to apply the rules to the supervised entities, but more and more the aim should be one set of rules so strong coordination of the supervisors at European level is needed. We support the strengthening of the 3L3 Committees and transforming them into European Authorities with real powers. Our members need certainty of the rules applicable.

Section 10 Markets Issues

Remuneration

We have responded separately on this issue to the FSA. We would point out that we have also had to respond to the European Commission and to IOSCO. Given the attention this subject was paid at the G20, it was likely that this would occur. Given the Commission's involvement in this issue now, it would help if FSA fell in behind in relation to investment firms. The FSA has a proper role in assisting HMT in negotiations at the Commission, and obtaining intelligence from firms as to impacts and feasibility of any Commission proposals (no doubt responses to the DP can be converted to this use). It would be unfortunate and costly if the UK introduced changes just ahead of and different from any pan-EEA approach.

Credit rating agencies

Q29: Does the DP highlight the correct issues concerning the role of CRAs and the use of their ratings?

The IMA believes that the DP correctly and comprehensively describes the role which credit ratings play in the financial system. In addition the DP usefully points up the failings of the agencies with respect to their ratings' methodologies of structured financial products and the conflicts of interest that affected the integrity of those ratings.

It may however be useful for the FSA to underline the fact that a credit rating merely describes the probability of default and the potential loss in the event of default; it does not describe other characteristics of the instrument such as valuation or performance. The IMA also has reservations regarding differentiated ratings for structured finance products. To add differentiated ratings might confuse investors and lead them to believe that the rating process for structured products is addressing those different issues. The IMA doubts whether having a differentiated ratings category would incentivise investors to conduct extra due diligence on the instrument.

Q30: Are the approaches outlined to address these issues appropriate and proportionate?

The IMA had in the past not supported regulation of CRAs for the reason that it would serve only to enhance the reputation of their ratings, rather than diminish them, by giving the CRAs a sort of "regulatory approved" status. We have instead supported self-regulation and adherence by CRAs to the IOSCO Code of Conduct introduced in December 2004⁵ as well as endorsing the proposed amendments to the Code consulted on in March 2008.⁶ Indeed, IMA members believe that this self-regulatory regime has led to an improvement in transparency in the corporate bond market.

⁵IOSCO Code of Conduct Fundamentals for Credit Rating Agencies, December 2004.

⁶IOSCO Consultation Report on The Role of Credit Rating Agencies in Structured Finance Markets, March 2008.

The events of the recent past in credit markets, however, have exposed weaknesses in this self-regulatory regime, specifically in the repeat business of structured finance. The IMA therefore supported the European Commission's proposal for the regulation of credit rating agencies' conduct of business, while cautioning against public disclosure of processes and methodologies. The more the CRAs have to explain their practices, the more issuers will model to meet those practices and standards.

Last year the IMA provided significant input into a cross-industry group looking at over-reliance on certain credit ratings. We were determined to ensure that some clear principles on the use of ratings for structured finance were prepared to respond to the Financial Stability Forum's call on trade associations. The IMA is pleased that it appears that the FSA has recognised the EFAMA/ESF/IMA Asset Management Industry Guidelines in Addressing Over-reliance upon Ratings⁷ as a useful document to aid institutional investors to establish processes and procedures when meeting their due diligence responsibilities for certain products.

Q31: What options should a review of the use of structured finance ratings in the regulatory framework consider?

No comment beyond noting that we supported the Commission's proposal to review where regulation required or promoted the use of credit ratings. We favoured an approach that sought to remove any reference unless a good case is made and associated risks (of over-reliance and behavioural changes for example) are mitigated to the extent possible.

Market regulation

Q32: Is this the most appropriate framework for post-trade transparency or are there other aspects we should be considering?

Up to a point, as regards transparency. But the approach set out at 10.54 and 10.55 has a significant flaw embedded within it. Subject to taking account of that flaw – which would significantly affect the work proposed - the measures set out are reasonable.

The flaw is that the focus on existing market structures will almost certainly tend to produce a static result. The review states: "*Intervention by regulators explicitly designed to alter market structure needs to be taken with great caution.....the FSA believes that regulatory intervention should focus on addressing risks, and not impose a specific market structure*". We agree with these statements in principle, but point out that there is a big difference between "imposing" a market structure and encouraging market participants to offer a wider range of trading options, with better specified settlement options. (It is also, arguably, inconsistent in that taking action on transparency will of course have the affect of altering market behaviour and therefore market structure, in some form.)

FSA will be aware that dealer liquidity has been impaired during the credit crisis. Designing a post-trade transparency regime that is appropriate for a dealer market

⁷ <http://www.investmentuk.org/news/research/2008/topic/european/imajointguidance111208.pdf>

will do little to encourage development of the market towards a wider array of trading, clearing and settlement options outside the concentrated dealer model. *This – the encouragement of less fragile market structures - is something that FSA should actively undertake for all markets within its remit.* This objective, which we believe is consistent with the FSA's market confidence objective in FSMA, goes much broader than the focus in the Turner Review on transparency. But by focusing on transparency the FSA appears not to be addressing other important elements of market operations. We would urge FSA to re-consider, and potentially broaden, its strategy in this area. We would expect to be included in future work by FSA.

Q33: Are there other measures which the FSA should be considering or promoting in international fora?

Yes.

- (i) FSA should be promoting the interests of investors in having a **consolidated tape** in the EEA securities markets. We do not propose a mandatory centralised tape, but the data being published needs to meet certain criteria to allow commercial entities to consolidate, manipulate and enrich the data that feeds trading decisions, valuations and performance assessments. This has been a consistent theme of discussion between the IMA and the FSA since 2007, was confirmed in IMA's review of Best Execution issued in 2008 and has been the subject of many industry speeches and statements. Post-trade equity data should meet seven criteria, it should be: reliable, comprehensive, comparable, discoverable, low latency, efficient and distributable. Current data are patently not meeting these. We consider risk regulators ought to be concerned that data on which clearing and risk management decisions are made are not as reliable as they could be, quite apart from the investor interest in this issue.
- (ii) there should be work on introducing a (XBRL) database of the terms of issued bonds, structured and securitised products akin to **EDGAR** for the EEA. The FSA should promote this as benefiting investors, improving confidence and facilitating the role of those involved with financial stability.

Q34: What other considerations should the FSA take into account with respect to OTC derivatives infrastructure?

The aspirations of the US with regard to both trading and clearing OTC derivatives, and in particular CDS, should be seen as a minimum framework for the EEA.

Investors have identified the following basic requirements that they would seek to have taken into account in the design of central clearing for OTC derivatives.

- Default protection should be available to investors as well as to the intermediary that is the counterparty to the contract with the investor;
- Intermediaries should be required to offer investors a choice as to how their contracts are dealt with for clearing purposes (where choice

is available), and be required to provide comprehensive information about the risk management impact and cost of the available options;

- Investors should not be expected to bear the cost of central clearing unless they gain explicit benefit, namely default protection; and the cost of obtaining default protection should be proportionate.

Additional factors that are relevant for investors include:

- a. The ability for investors to require that their monies and assets should be segregated from those of the counterparty (this may be achieved in different ways in different jurisdictions);
- b. The possibility of an option to allow investor assets that are segregated to be held, in addition, outside any general rights of netting or set-off that may have been agreed in terms executed with the counterparty in relation to other trades (this would almost certainly have to be achieved through clearing house rules relating to default arrangements);
- c. The option to segregate as described in paragraph b would be distinct from a general segregated account (as currently most usually operated). This form of super-segregation would in effect prevent the counterparty from taking account of segregated monies and assets when calculating its margining/collateral exposure to the clearing house, for example by netting off against other accounts held with the clearing house. It would permit investors that provide margin or collateral on a gross basis to keep this intact in the clearing system;
- d. That each contract entered into between the counterparty and the investor that is centrally cleared should get default protection by means of a "look through" from the investor contract all the way through to the clearing house; this is likely to require terms of business to be embedded in the trade contract (as a requirement on clearing members through clearing house rules) that acknowledge that the investor/counterparty contract is, once taken on by the clearing house, fully back-to-back with the counterparty/clearing house contract and therefore fully taken into the clearing house default arrangements.

Q35: Are any (other) changes to clearing arrangements needed? If so, what should they be?

The UK cash equity markets operate on the basis whereby the main market makers, regardless of the nature of the trade agreed with the client, in practice assert that the client-facing and market-facing trades are both principal trades and are legally and for all practical purposes therefore unconnected. This appears to be the basis on which the biggest broker/dealers operate their exchange-based business through the use of non-segregated accounts at the central clearing house; but with the result that there is no recognition within the central clearing system of the client based trading that is taking place. This model dominates the UK cash equity markets, thus leaving investors that trade in size with few other avenues to explore for improving the clearing of their trades. Whilst there are tangible benefits to the market makers, there are few if any benefits to the investor when it comes to clearing and default arrangements.

An extremely important lesson from the UK Lehman default, therefore, is that market structures that permit the separation of client- and market-facing trades are inherently fragile. This is both in terms of counterparty risk management and default, and in running a high risk of unfettered conflicts to develop within the market making activity.

Q36: Are any changes to settlement arrangements needed? If so, what should they be?

We have written at length to the FSA on the subjects of Qs 35 and 36. We shall respond to the HMT paper on the investment bank insolvency issues. We continue to disagree with FSA's assertion that the Lehman's default proceeded as expected and that certainty was obtained in weeks, and support the work by HMT to address these issues. We had raised with you and the Tripartite authorities long before the Lehman collapse our concerns over the operation of a default in the OTC markets. As an example, our response on 23 April 2008 to the Tripartite paper in relation to financial stability and depositor protection stated:

"For the IMA one of the potentially most complex issues in the paper is within the last sentence of 4.16 [Any SRR tool will need to make provisions to deal with banks' other activities in addition to their principal banking business]. It must not be forgotten that provisions under Part VII of the Companies Act 1989 alter contractual rights and a variety of self-help and other remedies.

"Policy needs to distinguish between situations that practically can be (broadly) compensated by monetary payment after the fact and those which cannot. In the latter, we would place the role of some banks in clearing and settlement activities ancillary to an exchange, that is to say situations where disruption of operation cannot be adequately compensated after the fact.

"In our view this brings into stark relief comments we have made before about the existing default arrangements in the OTC space. The proliferation of trading outside the default rules of organised exchanges and clearing houses, gives rise to serious questions about the existing regimes. As we have posed before – what was the counterfactual to Northern Rock's "nationalisation"? Had Northern Rock or a settlement bank gone into administration on a creditor application, or a winding-up petition been presented, would the existing regime of property rights and contractual arrangements operate to reduce or increase damage to financial stability? We are unconvinced that the existing regime could cope in the absence of an SRR (unless Government supports every potential failure so rendering the issues around default clauses and cross-border insolvency moot). This issue should be addressed."

We also raised this with FSA staff directly. We have more recently raised contingency planning were a custodian to fail and, separately, the need to address the risks introduced by interoperability in clearing systems more comprehensively than just the legislative changes to Part VII made by SI 2009/0853. We would welcome a dialogue with FSA on these.

We are disappointed the FSA has apparently failed to see as viable an option at 10.75 that IMA was keen to have considered, particularly as it would have provided benefit and choice to investors. We shall pursue with HMT our suggestion that there

should be an explicit requirement that investment banks (indeed any brokers) should offer facilities to segregate client business. Requiring clearing houses to have an offering when the intermediary is not obliged to allow that option to be taken up will not solve the problem.

Other

Although the discussion paper does not ask if there are other market regulation issues that the FSA ought to be considering, we would welcome a clear statement of the FSA's position on the use of its **suspension powers under section 313 A-D FSMA** in relation to securities admitted to trading on a regulated market. We have raised this at TACC.

The policy work by the FSA at the introduction of MiFID left open how the FSA would operate its powers in this area and how the operation of those powers would relate to any steps taken by a regulated market itself, including in comparison to the MAD powers. We think this matter should be addressed at CESR. Although the FSA may consider that suspension will usually be left to the regulated market, the assumption that will be the London stock exchange may not be correct. For example NYSE Euronext may suspend a share that is also traded on the London Stock Exchange. The impact of such a suspension would appear to depend upon whether that share was traded on the regulated market of NYSE Euronext or whether it was on an MTF operated by that regulated market. It could be, however, that any halt to trading would need to be imposed in the UK on, for example, Turquoise due to a statement by NYSE Euronext. The published statements of the FSA's policies are very unclear as to how it would operate if this occurred and when it would consider it was in investors' interests for there to be no halt to trading.

Section 13: Implications for other regulated sectors

Q37: Which of the issues set out for discussion in this DP are most relevant to other regulated sectors?

Sections 9 and 10 apply widely.

Q38: Are there any lessons which have been learned in other sectors which could be applied to banking?

Markets change their behaviour in response to regulatory requirements. So a rule designed to require compliance with a new obligation when an activity is carried out may well just cause everyone to change the activity, even if not immediately. In designing new regulatory systems one should never underestimate the capacity of markets to innovate their way round them, particularly when the immediate stress is removed.