FSA Annual International Seminar 2012

Banking Breakout Session

Thursday 29 November

Overview of Retail Banking Regulatory Issues

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Banking Sector, Conduct Business Unit

Overview

UK banks continue to operate in a challenging environment with on-going structural headwinds not least arising from the volume of legacy issues (e.g. Payment Protection Insurance - PPI) and fines (e.g. LIBOR).

While funding is less constrained now due to banks accessing the Funding for Lending Scheme, key challenges include :

- a low interest rate environment (increasingly reflected in squeezed Net Interest Margins)
- regulatory limits to the reduction of liquid assets
- Sensitivity of lending growth and asset quality assumptions to economic prospects for the UK and in the Eurozone

Overview

Further regulatory challenge exists in the form of implementing Retail Distribution Review (RDR), Mortgage Market Review (MMR) and the ring-fencing recommendations of the Independent Commission on Banking (ICB).

Banks are also looking to significantly cut costs which will have an impact on the resilience of their IT systems.

Overview

The combination of these factors means the on-going potential for conduct risks and for serious customer detriment remains high.

Characteristics Of UK Market I

- Retail banks have a large and stable current account customer base. Dominated by top 5 banks which hitherto have had a very stable market share.

- Extensive branch networks (“footprint”) with high footfall, originally developed to support their core banking business, give major banks excellent face-to-face opportunity to cross sell.

- Stable mortgage market shares across the main players – dominated by Lloyds Banking Group with 27%. But mutual mortgage and savings institutions (Building Societies) challenge the plcs in these core areas (and on saving accounts).

- Unlike Europe, no co-operative banking system (Co-operative Bank in the UK is not a co-operative bank in sense understood in Europe; rather it is part of a co-operative wholesale organisation).

Characteristics Of UK Market II

- "Free" if in credit banking – but charges for overdrafts, loans, etc.
- Packaged accounts (i.e. a set fee and a package of add-ons) may be of limited value to customer.
- Mortgage market – problems *inter alia* in terms of inability to re-mortgage and inadequacy of re-payment vehicles (for "Interest only" mortgages).
- Problem of "zombie" household / corporates (i.e. servicing debt interest - or dependent on forbearance - but unable to repay capital)
- Major policy debate – "how do we get banks to lend more to SMEs".

Warning ! Elephant In The Room !

- Government owns 43% of Lloyds Banking Group and 84% of RBS.
- UK Asset Resolution : 100% Government-owned businesses of Bradford & Bingley plc (B&B) and Northern Rock (Asset Management) plc (NRAM). Organisation supports around 655,000 customers with £72.2 billion of loans, with some 2,500 staff based at its main sites in West Yorkshire and the North East.
- Northern Rock ("Good Bank") sold to Virgin Money.

Retail And Regulation I

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- 2013 sees the consolidation of regulation under the Bank of England from the Financial Services Authority via the new Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).

- The Financial Policy Committee (FPC) within the Bank of England, which will have responsibility for macro-prudential regulation, will also assume its responsibilities next year.

- Financial Services Bill 2012 progressing through Parliamentary process – expected cutover date is 1 April 2013.

Against this background - and as the UK banking sector moves on from crisis resolution to rebuild - conduct issues will be pushed further up the agenda of management boards !

Retail And Regulation II

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- The Bank of England's Funding for Lending Scheme (FLS) launched in August 2012 promises cost-effective funding with some incentives for lenders to expand their domestic non-financial loan portfolios.

- FSA's agreement that up to 20% of Liquid Asset Buffer requirements can be met by pre-positioned collateral at the BoE should free up collateral for the three big domestics.

- Pressure on banks to meet Basel 3 capital ratios on a fully implemented basis by end 2013 and an uncertain economic environment mean banks are likely to carefully consider any meaningful change in their balance sheet plans.

Current Accounts - “All Change Please”

- Individuals more likely to divorce than change current account provider ! *Or so it is said …*
- *…true or not* - fact is that market shares of current accounts remain very stable. However this may change …

+ a new current account redirection service will be implemented by September 2013;
+ disillusionment with long established bigger players;
+ competition from Supermarket banks and new entrants (e.g. Metro Bank); and,
+ divestment of branches by Lloyds and RBS may create new opportunities for existing or new players.

Retail Banks – Other Issues

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- Non-bank competition – “peer to peer” lenders like Zopa / Funding Circle plus NS&I (National Saving & Investment).
- IT infrastructure – are they “fit for purpose” (recent “outage” at RBS Group and “denial of service” attack at HSBC).
- Security - challenge of ensuring confidence in IT and mobile banking.
- More general challenge of fraud and anti-money laundering processes.
- Customer engagement & education.

“ Know What Grinds My Gears ? ”

“Stop trying to sell me stuff, I just want to make a transaction !”

“You’re charging me how much ?”

“I want to speak to a person not a machine !”

“I definitely didn’t buy that on my credit card !”

“How come my deposit rate’s so darned low and my mortgage rate’s so darned high ?”

“Terms and conditions ? My brain hurts !”

Banks – can’t live with ’em …

The Word On The (Main) Street

UK bank consumer less tolerant of poor service and are becoming more vocal about poor service and inappropriate product, and there are more outlets for their frustration !

Challenge – sort the *intelligence* from the *white noise*.

- **Market Intelligence**
- **Twitter / Social Media**
- **Engagement with consumer bodies and trade bodies**

But key issue is to *look ahead* and *anticipate*.

Credit Unions – Key Issues / Risks

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The FSA currently supervises 625 credit unions, including 176 in Northern Ireland (which became FSA-regulated on 31 March 2012). These have between them a membership of 1.1 million and assets close to £7.3bn. The government is encourging a push by the sector to see credit unions membership double.

Credit Unions are largely run by unpaid volunteers, providing services to people who may have had no dealings with the commercial banking sector.

Credit Unions that undertake regulated mortgage or insurance mediation activity need to apply specifically for those permissions. Currently 40 Credit Unions have General Insurance permissions and 6 have mortgage lending permissions.

Payment Institutions & E-Money Issuers

The FSA currently supervise around 200 Authorised Payment Institutions (APIs, with further applications being processed by ACRD) and close to 1,000 small (i.e. registered) payment institutions (SPIs, again with more in the pipeline for authorisation).

The Electronic Money Regulations (EMRs) came into force on 1 May 2011 and we currently supervise 29 Authorised E-money Institutions (EMIs) and 3 Registered or Small E-Money Institutions. There are likely to be a number of larger firms coming into this sector. Recent example, O2, which received authorisation in the UK in November having previously "passported" in from Gibraltar.

So …

... What are we doing ?

FCA Approach Will Emphasize Five Main Elements

- be more forward-looking in assessment of potential problems – looking at how we can tackle issues before they start to go wrong (helped by new intervention powers);
- intervene earlier when we see problems (looking at these through eyes of consumers) before they cause harm, in order to ensure consumers get a better deal and markets are fair and orderly;
- we will want to tackle underlying causes of problems that we see, not just the symptoms, as this will be more effective and efficient in the longer term for consumers and firms;
- secure redress for consumers if failures do occur; and
- take meaningful action against firms that fail to meet our standards through levels of fines that have a deterrent effect.

The Objectives

- Promoting effective competition in the interests of consumers.
- Securing an appropriate degree of protection for consumers.
- Protecting and enhancing the integrity of the UK financial system.

Competition : A New Objective

Competition is defined as the process of rivalry between firms leading to good consumer outcomes.

FSA will deal with the weakness in competition through :

‘Competition Objective’ - identifying and tackling the issues caused by lack of competition; and,

‘Competition Duty’ - thinking about competition and how it could affect the retail banking industry.

FCA to embrace this new objective.

Supervisors to make bold interventions to tackle weakness in competition

Competition to be integrated in the supervisory model and the supervisors to take this into account

Competition to be a part of the risk framework

Thank you …

FSA®

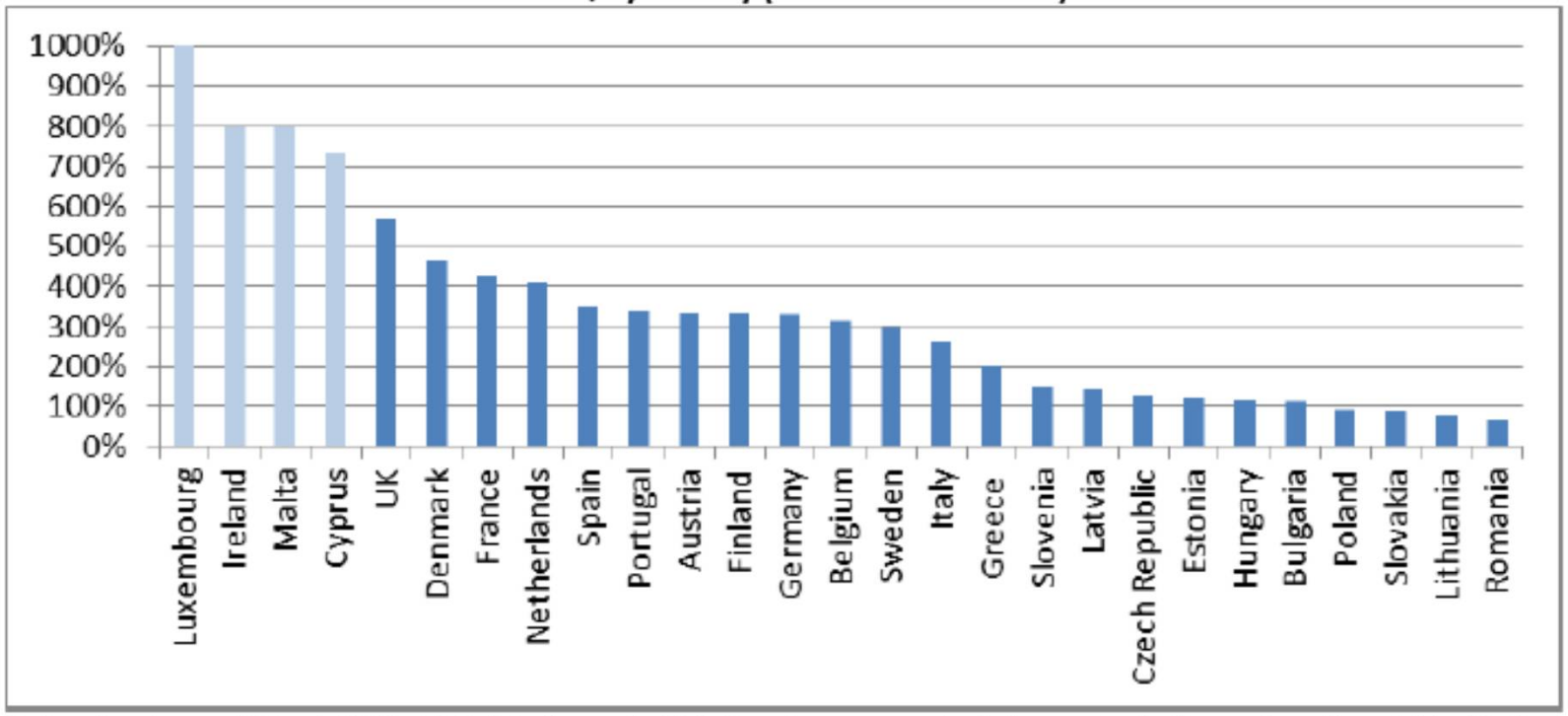
... Any questions ?

Structural reform in the UK (and beyond)

Diego Escanero, Banking Policy Department

Is the system overleveraged?

Chart 2.3.3: **Total assets of MFIs in the EU, by country (in % of national GDP)**



Notes: Assets as of March 2012, GDP data for end 2011. Based on aggregate balance sheet of monetary financial institutions (MFIs). Vertical axis cut at 1000% (ratio for Luxembourg is 2400%). Data on MFI includes money market funds.
Source: ECB data. Eurostat for GDP data.

Volcker/Vickers/Liikanen

Companies concerned		
The Volcker Rule (United States)	**Ring-fence bank (ICB, United Kingdom)**	**Liikanen Report (European Union)**
All US institutions that receive support from the public (deposits guarantee from the FDIC, access to the Federal Reserve's liquidity) and their holding entities (banks/savings-and loans /financial holding companies); foreign banks or holdings (BHCs) which have a US branch or subsidiary; all subsidiaries (at least 25% of common stock) of the above institutions regardless of their location.	All banks, bank holdings and subsidiaries of foreign groups which supply mandated services: deposits from households and businesses.	Banks for which the assets held for trading and available for sale represent between 15% and 25% of their total assets or exceed €100 billion and for which the supervisors determine, based on thresholds calculated by the EC, the obligation to separate these activities within the same banking group.
Prohibited activities / Activities to be separated		
Volcker Rule (United States)	**Ring-fence bank (ICB, United Kingdom)**	**Rapport Liikanen (Union européenne)**
Own account trading Committing as principal (i.e., for the bank's trading account) in any buy or sell transaction for any security, derivative, futures and forwards, or puts and calls on such securities, derivatives or contracts. The rule defines the trading account as the account used to acquire or take positions on securities and financial instruments for the purpose of selling them or liquidating them in the short term in order profit from their price fluctuation. **Investment fund** The acquisition or custody of shares, or partnership or any other equity interest or sponsoring in a hedge fund or a private equity fund. Sponsoring includes the functions below: - being a general partner, executive member or custodian; - choosing or controlling a majority of directors, custodians or executives of the fund; -sharing with the fund the same name or a similar name for promotional or commercial purposes or having the same corporate purpose.	All services outside the European Union and all services to financial institutions, except the collection of deposits and payment services. Regardless of the customer, all services involving activities of the following types : • structuring, arranging or executing transactions on derivatives as an agent or principal. • investment in equities, corporate debt securities convertible /exchangeable debt securities, convertible bonds, equity interests, mutual funds, publicly-traded etc. • origination, exchange, loans or market-making role for securities (including debt securities, equities, derivatives or endorsed bonds). However, the ring-fenced bank can originate and hold its own securities. • underwriting the sale of securities (debt or equities), including private placements.	The activities to be separated include own account trading (proprietary trading on securities and derivatives) and other high-risk market activities (closely linked to securities and derivatives). Market-making activities must also be separated from deposit banking.

Continued on next page……

Type of separation		
Banks or groups subject to this rule cannot hold subsidiaries engaged in the banned activities even if they are capitalized separately or if they are independent.	The government suggests limiting the possibility for a ring-fenced bank to hold subsidiaries. A ring-fenced bank can neither own nor hold stakes in the capital of a bank that is not ring-fenced within the same banking group.	The savings bank and the trading entity can operate in the same banking group (holding).
Exemptions and authorized activities		
Volcker Rule (United States)	**Ring-fence bank (ICB, United Kingdom)**	**Liikanen report (European Union)**
Own account trading 1/ Transactions involving eligible securities (Treasury, agency bonds, bonds issued by Fannie Mae, Freddie Mac, Federal Home Loan Banks, Ginnie Mae, Farmer Mac, or a Farm Credit Bank, sovereign bonds or municipality bonds); 2/ transactions related to underwriting or market-making activities at the request of a customer or a counterparty; 3/ hedging transactions; 4/ transactions as an agent for customers; 5/ investments in small businesses, welfare investments and other qualified projects; 6/ transactions for a regulated insurance corporation for its general insurance account; 7/ transactions connected to the securitization or sale of loans; 8/ proprietary trading activities conducted by non-US subsidiaries or branches of non-US banks or financial holdings. **Investment fund** a/ The same exemptions (from 1 to 8) apply for investment funds. However, with respect to point (8). A fund in which a non-US affiliate of a non-US bank invests cannot be offered or sold to a US resident. b/ Funds organized and offered as a component of a fiduciary, trust, investment consulting operation and subject to additional conditions including the prohibition including the limited participation of the customers of these services alone; the holding or investment in a fund is capped at 3% of the Tier one capital of banks; no hedged transaction or extension of guarantee between the bank and the fund and disclosure of information; no holding by the bank's staff or fund directors; no similar name.	The following are exempted from ring-fencing: small banks (less than £25 billion of deposits) and mortgage companies; private banking Ring-fenced banks are allowed to conduct financial activities other than the authorized activities provided they are strictly necessary for their cash management activities, i.e., risk management (purchase of derivatives from non ring-fenced banks in order to hedge interest rate risk, liquidity management (purchase of liquid assets, transactions on the interbank market), financing (loans, deposits other than those of individuals and SMEs, market financing).	Authorized activities include but are not limited to, loans to companies regardless of their size, their commercial financing, real estate loans, consumer loans, interbank lending, participation in club deals, plain vanilla securitization operations, for funding requirements, private banking and asset management, exposure to regulated monetary funds. Deposit banks are also allowed to use derivatives for own assets and for purposes of managing commitments as well as the selling and buying of assets to manage assets in the liquidities portfolio. Providing hedging services (options, swap) to non-banking customers and underwriting securities should not be separated.

Banking Reform Bill: The new PRA continuity objective

New continuity statutory objective – protect the continuity of services provided in carrying on deposit-taking.

PRA must, so far as reasonably possible, act in a way:

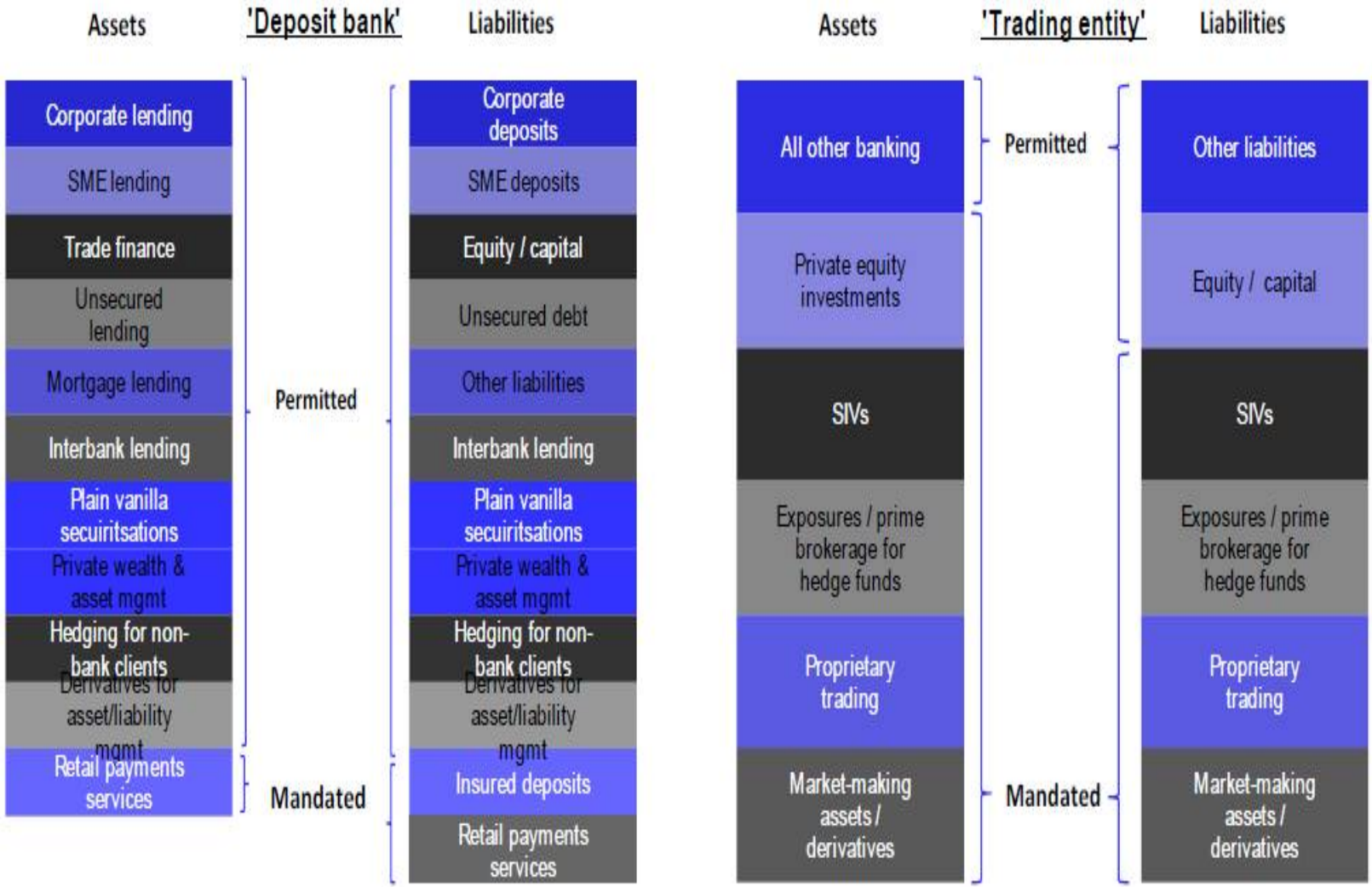
- **which is compatible with continuity objective (CO); and**
- **which the PRA considers most appropriate for advancing its general objective (GO) or its continuity objective.**

So the PRA should act in a way which does 'no harm' to the continuity of deposit-taking in the UK.

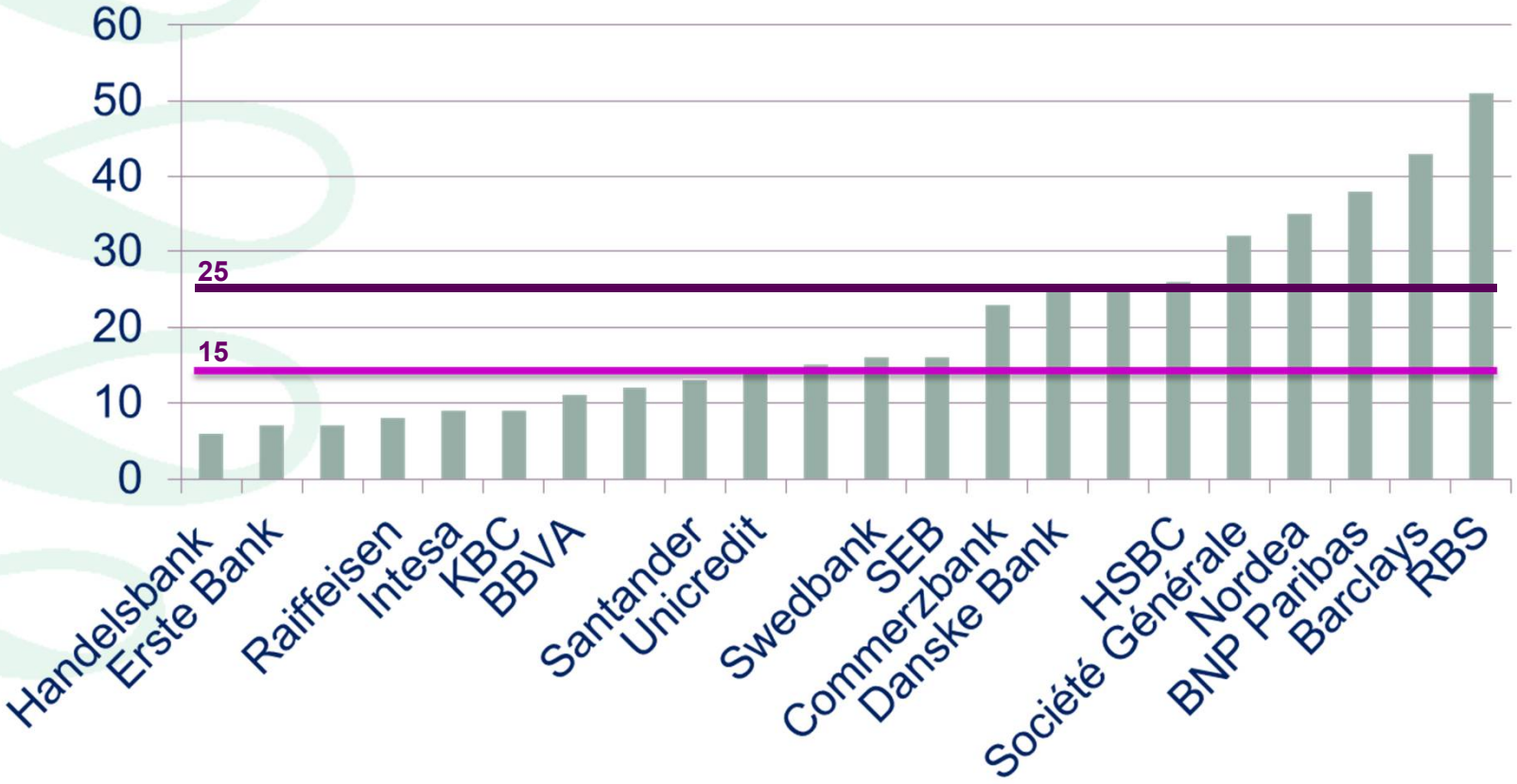
Banking Reform Bill: Loss absorbency requirements

- **Bail-in powers –** for unsecured creditors to absorb losses
- **Primary Loss Absorbing Capacity (PLAC)**
  = reg capital + unsecured debt (> 12 months)
  = 17% of RWAs or less including ring fence buffer of up to 3% extra equity
- **Group wide PLAC** – exemption for overseas operations
- **Resolution buffer –** up to 3% of RWAs
- **Leverage ratio** – 3%
- **Depositor preference** – insured depositors ranked ahead of other unsecured creditors

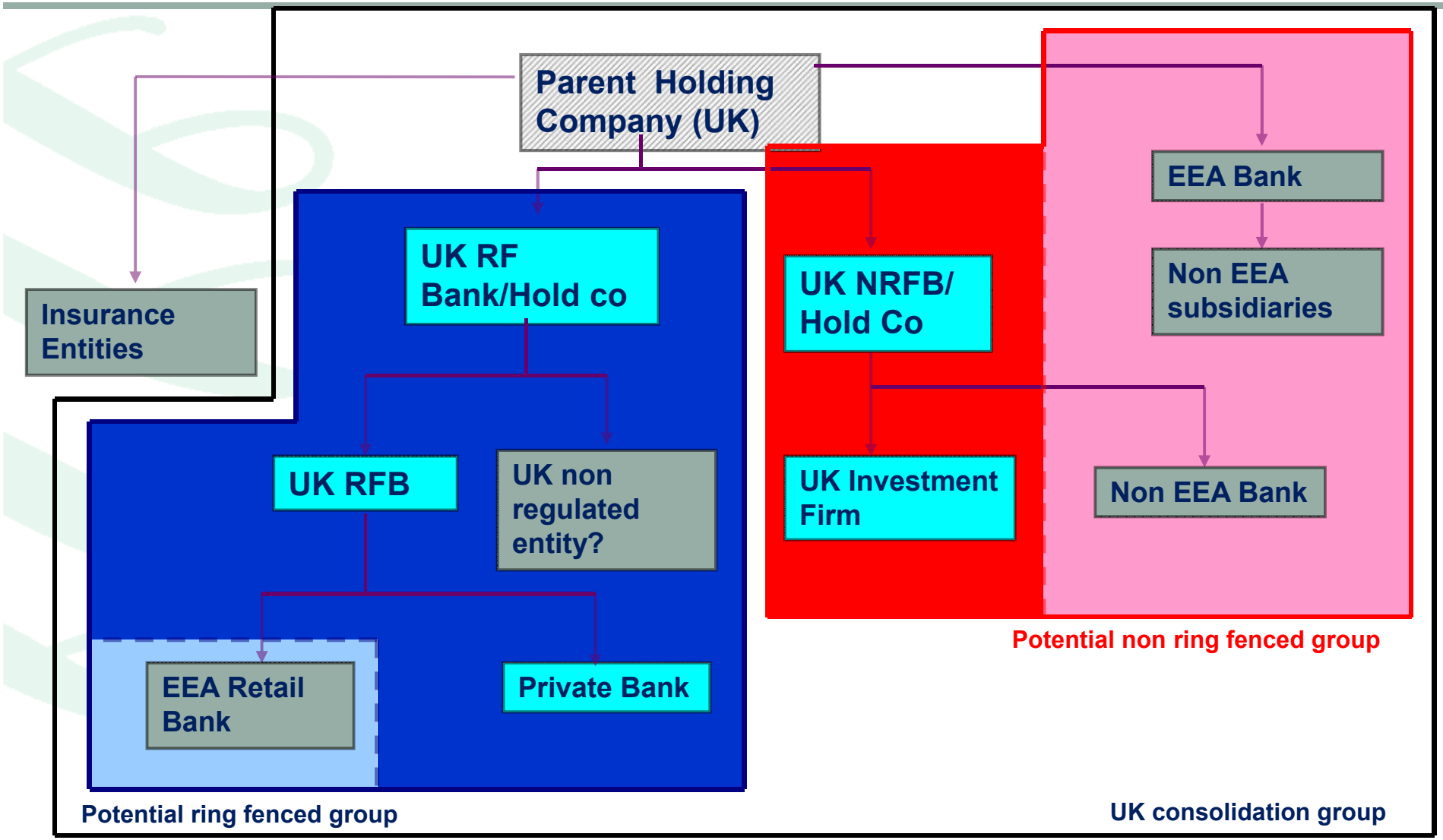
Liikanen: What is in and what is out



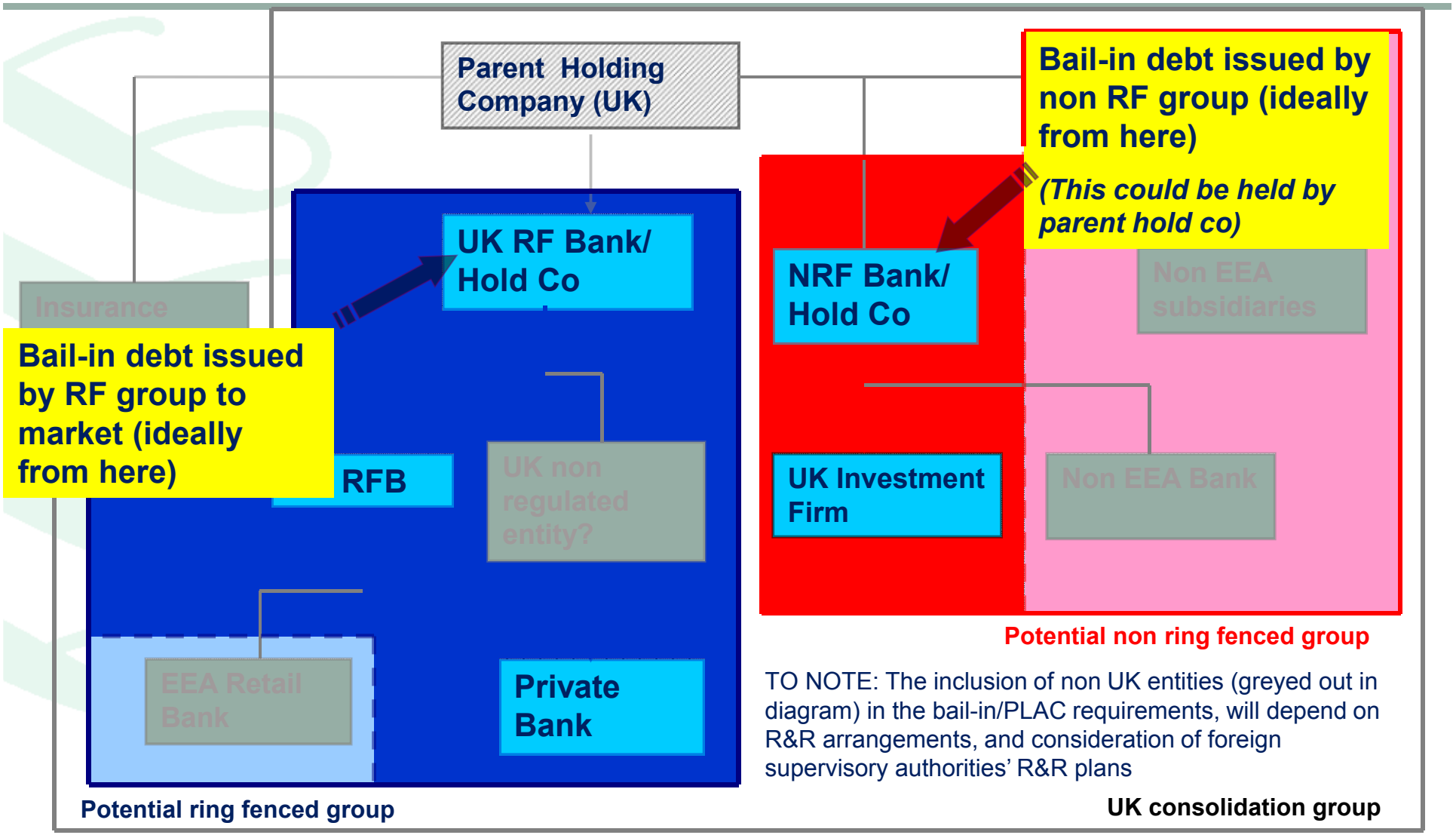
Summary of banks' trading assets as % of total assets, according to High-level Expert Group.



Potential prudential regime post ICB: Ring fenced group



Level from which bail-in debt could be issued



TO NOTE: The inclusion of non UK entities (greyed out in diagram) in the bail-in/PLAC requirements, will depend on R&R arrangements, and consideration of foreign supervisory authorities' R&R plans

Supervising systemically important Financial Institutions – A case study:

Standard Chartered Bank

Mark Steele

Lead Associate – Standard Chartered Bank Supervision Team

International Regulators Seminar 29th November 2012

Agenda

- Overview of Standard Chartered Bank
- Challenges of regulating an international bank
- Challenges for supervising Standard Chartered Bank
- Case studies
  - recovery & resolution
  - liquidity
  - business model assessment
- Conclusions

Who are Standard Chartered Bank?

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- A UK headquartered bank, SCB was incorporated by Royal Charter in 1853.
- As at 31st December 2011 SCB held total assets of c$600bn generating an operating income of $17.6bn.
- SCB operates in over 80 countries across the globe with its primary focus being Africa, Asia and the Middle East.
- SCB operates two businesses; a Wholesale Bank and a Consumer Bank
- Historically its primary business model is the provision of trade finance, cash management and US dollar treasury services to companies across its footprint
- SCB is the 7th largest USD clearer (via its New York Branch)
- Systemic in a number of countries across Asia, Africa and the Middle East. In November 2012 SCB was officially designated as a GSIFI
- Hybrid business structure with a mixture of branches and subsidiaries

Challenges of regulating an international bank

- International firms are often more complex
- Often operate within diverse markets
- Differing rules and regulations
- Differing speed of implementation of International rules
- Memorandums of Understanding (MOU's)
- Data Sharing
- Coordination and Communication

Challenges of supervising Standard Chartered Bank

- A **UK headquartered bank**, SCB was incorporated by Royal Charter in 1853.
- As at 31st December 2011 SCB held **total assets of c$600bn** generating an operating income of $17.6bn.
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- **Systemic in a number of countries** across Asia, Africa and the Middle East. In November 2012 SCB was officially designated as a **GSIFI**
- Hybrid business structure with a mixture of **branches** and **subsidiaries**

Regulator Engagement

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So how do we engage with other regulators…

- Global & Core Colleges
- Crisis Management Group
- Visiting overseas regulators
- Bilateral communication

Regulator Engagement

…and what are we engaging on?

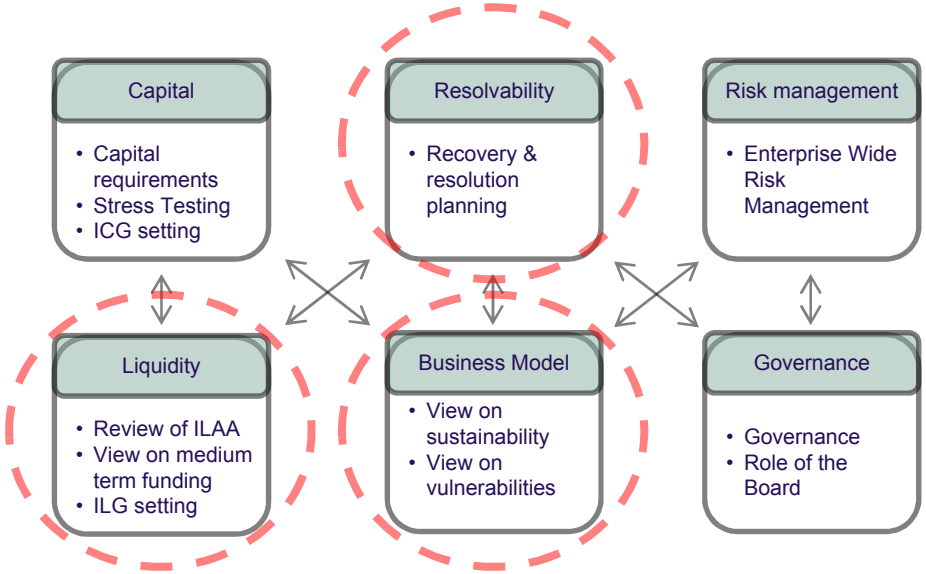
- Home country concerns
- Host country concerns
- FSA supervisory work streams
- Results of reviews by overseas regulators
- Granting permission for new branches / subsidiaries
- Letters of ‘good standing’
- Knowledge sharing
- Evolving regulatory frameworks

So how to we supervise Standard Chartered Bank?

PRA Supervision Framework

Gross risk		Safety & Soundness		
Potential impact	Risk context	Operational mitigation	Financial mitigation	Structural mitigation

Potential Impact	External context	Business risk	Risk management and controls	Management and governance	Liquidity	Capital	Resolvability



Case Study (1) – Recovery and Resolution Planning

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- Recovery & Resolution Planning (or “living wills”) requires the firm, and its regulators, to understand the recovery options available in a severe stress, and how the firm might be resolved.
- SCB has been designated a GSIFI by the FSB and therefore the FSA, alongside members of the Crisis Management Group (CMG), are to agree the following:
  - A recovery plan for the Group
  - A resolution strategy for the Group
  - Agreement of a cross-border cooperation agreement
- The CMG is a select group of regulators from the countries where SCB have a material presence
- CMG meetings occur bi-annually
- Once agreed the resolution strategy has to be communicated to all other regulators

Recovery & Resolution Planning - Considerations

FSA

- Although a GSIFI SCB is not domestically systemic in all the countries in which it operates
- Critical functions differ across countries or regions
- Speed of implementation of resolution regimes
- How to coordinate regulatory activities under business as usual
- How to coordinate regulatory activities in a crisis

Case Study (2) – Liquidity Supervision

- Our liquidity regime requires that *"a firm must at all times maintain liquidity resources which are adequate, both as to amount and quality to ensure that there is no significant risk that its liabilities cannot be met as they fall due".*

- Our liquidity regime is a Solo regime – i.e. UK Bank and its branches only

Supervisory Considerations

- Management of liquidity across the Group and within each Country
- Local regulatory requirements, and future developments
- Fungability and convertibility of liquidity and liquid resources
- Dynamics of local markets

Case Study (3) – Business Model Assessment

- As part of our ongoing supervision of SCB, we undertake detailed analysis of the firm's business model in order to fully understand how it generates profits (or losses), cash and capital in order to determine the main threats to its viability and sustainability.

Supervisory Considerations

- Dynamics of local markets
- Macroeconomic environment
- Regulatory hurdles / expectations
- Are management growth aspirations in each country or region realistic?

Conclusions

FSA

It would be impossible to adequately supervise Standard Chartered Bank without cross-country regulatory engagement:

- Memorandums of Understanding (MOU's)
- Formal engagement via Global College and CMG
- Informal / ad hoc engagement via teleconference or email
- Sharing information (firm specific + macroeconomic)
- Visiting overseas regulators
- Awareness of overseas regulatory developments

Questions ?

European Policy Developments

Russell Jackson
Alex Stringer
George Lee
Venetia Wingfield
International Banking Policy

Current developments

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- Significant volume of inter-locking legislation
- Inter-dependencies between the completion of different texts eg: Point of Non-viability in CRD IV & RRD or resolution financing in RRD and Banking Union proposals
- Divergence of institutional views
- Divergence of Member State views across files

FSA aims in EU negotiation

- Establishment of the single rule book for banking
- Implementation of Basel III
- Establishment of an effective resolution regime for Europe transposing the FSB key attributes
- Development of the Single Supervisory Mechanism for the Eurozone at the same time as the preservation of the single market and a flexible and judgement based supervisory regime

Main areas of focus

- CRD IV
- Recovery and Resolution Directive
- Banking Union

Future developments

- Finalsing Basel III implementation – LCR, NSFR, Leverage Ratio
- Liikanen proposals – Vickers
- Shadow Banking
- CRD V – Fundamental review of the trading book

CRD IV

Alex Stringer

Basel and the EU: Background

- **Basel Committee on Banking Supervision (BCBS) –**
  - agrees international framework for minimum capital rules
- **Basel I** 1980s
- **Basel II,** 2000s **–** two directives make up the Capital Requirements Directives (CRD)
- **Basel II.5 – CRD II and CRD III**
- **Now Basel III**

CRD 4

- The CRD 4 package takes the **Basel III** accord and implements it into EU law

- As well as reflecting the Basel III capital proposals, the CRD 4 legislation also includes **new proposals on sanctions for non-compliance with prudential rules, corporate governance and remuneration**

- The Commission's approach supports the development of a **Single Rule Book** for financial services regulation, which the UK signed up at the June 2009 European Council. Proposals will capture credit institutions (banks & building societies) and certain investment firms

CRD 4 – Format & Key Contents

- CRD 4 package consists of two legal instruments – a Capital Requirements **Directive** and a Capital Requirements **Regulation**

  - CRR contains Pillar 1 and Pillar 3 requirements
  - CRD contains requirements for Pillar 2, supervisory review, governance, remuneration and buffers framework

- CRR will be directly applicable while the CRD will be transposed into UK law through HM Treasury Regulations and FSA Handbook

- EBA responsible for drawing up binding Technical Standards - proposed provisions for over 100 standards to be drafted

- Principle of maximum harmonisation will apply to the implementation of much of the legislation

Maximum harmonisation and macroprudential regulation

- **Regulatory reform**
  - The FPC's role
- **The Independent Commission on Banking**
  - The ring-fence, capital buffers, bail-in

EU legislative process - Key Points

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EU Process

- **CRD 4 subject to co-decision procedure:**

- **Agreement must be reached between European Parliament, Council and Commission**
- **Negotiations in their (hopefully) final stages**

- **Date of entry into force of the legislation not yet agreed**

Issues under negotiation

- Negotiations are fast moving but key questions include:
- The introduction of buffers for systemically important banks
- National macroprudential flexibility and proportionate EU level controls
- The legal mandate for liquidity and leverage standards
- Remuneration

Next Steps

- Internal programme to prepare for implementation since August 2011
- Once final text agreed a lot needs to be done to be ready for implementation, including:
- Changes to FSA rules (alongside split to PRA and FCA)
- Decisions on waivers, permission and national discretions
- IT system for new common data reporting
- Preparation to supervise against new EU rules

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EU Bank Recovery and Resolution Directive

George Lee

1. Context

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Resilience

Reducing the probability of failure

- *Basel III / CRD IV*
- *Additional capital for systemically important financial institutions (G-SIB surcharge)*
- *Macroprudential regulation*

Resolution

Reducing the impact of failure

- *Too 'big' to fail*
- *-> a resolution regime for banks, investment firms*
- *Protect depositors*
- *Minimise taxpayer exposure*
- *Restore market discipline*
- *Break/weaken sovereign / bank debt links*

1. Context – international (FSB and EU)

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- **FSB Key Attributes for Effective Resolution Regimes**
- **Agreed by G20 Leaders at Cannes as international standard (Nov. 2011)**
- **EU response:**
  - Jan. 2011: *Technical proposal for a Crisis Management Framework*
  - March 2012: *Discussion paper on the debt write-down tool*
  - June 2012: *Commission proposal for an EU Recovery and Resolution Directive*
  - October 2012: *Rapporteur's Draft Report*

RRD: Key components

FSA

i. *Before resolution: recovery and resolution plans, preventative powers*

ii. *The moment of resolution: conditions for resolution, objectives*

iii. *Resolution tools and powers…*

2. The RRD – Key components

- ***Resolution Tools***
  - Asset separation tool
  - Bridge bank tool
  - Sale of business tool
  - Bail-in
- ***Resolution Powers / Safeguards***
  - Take control and exercise all rights conferred on shareholders
  - Remove or replace senior management
  - No creditor left worse off then in insolvency

FSA

Banking Union

Venetia Wingfield

Banking Union proposal

FSA

Commission proposals for BU were issued in September and provided for:

1. **ECB regulation** providing for a Single Supervisory Mechanism (SSM), with direct ECB prudential supervision of *all* Eurozone (EZ) credit institutions;
2. Changes to the **EBA regulation** to ensure its 'continued proper functioning';
3. A '**communication**' articulating how the different elements of BU, including future proposals for an EZ resolution authority and a possible EZ Deposit Guarantee Scheme, as well as a ‘supervisory handbook’ for the EU 27, will fit together.

FSA position

- UK supports the Banking Union: its success is critical to all of Europe.
- Given that we have no plans to join the Euro we do not intend to join the SSM. But we are absolutely committed to preserving the integrity of the single market and believe this remains achievable with the new dynamic. The role of the EBA continues to be important.
- Not for us to say what or how the ECB should supervise but we do have an interest: supervision isn't carried out in isolation from other member states now, and neither will it be in the future.
- We envisage continuing to play a strong role in European policy and rule making and to apply robust judgement in our supervision of UK banks.

Recovery and Resolution

Eleanor Beamond-Pepler and Alex Brown

29 November 2012

Overview

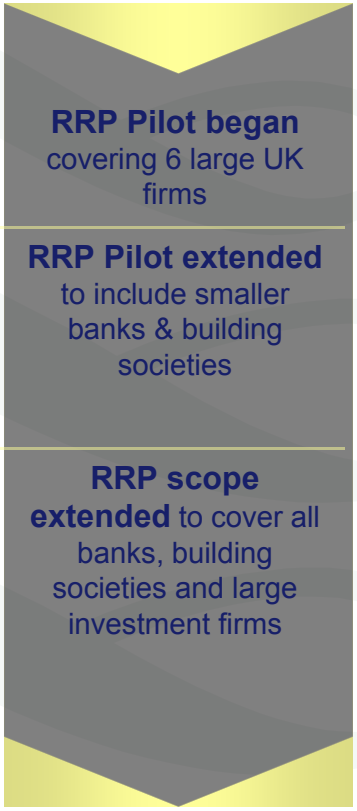
- Context – UK and international
- Policy developments
- Sharing our experience
- International co-ordination

Context – UK perspective

FSA

- **Financial crisis highlighted the need for**
  - Authorities to have more effective tools and information to enable the orderly resolution of financial institutions without recourse to taxpayer support
  - Firms to be better prepared to recover from stress scenarios
- **UK context**
  - PRA will have objective of promoting the safety and soundness of regulated firms, including seeking to minimise any adverse effects of firm failure on the UK financial system and by ensuring that firms carry on their business in a way that avoids adverse effects on the system
  - It will not be the PRA's role to ensure that no PRA-authorised firm fails
- **UK initiatives consistent with direction of travel in Europe and more broadly**
  - RRD published in draft June 2012
  - FSB Key Attributes of Effective Resolution Regimes

Timeline



2009	*Feb* - Special Resolution Regime (SRR) introduced by **Banking Act 2009**	
2010	*April* - **Financial Services Act 2010** – requires FSA to make rules providing for Recovery & Resolution Plans	
2011	*Aug* - FSA published RRP consultation & discussion papers - **CP11/16**	*Nov* - **FSB Key Attributes** of Effective Resolution Regimes agreed by G20 as international standard
2012	*May* - FSA published Feedback Statement **FS12/1** & draft core rules *Dec* – Resolution plans in place for all G-SIFIs	*June* – Proposed **EU Directive** on Recovery and Resolution (RRD) published
2013	*Dec* – final FSB assessment methodology in place	Political agreement on RRD expected
2015		*Jan* – **EU Directive** expected to enter into force

Objectives and policy implementation

FSA

- **RRPs aim to ensure that financial institutions**
  - Assess and document the recovery options that would be available to them under a range of stresses
  - Enable these options to be mobilised quickly and effectively
  - Supply the regulatory authorities with information and analysis to enable them to carry out an orderly resolution
- **Recovery plans**
  - Required for each institution
  - Must be updated at least annually or after changes that might impact the recovery plan
  - Shall not assume any support from public funds
- **Realism is important**
  - Plan should contain effective measures that would be likely to restore the firm to health
  - Supervisor can require remedial actions

RRP Modules

Module	Contents
1	Overview
2	Recovery Plan
	Resolution Pack
3	Group structure and key legal entity information
4	UK Economic Function Identification Matrix
5	UK Critical Function Contingency Analysis
6	Plans to overcome barriers to satisfactory resolution

Recovery & Resolution Directive

FSA

- Draft directive text published in June 2012, still under development and negotiation
- Due to come into force Jan 2015
- Minimum harmonising
- EBA to report back to Commission by 1 Jan 2018 on implementation of recovery and resolution plans
- Proposed directive requirements broadly in alignment with UK direction of travel
- Likely more detail to come in the draft technical standards

RRD and groups

- **Recovery plan required for**
  - Whole group *and*
  - Each institution that is part of the group

- **Aim is to achieve stabilisation of group as a whole or any institution in the group**

- **Assessment of group plans is responsibility of consolidating supervisor, in consultation with supervisors of the firms within the group**

Experience of submissions

FSA

Recovery

- We have received a number of versions from the larger firms. Plans continue to improve.
- We will need to form a view as to whether the plans are effective.
- This may be different in response to an idiosyncratic vs market wide stress.

Resolution

- We have received very lengthy submissions.
- Firms in general spent less time considering the barriers to resolution.
- It will be a long road but we have started to make progress

International co-ordination

FSA

- Co-ordination primarily driven through Crisis Management Groups
- International cooperation will be enhanced through the completion of the firm-specific Cooperation Agreements (as outlined by the FSB)
- Involvement from senior officials within regulators and central banks will be necessary
- We need to respect confidentiality but information sharing and openness is key

Questions

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FSB Shadow Banking Task Force

Regulation of securities lending/repo

David Rule

29 November 2012 (FSA International Seminar)

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Introduction

Workstream on Securities Lending and Repos

- One of the five workstreams under the Financial Stability Board (FSB) Shadow Banking Task Force

The Workstream published its interim report in April 2012, which

- Provided an overview of the securities lending market;
- Described their locations within the shadow banking system; and
- Discussed the financial stability issues arising from practices in these markets

The Workstream published a public consultative document in November 2012, which includes 13 policy recommendations on

- Transparency
- Regulation
- Structure

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Securities lending and repo markets

Securities lending

- Typically, financial institutions borrow securities to cover short sales (including for clients) and asset managers lend securities to enhance return.
- The securities loan can be collateralised by cash or securities. In case of cash collateral, the securities lender reinvests the cash (often through an agent) in money market instruments.
- Total securities on loan globally: $1.8 trillion

Repo

- Repurchase agreements (repos) are typically used by banks and other financial institutions to obtain secured funding
- At the beginning of a repo, the cash borrower sells securities with a simultaneous agreement to repurchase equivalent securities at a future date for the original value plus a repo rate
- Total size: US ($2.1-2.6 trillion excluding CCP), Europe ($8.3 trillion), Japan ($2.4 trillion), Canada ($218 billion)

Financial stability risks in securities lending and repo markets

Pure shadow banking risks

- Using repo to create short-term, money-like liabilities, facilitating credit growth and maturity/liquidity transformation outside the banking system ;
  - The policy goal is to ensure sufficient transparency to the authorities and limit risks to financial stability from excessive leverage and maturity transformation
- Securities lending cash collateral reinvestment;
  - The policy goal is to subject cash collateral reinvestment to regulatory limits on liquidity and leverage risks

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Financial stability risks in securities lending and repo markets (cont'd)

Risks that span banking and shadow banking

- Tendency of secured financing to increase procyclicality of system leverage;
  - The policy goal is to restrict, or put a floor on the cost of, secured borrowing against assets subject to procyclical variation in valuations/volatility, to reduce the potential for the excessive leverage to build-up and for large swings in system leverage when the financial system is under stress
- Risk of a fire sale of collateral securities;
  - The policy goal is to mitigate the risk that large forced sales of collateral in one market segment arise as a channel of risk transmission beyond that market segment and throughout the broader financial system

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Financial stability risks in securities lending and repo markets (cont'd)

Risks that span banking and shadow banking (cont'd)

- Re-hypothecation of unencumbered assets
  - The policy goal is to reduce financial stability risks arising from client uncertainty about the extent to which assets have been re-hypothecated and the treatment in case of bankruptcy, and to limit re-hypothecation of client assets (without an offsetting indebtedness) to financial intermediaries subject to adequate regulation of liquidity risk
- Interconnectedness arising from chains of transactions involving reuse of collateral
  - The policy goal is to reduce the risk of financial contagion and opacity.
- Inadequate collateral valuation practices
  - The policy goal is to improve collateral valuation standards

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Policy recommendations on transparency

Improvement in regulatory reporting

- More granular data on securities lending and repo exposures amongst large international financial institutions

Improvement in market transparency

- Feasibility studies for trade repositories
- Market wide surveys as an interim step

Improvement in corporate disclosures

- Public disclosure requirements for financial institutions' securities lending, repo and wider collateral management activities

Improvement in reporting by fund managers to end-investors

- Reporting requirements for fund managers to end-investors

Policy recommendations on regulation

Minimum haircuts

- Key principle: Minimum haircuts may limit the build-up of excessive leverage and reduce procyclicality in the financial system via the financing of risky assets, in particular by entities not subject to prudential regulation.
- Standards for methodologies used by market participants to calculate haircuts
  - Haircuts should be based on the long-run risk of collateral and be calibrated at a high confidence level
  - Haircuts should capture other risk considerations, e.g. concentration and wrong-way risk

Policy recommendations on regulation

Minimum haircuts (cont'd)

- Numerical floors
  - Two broad approaches: high level and back-stop level
  - Scope
    - Transaction type (financing transactions vs. lending/borrowing of securities)
    - Counterparty type (all market participants vs. exposures of regulated financial intermediaries to other entities and exposures amongst other entities vs. exposures of regulated financial intermediaries to other entities)
    - Collateral type (possible exclusion of sovereign bond repos)
  - Implementation (firm-specific regulation vs. market regulation)
  - The FSB should be mindful of possible unintended consequences for market liquidity and the functioning of markets and should consult on whether a framework of numerical floors would be effective and workable in achieving the policy objectives

Policy recommendations on regulation

Minimum standards on cash collateral reinvestment

- Key principle: The proposed minimum standards should focus on limiting risks arising from cash collateral reinvestment, in particular liquidity risk.
- Scope: all financial entities that are engaged, with or without an agent, in securities lending against cash collateral where the cash collateral is reinvested in a portfolio of assets.
- Draft proposed requirements on
  - (i) high-level principles
  - (ii) mitigating liquidity, credit, and other risks associated with cash collateral reinvestment
  - (iii) stress tests
  - (iv) disclosure requirements

Policy recommendations on regulation

Requirement on re-hypothecation

- Definition: “re-use” includes any use of securities delivered in one transaction in order to collateralise another transaction; “re-hypothecation” is defined more narrowly as re-use of client assets.
- Regulations should address the following principles
  - Financial intermediaries should provide sufficient disclosure to clients in relation to re-hypothecation of assets so that clients can understand their exposures in the event of a failure of the intermediary;
  - In jurisdictions where client assets may be re-hypothecated for the purpose of financing client long positions and covering short positions, they should not be re-hypothecated for the purpose of financing the own-account activities of the intermediary; and
  - Only entities subject to adequate regulation of liquidity risk should be allowed to engage in the re-hypothecation of client assets.
- An appropriate expert group on client asset protection should examine possible harmonisation of client asset rules with respect to re-hypothecation

Policy recommendations on regulation

Minimum regulatory standards for collateral valuation and management

- WS5 proposes the following principles:
  - Securities lending and repo market participants (and, where applicable, their agents) should only take collateral types that they are able following a counterparty failure to: (i) hold outright without breaching laws or regulations; (ii) value; (iii) risk manage; and (iv) liquidate in an orderly way.
  - Securities lending and repo market participants (and, where applicable, their agents) should have contingency plans for the failure of their largest market counterparties, including in times of market stress. These plans should include how they would manage the collateral following default.
  - Collateral and lent securities should be marked to market at least daily and variation margin collected at least daily where amounts exceed a minimum acceptable threshold.

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Policy recommendations on structure

Central clearing

- Authorities should evaluate the costs and benefits of proposals to introduce CCPs in their securities lending and repo markets, especially in cases where important funding providers in the repo market are currently not participating in existing CCPs.

Changes to bankruptcy law treatment of repo and securities lending transactions

- Changes to bankruptcy law treatment and development of Repo Resolution Authorities (RRAs) may be viable theoretical options but should not be prioritised for further work at this stage due to significant difficulties in implementation.

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Annex 1: Proposed policy recommendations on securities lending and repos

Recommendation 1: Authorities should collect more granular data on securities lending and repo exposures amongst large international financial institutions with high urgency. Such efforts should to the maximum possible extent leverage existing international initiatives such as the FSB Data Gaps Group, taking into account the enhancements suggested by the Workstream.

Recommendation 2: Trade repositories (TRs) are likely to be the most effective way to collect comprehensive repo and securities lending market data. The FSB should consult on the appropriate geographical and product scope of such TRs. The FSB should encourage national/regional authorities to undertake feasibility studies for the establishment of TRs for individual repo and securities lending markets, as well as coordinate and facilitate those efforts. Depending on the consultation findings on the appropriate geographical and product scope of TRs, the FSB should establish a working group to identify the appropriate scope and undertake a feasibility study for one or more TRs at a global level. Such feasibility studies should involve market participants.

Recommendation 3: As an interim step, the FSB should coordinate a set of market-wide surveys by national/regional authorities to increase transparency for financial stability purposes and inform the design of TRs. Such market-wide surveys should make publicly available aggregate summary information on securities lending and repo markets on a regular basis.

Recommendation 4: The FSB should work with standard setting bodies internationally to improve public disclosure requirements for financial institutions' securities lending, repo and wider collateral management activities as needed, taking into consideration the items noted above.

Recommendation 5: Authorities should review reporting requirements for fund managers to end-investors in line with the proposal by the Workstream.

Recommendation 6: Regulatory authorities should introduce minimum standards for the methodologies that firms use to calculate collateral haircuts. Those guidelines should seek to minimise the extent to which these methodologies are pro-cyclical. Standard setters (e.g. BCBS) should review existing regulatory requirements for the calculation of collateral haircuts in line with this recommendation.

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Annex 1: Proposed policy recommendations on securities lending and repos (cont'd)

Recommendation 7: In principle, there is a case for introducing a framework of numerical floors on haircuts for securities financing transactions where there is material procyclicality risk. Such floors would work alongside minimum standards for the methodologies that firms use to calculate collateral haircuts. However, the FSB should be mindful of possible unintended consequences for market liquidity and the functioning of markets. The FSB should consult on whether a framework of numerical floors would be effective and workable in achieving the policy objectives. This would include consultation on the levels and the scope of application of such framework by counterparty, collateral, and transaction type (see sections 4.1.4 - 4.1.5).

Recommendation 8: Regulatory authorities for non-bank entities that engage in securities lending (including securities lenders and their agents) should implement regulatory regimes meeting the proposed minimum standards for cash collateral reinvestment in their jurisdictions to limit liquidity risks arising from such activities.

Recommendation 9: Authorities should ensure that regulations governing re-hypothecation of client assets address the following principles:

- Financial intermediaries should provide sufficient disclosure to clients in relation to re-hypothecation of assets so that clients can understand their exposures in the event of a failure of the intermediary;
- In jurisdictions where client assets may be re-hypothecated for the purpose of financing client long positions and covering short positions, they should not be re-hypothecated for the purpose of financing the own-account activities of the intermediary; and
- Only entities subject to adequate regulation of liquidity risk should be allowed to engage in the re-hypothecation of client assets.

Recommendation 10: An appropriate expert group on client asset protection should examine possible harmonisation of client asset rules with respect to re-hypothecation, taking account of the systemic risk implications of the legal, operational, and economic character of re-hypothecation.

Recommendation 11: Authorities should adopt minimum regulatory standards for collateral valuation and management for all securities lending and repo market participants.

Recommendation 12: Authorities should evaluate the costs and benefits of proposals to introduce CCPs in their securities lending and repo markets, especially in cases where important funding providers in the repo market are currently not participating in existing CCPs.

Recommendation 13: Changes to bankruptcy law treatment and development of Repo Resolution Authorities (RRAs) may be viable theoretical options but should not be prioritised for further work at this stage due to significant difficulties in implementation.