

## Just released, the FSA's policy stance regarding banks considered "too-big-to-fail"

The Financial Services Authority (the "FSA") yesterday published the "Turner Review Conference Discussion Paper – A regulatory response to the global banking crisis: systemically important banks and assessing the cumulative impact" (the "Discussion Paper"). The Discussion Paper expands upon The Turner Review published in April of this year by further addressing two key issues:

- the moral hazard associated with systemically important banks ("SIBs"); and
- assessment of the cumulative impact of the various changes to capital and liquidity requirements<sup>1</sup>.

The purpose of the Discussion Paper is, as was the case with The Turner Review, to stimulate debate by describing the problems associated with the issues, identifying various policy options for addressing the perceived problems and setting forth the FSA's current position in relation to the issues.

### Systemically important banks (SIBs)

The Discussion Paper comes on the heels of the growing global debate regarding the future of banks and other financial institutions that are considered "too-big-to-fail." For example, the financial reforms proposed by the Obama administration in US suggest that its preferred approach is to address the concerns associated with SIBs through greater regulation<sup>2</sup>. On the other hand, current and former central bank heads, such as Mervyn King<sup>3</sup> and Alan Greenspan<sup>4</sup>, have suggested that institutions that are "too-big-to-fail" should be broken up. These and many other aspects of the debate regarding the regulation of SIBs are set out in the Discussion Paper and we summarise below a few that we believe will be of particular interest.

**1. Defining a SIB:** the Discussion Paper very broadly classifies an institution as a SIB "when its collapse would impair the provision of credit and financial services to the market with significant negative

consequences for the real economy." The Discussion Paper clarifies this classification by suggesting three categories of factors that may cause a firm to be considered "systemically important," which are (a) size (whether absolute or relative to a specific market), (b) inter-connectedness (e.g., its failure would have a "domino effect") and (c) whether it is part of a systemically important "herd" of firms (e.g., building societies).

**2. Defining the problem:** the Discussion Paper identifies three separate concerns related to SIBs that are considered "too-big-to-fail". First, and probably that which is most commonly discussed, is the concern that the existence of SIBs will result in a "moral hazard," whereby implicit governmental support will encourage such firms to take on greater risk than they otherwise would. Second, but closely related to the first, is the concern that government support of SIBs results in the "socialisation of losses" when economic conditions are bad without the benefit of when they are good. Third, is the concern that certain SIBs are so large relative to the size of their national government that they will be "too-big-to-rescue".

**3. Alternative policy approaches:** the Discussion Paper focuses on three general policy responses to address the problems associated with SIBs. One policy response, similar to that suggested by Mervyn King, is to break-up SIBs or limit the banking activities that may be conducted by a single firm (or "narrow banking"). A second policy approach is to implement regulations that would make the failure of SIBs less likely. Such regulations might include greater capital and liquidity requirements, or contingent capital (i.e., capital that converts to common equity upon certain triggers). Finally, regulations may be established to make SIB failures more akin to those of non-systemic institutions. The rationale behind this approach is to reduce moral hazard risk by making clear that losses are possible for non-equity claims, thereby encouraging the non-equity claims to adequately allocate the cost of such risk to the SIB.

4. **Narrow banking:** one specific policy approach that the Discussion Paper looks at in detail is the debate surrounding proposals to narrow the banking activities that firms may engage in. The Discussion Paper sets out a range of approaches that have been suggested, such as requiring the separation of commercial bank activities from investment banking activities, similar to the divide that had existed for a long period under the Glass-Steagall Act in the US. Another suggested approach, which is certain to be heavily debated, argues that a distinction between commercial banking activities and investment banking activities is impractical and instead a division should be made between institutions that take deposits and perform payment activities and those that engage in commercial lending and trading activities.

5. **Reduction of inter-connectedness through central clearing counterparties:** the Discussion Paper highlights the reduction of risk associated with the “multiplicity and complexity” of trading derivative contracts as a key to improving the financial stability of SIBs. Most prominently, the Discussion Paper looks at suggestions to reduce such risks through greater use of central clearing counterparties. The Discussion Paper also suggests that the counterparty risk may be reduced through more appropriate capital and margin requirements. These solutions are very similar to the regulatory proposals set out in the European Commission’s communication titled “Ensuring efficient, safe and sound derivatives markets: future policy actions”, which was just published on 20 October 2009<sup>5</sup>.

6. **Current FSA policy:** the FSA’s discussion of SIBs concludes by setting out its current policy stances regarding the regulation of SIBs, which include:

- applying some form of capital (and perhaps liquidity) surcharge internationally for SIBs, which might be combined with an effort to place greater “standalone sustainability of national subsidiaries, with overt understanding that home country authorities will not be responsible for the rescue of entire groups”;

- reducing the inter-connectedness of SIBs by moving over-the-counter derivative trading to central clearing counterparties (with proper collateral and margin requirements);
- increasing capital requirements for riskier trading activities; and
- requiring SIBs to produce recovery and resolution plans (“living wills”) which set out how operations would be resolved in an orderly fashion.

## Cumulative impact

The Discussion Paper also addresses the need for considering the “cumulative impact” of the capital and liquidity reforms being considered internationally (i.e., primarily those being prepared by the Basel Committee on Banking Supervision). Whilst the FSA recognises the global movement towards significantly increased capital and liquidity requirements for banking institutions, it also recognises the negative impact any such increase may have on the cost and availability of credit.

The FSA is concerned that not enough attention has been given to the trade-offs associated with higher capital and liquidity requirements. The Discussion Paper does not set out ‘the answer’ for what the right level of capital and liquidity is to minimise the trade-offs between increased financial stability and reduced availability of credit, but instead considers several illustrative models that might be used to assess the optimal level of credit and liquidity.

The Discussion Paper also makes clear that the FSA does not consider its concerns with the trade-offs of increased financial stability and decreased lending to apply to the increased capital requirements associated with trading activities.

## Next steps

The Discussion Paper concludes by setting out various next steps that FSA will take in relation to the issues, which include:

- **Conference:** a Turner Review conference will be held on 2 November 2009 and the issues of the Discussion Paper will form the agenda.
- **Cumulative impact:** the FSA intends to continue to encourage global debate surrounding the cumulative impact of capital and liquidity reform through on-going analysis.
- **Living wills:** the FSA intends to further its pilot programme to create living wills for certain banking institutions in the UK.

Comments to the Disclosure Paper are due by 1 February 2010.

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1 [http://www.fsa.gov.uk/pubs/discussion/dp09\\_04.pdf](http://www.fsa.gov.uk/pubs/discussion/dp09_04.pdf)

2 [http://www.financialstability.gov/docs/regs/FinalReport\\_web.pdf](http://www.financialstability.gov/docs/regs/FinalReport_web.pdf)

3 [http://www.ft.com/cms/s/0/7056b56a-bda8-11de-9f6a-00144feab49a.html?nclick\\_check=1](http://www.ft.com/cms/s/0/7056b56a-bda8-11de-9f6a-00144feab49a.html?nclick_check=1)

4 <http://www.bloomberg.com/apps/news?pid=20601087&sid=aJ8HPmNUfchg>

5 <http://reaction.mayerbrown.com/rs/vm.ashx?ct=24F7671BDFAE4EE0CDD880A5D62D911091907ABFDA9818CF5AE175767CEAC80BDF416>

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