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Credit crisis continues - the FSA highlights key areas of regulatory concern for banks

Hector Sants' interview

In a recent interview with the BBC, Hector Sants, the Chief Executive of the UK Financial Services Authority (the "FSA"), gave his views about some of the key regulatory risks facing banks and other FSA regulated firms arising from the credit crisis. Later that day he elaborated his points in a speech at an industry conference. His comments reflect the FSA's risk based approach to regulation which involves the FSA in trying to identify and reduce the risks facing the financial sector. They also recognise the criticism the FSA has faced as a result of its failure to foresee and prevent the problems at the troubled bank, Northern Rock.

Banks' business models

Sants talked about the new market conditions and the increasing cost of credit. He said that, from a regulator's perspective, the higher cost of credit was not necessarily a bad thing, because this would better reflect the risks associated with the provision of credit; easy credit was not necessarily in the long term interests of either the economy or of consumers.

However, he noted that banks would need to give consideration to how their business models will need to adapt to these changed market circumstances. Sants does not expect that markets will ever return to how they were before the current crisis and so banks will need to adopt a more traditional, lower risk, approach to their business. This would mean banks returning to how they used to carry on their business, when they tended to keep the risk of a transaction (for example, a mortgage loan) on their balance sheets over the life of that transaction. In recent years, banks have sought to take these risks off their own balance sheets and pass them on to other parties, which has allowed them to write more business by dispersing risk around the financial sector. In future, however, it is going to be more difficult, although not impossible, to disperse risk in this manner. Sants thought that simpler structures would be needed in the future and believes that banks would need to return to a more traditional and prudent approach to their lending practices.

Sants recognised that it is, of course, difficult for banks to predict and manage all possible risks that they may face. However, his view is that too many financial institutions have strayed from a fundamental rule in managing risk by buying complex financial instruments that they do not fully understand. The fact that so many investors have bought such products has made the market for these products much larger in size that it would otherwise have been, which in turn has made this market inherently unstable.

The FSA considers that it is particularly necessary that both the regulator and the firms it regulates increase their focus on risk now that market conditions have deteriorated. In these more difficult conditions, the FSA believes that markets could be more vulnerable to external shocks and that the impact of such shocks on regulated firms could be more significant than in previous years.

Bankers' remuneration

In the context of the FSA's approach to identifying potential risks facing banks, Sants also talked about bankers' remuneration as being too short-termist and as incentivising behaviour which was not conducive to financial stability, and which may also not be in shareholders' best long-term interests.

He said that there was an asymmetry between returns to employees and returns to shareholders. There was often an incentive for employees to take a risk on a transaction if it increased their bonus. However, if, a few years later, the deal did not work out in the way expected when an employee's bonus was determined, it would be the shareholders, rather than the employee, who would incur the loss. Hector Sants was not saying that the FSA would, or should, become involved in regulating employees' remuneration, but was saying that this was another form of risk that banks faced. The FSA encouraged banks' management to take steps to minimise this type of risk.

Banks' capital and liquidity requirements

The FSA has also focused on the liquidity requirements for banks and, last December, published a Discussion Paper on this issue which drew lessons from how banks had coped with the recent market turbulence. The FSA will also be conducting more rigorous supervisory reviews of firms to ensure that its requirements are applied appropriately and is developing new reporting requirements to support its work in monitoring liquidity.

Clive Briault, Managing Director of Retail Markets at the FSA, also spoke on these matters, and emphasised that a major supervisory objective for the FSA is to ensure that regulated firms continue to maintain adequate levels of liquidity. He said that firms should be protecting themselves from current vulnerabilities by putting in place adequate capital and by undertaking robust liquidity stress testing to take account of current and prospective market conditions. He noted that banks had already been required to assess their overall capital positions in light of current and anticipated market developments, and to consider, where necessary, how to strengthen their capital positions.

Sir John Gieve's views on improving the capital and liquidity regulatory regime

On the same day that Hector Sants and Clive Briault made their comments, Sir John Gieve, the deputy governor of the Bank of England, gave his views about risk and regulatory capital requirements. He put a slightly different emphasis on how he thought regulators should deal with these matters; he thinks that regulators should consider how far the regulatory regime for capital and liquidity can be tailored so as to require lenders to set aside more capital in an economic upswing, but be allowed to apply looser standards in a downturn.

He believes that the regulatory system should be designed to raise requirements in times of rapid economic growth in order to dampen the upswing, but create additional headroom for losses as the cycle turns downwards. He stated that, in his view: "the key lies in the measurement of risk and the repeated inclination to underprice risks at the top of the cycle and thus take comfort from exaggerated estimates of risk adjusted returns; and the corollary, a tendency to overprice risk as the cycle swings down" and that "strong economic growth, low interest rates and rapid increases in asset prices lead to overconfidence and bad lending at the top of the cycle; defaults, de-leveraging and retrenchment follow in the downswing". It will be interesting to see the extent to which the FSA and other regulators will follow these suggestions, but it appears that the FSA will be unlikely to relax its capital requirements in the current downturn.

Other FSA regulatory concerns

One of the FSA's regulatory themes is "treating customers fairly". In his interview, Hector Sants recognised that if there was a deterioration in the real economy resulting from the credit crisis, then consumers would find meeting their financial obligations more difficult. In these more difficult economic circumstances, he thought that banks and other FSA regulated firms would have to be even more careful to treat their customers fairly. In this context, firms would also have to focus on their obligations not to mis-sell their products – they will need to make sure that their products are appropriate for consumers and that the products are explained to consumers in a way that they can understand.

The FSA's regulation of Northern Rock

As regards the FSA's supervision of Northern Rock, Sants admitted that its standard of supervision had not been adequate and that these shortcomings needed to be addressed. The FSA has conducted an internal review on the way it supervised Northern Rock and will, towards the end of March, be publishing the conclusions from this review. However, even before publication, Sants said that you could already draw a few conclusions.

He didn't think that the Northern Rock crisis meant that the FSA's basic regulatory philosophy was wrong. The FSA will continue its move towards a more principles and outcomes based regime based on fewer, less prescriptive rules. The aim of the FSA is to focus on the likely outcomes and consequences of actions, including a consideration of risks, rather than on detailed rules. This approach will continue.

Sants said that the higher levels of the FSA had understood how Northern Rock's business model was dependent on wholesale financing - which financing subsequently became very difficult to obtain. His view was that the key question was whether the management of Northern Rock understood fully what would happen to their business model in a period of extreme stress. Sants admitted that the FSA should have been more rigorous in ensuring that the management of Northern Rock fully understood the consequences of this dependence on wholesale financing. He accepted that the FSA should have challenged Northern Rock's management in respect of their risk management practices and their understanding of the risks posed by their business model. Therefore, even before the publication of its internal review, Hector Sants has acknowledged that the FSA should have been more effective and efficient in its supervision of Northern Rock.

The FSA's regulatory focus

Stung by criticism of how it failed to prevent the crisis at Northern Rock, it is apparent that the FSA will be focusing more on how banks manage and (as far as possible) minimise the potential risks they face, and that the FSA will be concentrating on how banks ensure that they have sufficient liquidity to deal with current and anticipated market conditions.

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