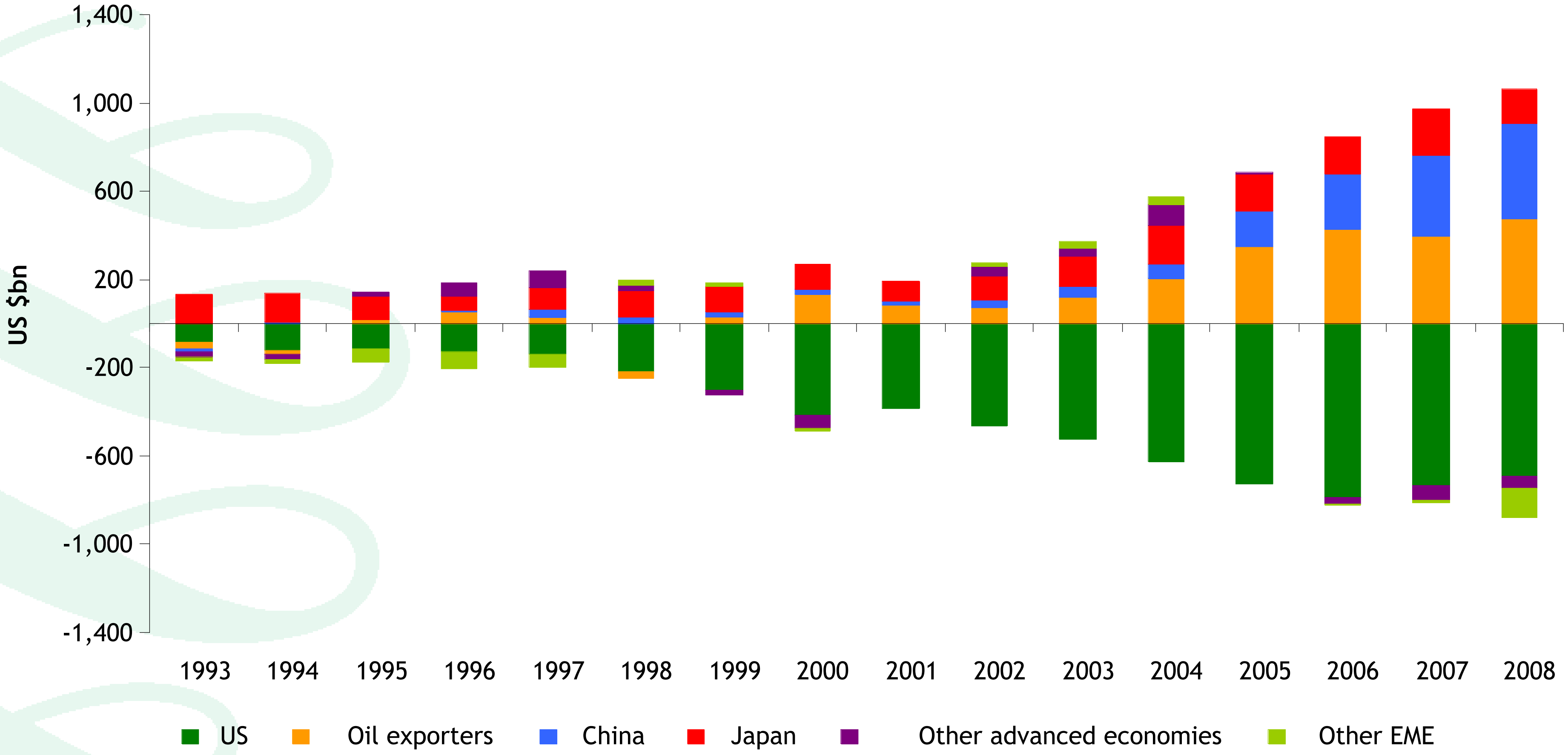
The Turner Review
A regulatory response to the global banking crisis

Lord Turner

Chairman

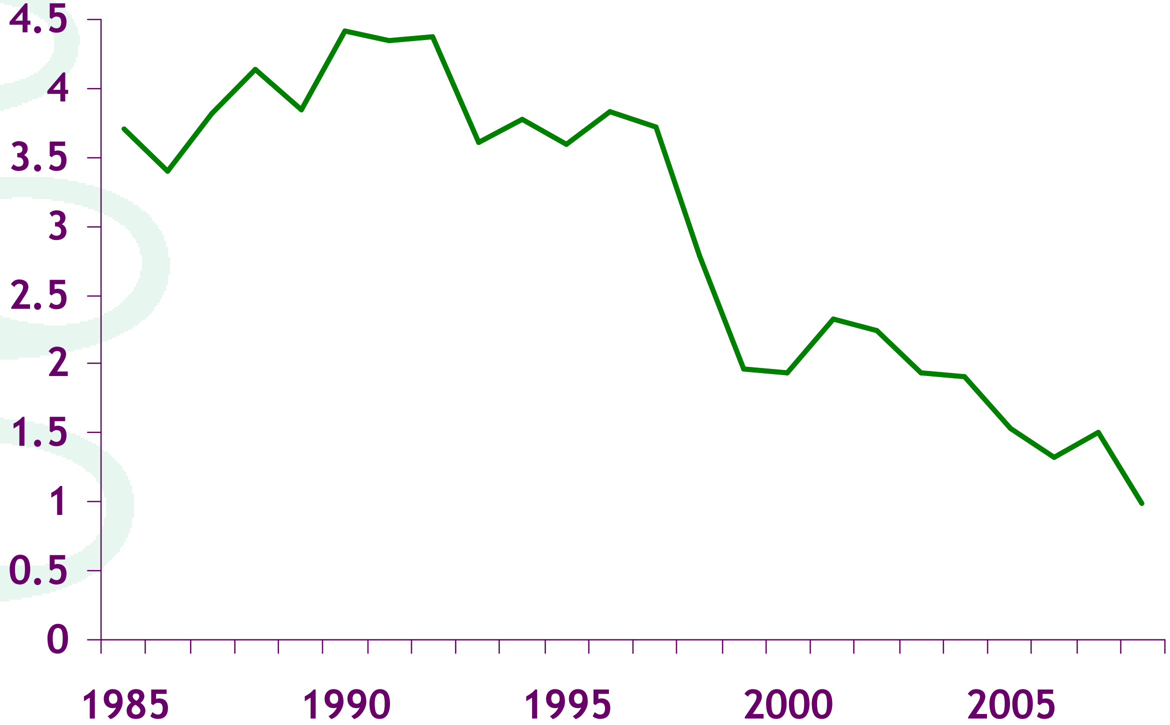
Financial Services Authority

Exhibit 1.1: Global current account balances



Source: IMF, FSA calculations

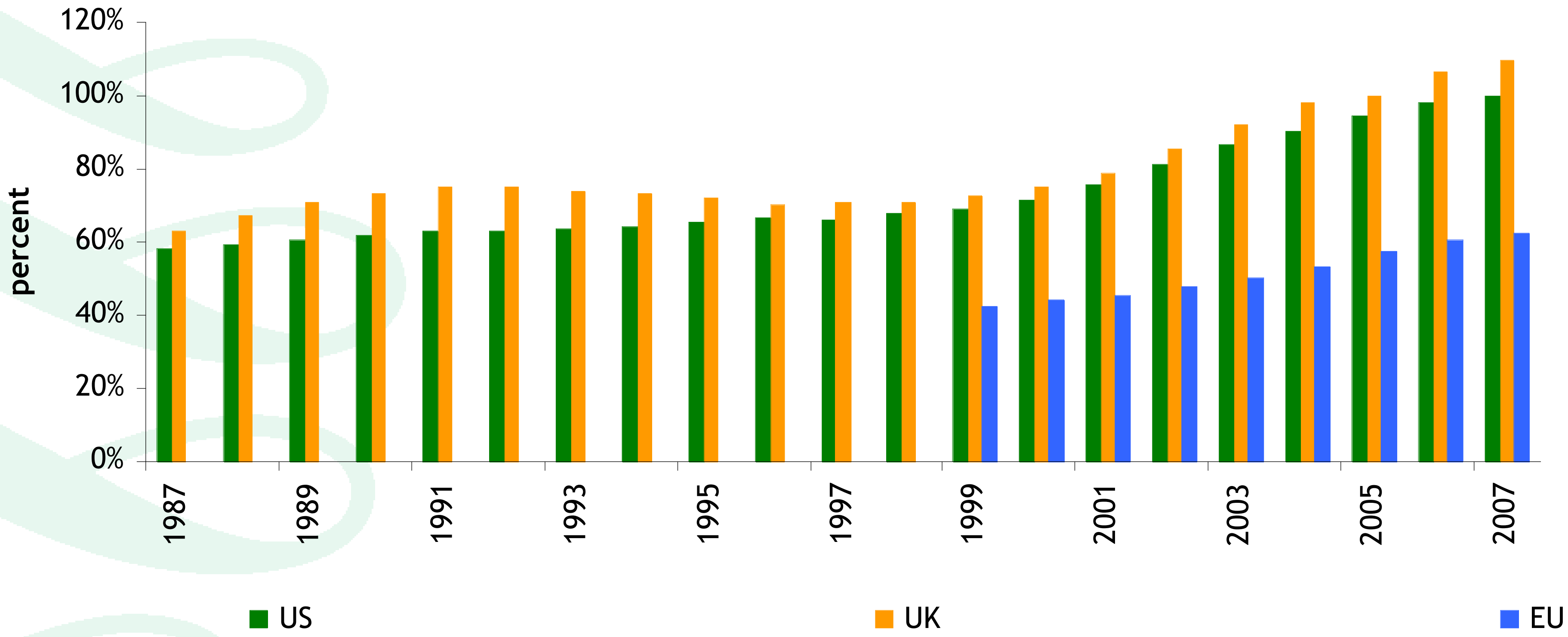
Exhibit 1.3: UK real interest rates (20 year bonds, yield at May 25th or nearest week day)



Note: For the years 1985, 86, 89, 90 & 91 no 20 year yield is precisely available; the longest available yield (in range 16-19 years) is shown

Source: Bank of England Real Yield curve calculations

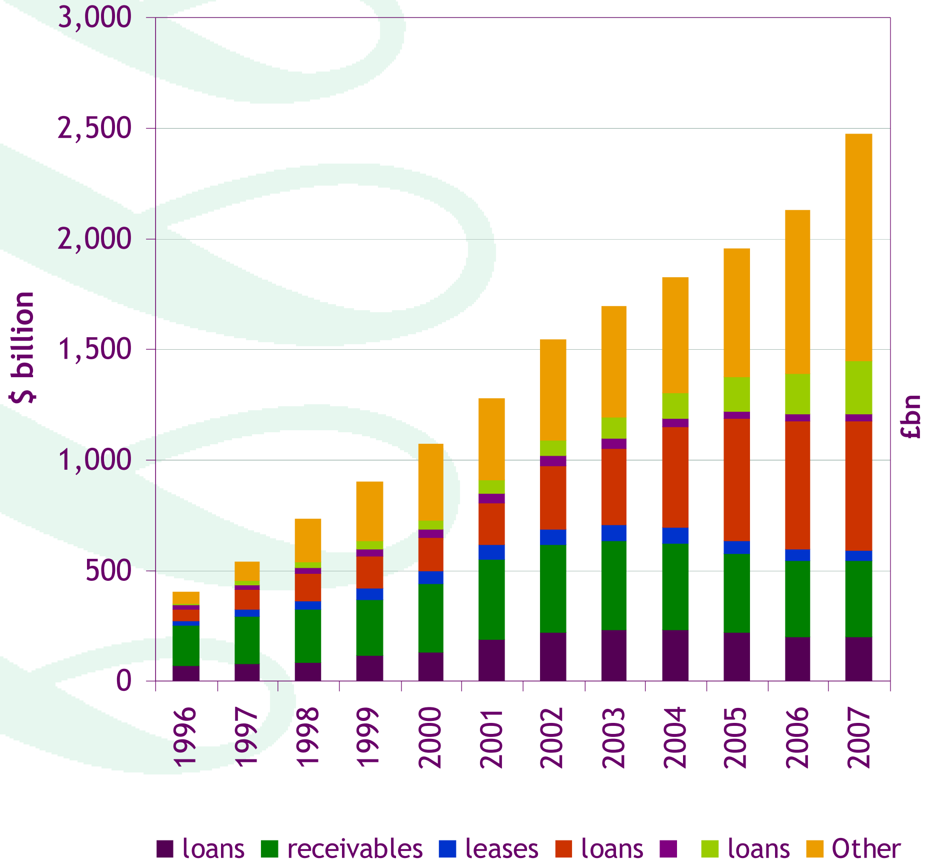
Exhibit 1.4: Household debt as proportion of the GDP



Source: ONS, Federal Reserve, Eurodata, Bureau of Economic Analysis, FSA calculations

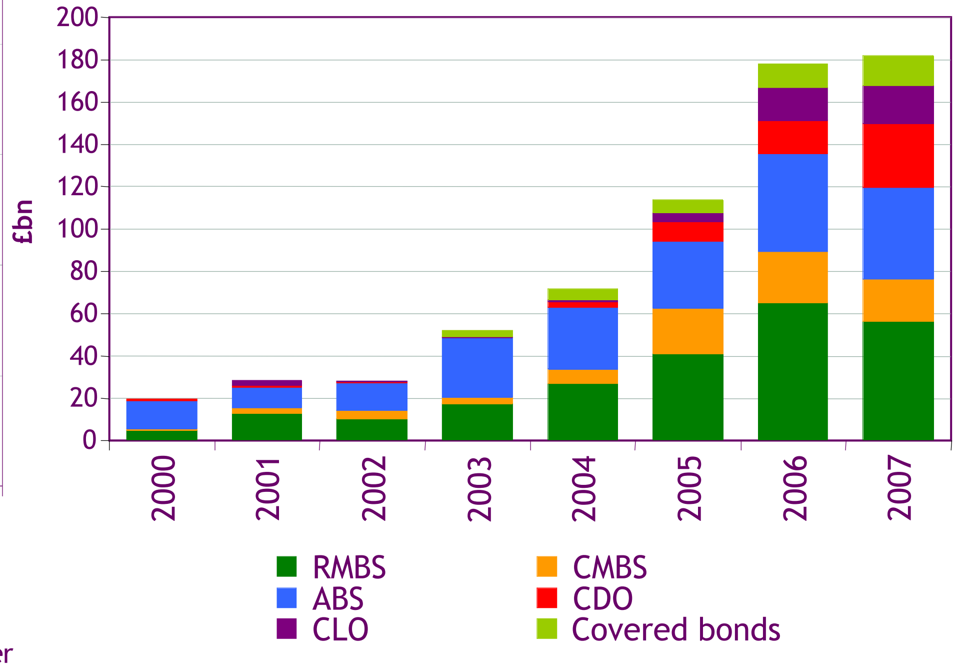
Exhibit 1.5: The growth of securitised credit

ABS – volumes outstanding, US



Source: SIFMA

Securitisation issuance trends in the UK

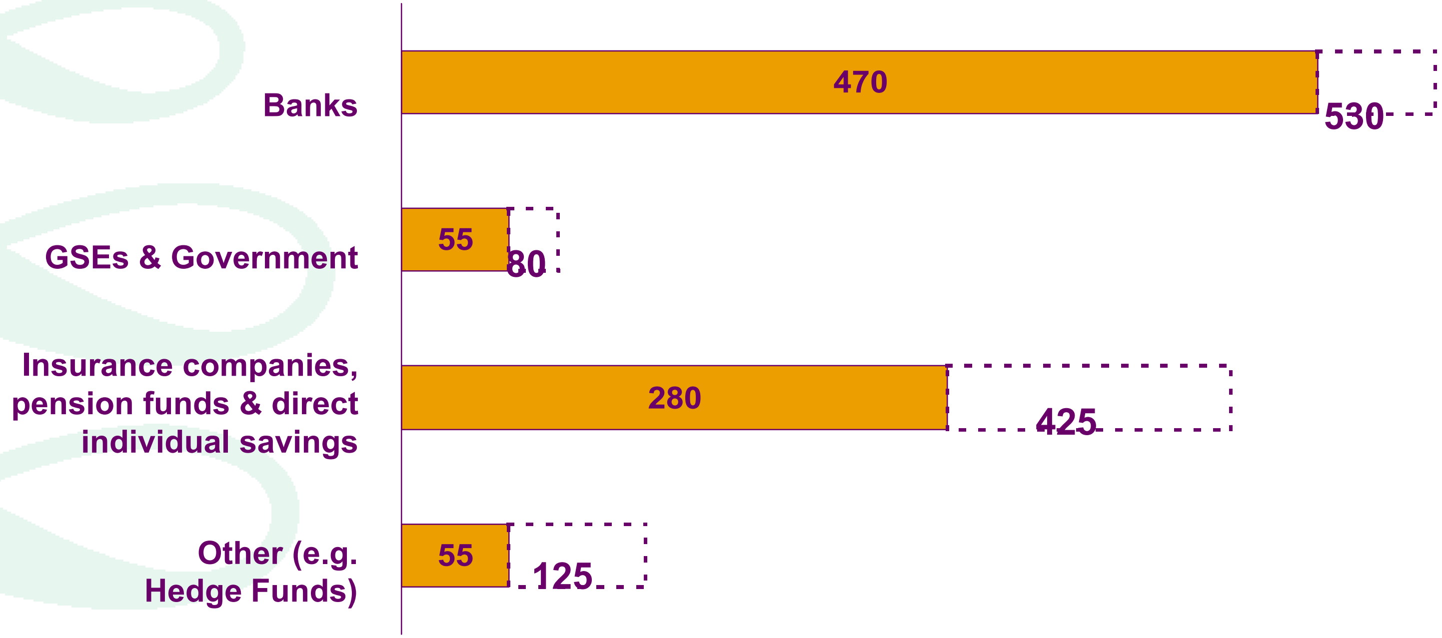


Source: Oliver Wyman

Key Drivers of the Crisis

- Mutation of the securitised credit model
  - Massive growth and increased complexity
  - Risk retained on banking balance sheets
- Increased leverage in multiple forms
- Increased maturity transformation, by banks and shadow banks, in new forms: reliance on "liquidity through marketability"
- Misplaced reliance on apparently sophisticated maths
- Hard-wired pro-cyclicality, ratings triggers, margin calls
- Lack of adequate/ counter-cyclical capital buffers

Exhibit 1.8: Estimates of mark to market losses on US credit securities: at April 2008



Source: IMF Global Financial Stability Report, October 2008

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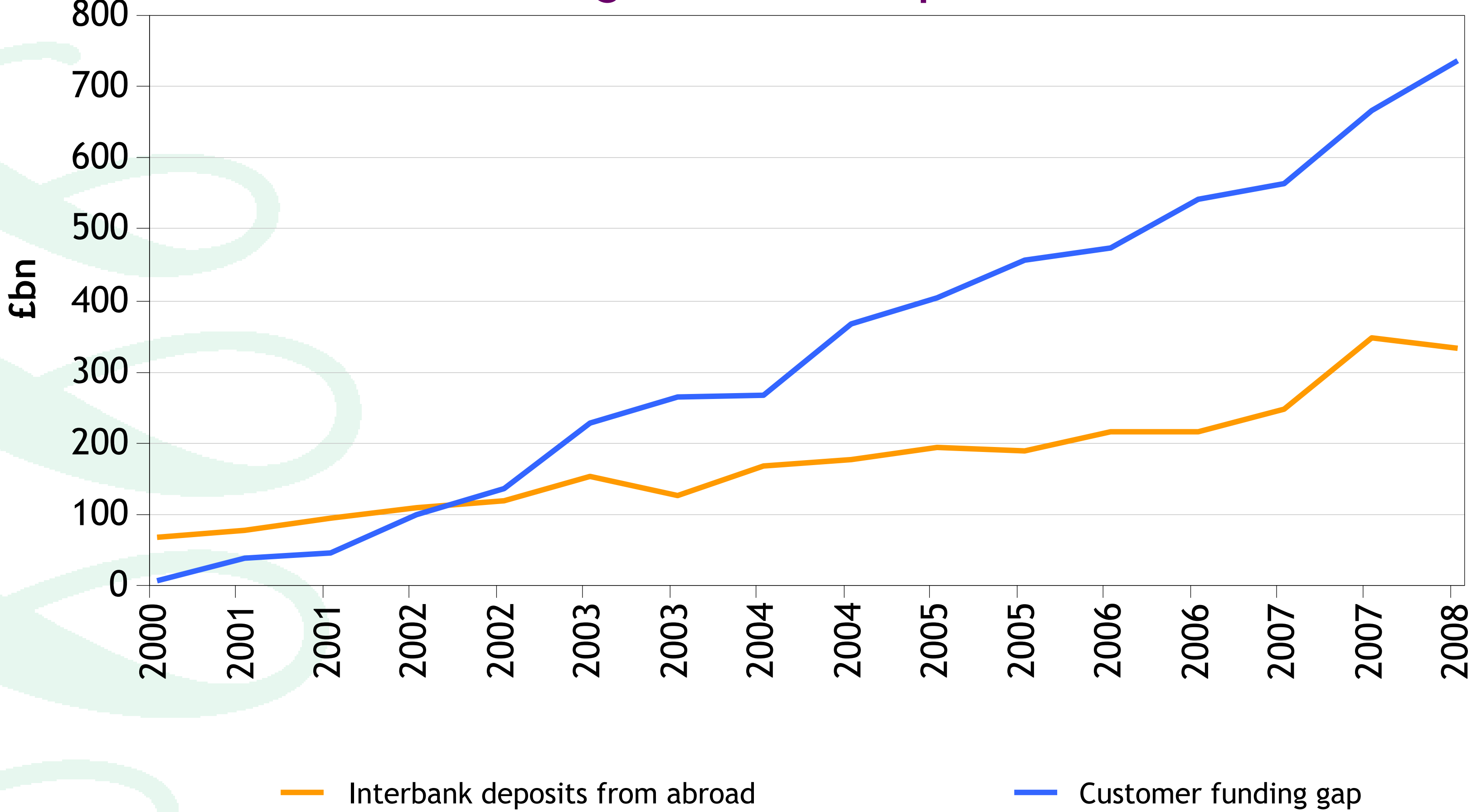
UK special factors

- Home country of leading banks involved in trading activity
- Rapid growth of mortgage debt; rising property prices
- Credit growth financed from overseas through securities sales and bank lending
- Rapid and risky growth of mortgage banks

Exhibit 1.25: Major UK banks' customer funding gap and foreign interbank deposits



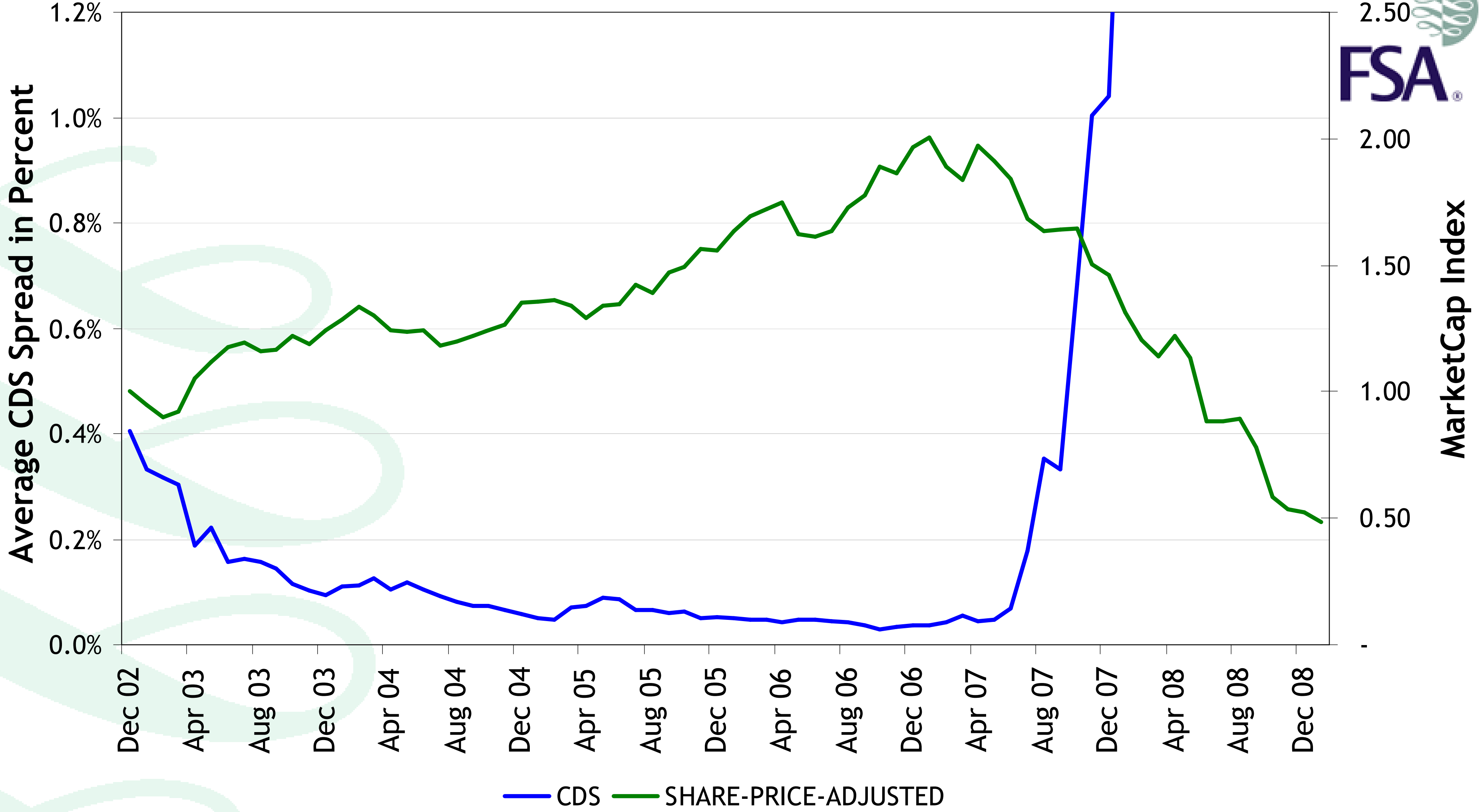
Source: Bank of England, Dealogic, ONS, published accounts and Bank of England calculations

The customer funding gap is customer lending less customer funding, where customer refers to all non-bank borrowers and depositors.

Five fundamental theoretical issues

1. Are financial markets rational or subject to herd/momentum effects?
2. Is the securitised credit model inherently unstable?
3. Misplaced reliance on sophisticated maths: fixable deficiencies or inherent limitations?
4. Has financial innovation been socially useful?
5. Does market discipline work?

Exhibit 1.27: Composite Time Series of Select Financial Firms' CDS and share prices



Firms included: Ambac, Aviva, Banco Santander, Barclays, Berkshire Hathaway, Bradford & Bingley, Citigroup, Deutsche Bank, Fortis, HBOS, Lehman Brothers, Merrill Lynch, Morgan Stanley, National Australia Bank, Royal Bank of Scotland and UBS

CDS series peaks at 6.54% in September 2008.

Source: Moody's KMV, FSA calculations

Recommendations

1. Fundamental changes in capital, liquidity and published accounts
2. Institutional and geographic coverage: economic substance not legal form
3. Other important changes: credit ratings, remuneration and counterparty risks
4. Macro-prudential analysis and the need for intellectual challenge
5. A new FSA approach to supervision: more intrusive and more systemic
6. Governance and risk management: firm responsibilities and structures
7. "Narrow banking" versus "investment banking": major constraints but not complete separation?
8. Cross-border banks: more international cooperation <u>and</u> more national powers

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Capital, accounting and liquidity

- Increase the quantity and quality of overall bank capital
- Major changes to trading book capital
- Made the banking system a shock absorber not a shock amplifier
  - Avoid procyclicality in Basel 2 implementation
  - Create countercyclical capital buffers
- Anticipate future likely losses in published accounts
- Introduce a gross leverage ratio backstop
- Major intensification of liquidity regulation and supervision

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Exhibit 2.9: The conventional wisdom – 2006

"There is growing recognition that the dispersion of credit risk by banks to a broader and more diverse group of investors, rather than warehousing such risk on their balance sheets, has helped make the banking and overall financial system more resilient.

The improved resilience may be seen in fewer bank failures and more consistent credit provision. Consequently the commercial banks may be less vulnerable today to credit or economic shocks"

IMF Global Financial Stability Report, April 2006

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“Narrow Banking” vs “Investment Banking”

Proposition: Distinguish

- Narrow banking – classic retail and commercial banking: regulated, insured
- Investment banking – risky trading activities: unregulated, unsupported in crisis

Complication

- Pure investment banking firms still systemically important (Bear Sterns)
- Undiversified narrow banks can be risky: Northern Rock, Indy Mac, WAMU
- Global economy needs complex global finance capabilities

Way forward

- Not complete separation
- But capital and liquidity policy constraints on risky activity
- Commercial banks focused on serving customer needs

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European Union level regulatory body

EU institution replacing existing level 3 Committees

Regulation: technical rule-making

- Drafting of detailed technical rules
- Advice to Commission on Directive texts
- Non-binding guidance to Member States and industry on best practice implementation

Supervision: Oversight of national supervisors

- Oversight of European colleges of supervisors
- Peer reviews of supervisory approaches: best practice guidance on "comply or explain" basis

International and macro-prudential

- European representation alongside Member States on international bodies
- Role in European macro-prudential analysis, alongside ECSB

Wider issues – open questions

Product regulation?

- Retail e.g. mortgages
- Wholesale e.g. CDS

Other countercyclical tools?

Balancing liquidity versus financial stability concerns