



Key Contact

Ben Blackett-Ord
bblackett-ord@bovill.com

“... firms with trading books can expect to be hit hard...”

London office

82 Blackfriars Road
London
SE1 8HA

Phone: 020 7620 8440
Web: www.bovill.com

THE TURNER REVIEW: WHAT IT MEANS FOR INVESTMENT FIRMS

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Overview

In his introduction Lord Turner states that the review's focus “is on banking and bank-like institutions, and not on other areas of the financial services industry”. However, it is clear from the review that certain types of investment firm can be regarded as “bank-like” and that there will be implications for investment firms more widely. This Briefing Note attempts to assess the implications for investment firms.

Bank-like

The main thrust of The Turner Review is on commercial and investment banks and in particular on the major banking groups. The focus is wider than simply deposit taking institutions, indeed the scale and complexity of the trading activities of investment banks (entities that are in many cases not regulated as banks) are cited as being among the causes of the current crisis. Further, it is Lord Turner's view that regulatory and supervisory coverage should follow the principle of economic substance and not legal form: “bank-like” institutions need to be regulated the same way as banks. A key outcome of the review is the intention to significantly increase the capital required against trading book activities. Whilst the existence of a trading book might not, of itself, be enough to make a firm “bank-like” it might be a significant contributing factor.

A comment made later in the report on the subject of remuneration policies is telling: “The major increases in capital required against trading book activity...are likely to play a much more significant role in reducing the aggregate scale of trading activity, and so reduce the aggregate remuneration of people involved in those activities, than any policies designed directly to influence remuneration”. So the first point to bear in mind is that firms with trading books can expect to be hit hard.

Hedge Fund-like

On the face of it a hedge fund is not much like a bank. However, their trading activities can be considered similar to the proprietary trading activities of investment banks, as perhaps can the activities of other types of unregulated fund. Whilst UK based hedge fund managers are FSA regulated the funds themselves, like other types of offshore fund, are not. Going forward the FSA aim to gather much more extensive information on hedge funds from the regulated entities with which they interact, in particular the fund managers and prime brokers. Given that there is no agreed definition of a hedge fund the scope of this proposed indirect regulation remains unclear. However, proprietary trading activities conducted through unregulated entities may find themselves being treated as hedge fund like.

The review also states that “regulators need the power to apply appropriate prudential regulation to hedge funds or any other category of investment intermediary, if at any time they judge that the activities have become bank like in nature or systemic in importance”. The implications of this potentially far reaching statement will not be apparent for some time as such a position would probably require changes to UK, if not EU, legislation.

“...supervision will be more intrusive and more systemic..”

Manchester office

Barnett House
53 Fountain Street
Manchester M2 2AN

Phone: 0161 247 8562
Web: www.bovill.com

Branches of EU and other non-UK institutions

The current crisis has highlighted deficiencies in the cross border passporting system as it applies to banks. The failure of Landsbanki illustrated that existing single market rules can create unacceptable risks where for example there is an imbalance between the regulatory powers that can be brought to bear by a host state and the perceived risks, whether to depositors or systemic, created by a branch presence in the state concerned. Whilst all EU banks are subject to the Capital Requirements Directive, it is not that directive that provides passporting rights but the Banking Co-ordination directive for commercial banks and the Markets in Financial Instruments Directive for investment banks, fund management houses and other types of investment firm. Since for many firms the principal benefit of the EU financial services directives is the ability to passport, the charge that the regime has failed to provide an appropriate level of local regulation of incoming branches is a serious one. It is against this backdrop that Lord Turner is proposing the creation of an EU regulator with powers to make rules and oversee the activities of national supervisors. The unpalatable alternative is increased national powers in respect of incoming institutions and the consequent erosion of one of the key principles underpinning a single market in financial services.

Implementation and Supervision

The FSA is not in a position to implement all of Lord Turner's recommendations of its own volition. In a number of areas changes will be required to UK legislation, EU directives and in some cases with wider international agreement. That said, the way in which the FSA will be moving has been mapped out and a number of steps can be taken. So what should investment firms expect ?

Under the FSA's existing Supervisory Enhancement Programme supervision generally is to be more intrusive and more systemic with increased focus on business models, strategies, risks and outcomes rather than primarily on systems and processes. This will particularly be the case with high impact firms. For Approved Persons the focus will be increasingly on technical skills as well as probity. More information requests can also be expected in relation both to key risks and to relationships with perceived bank like entities such as hedge funds. Supervisory focus can also be expected on remuneration policies and the extent to which such policies can create incentives for inappropriate risk taking.

Pending any changes in UK or EU legislation, or internationally, the FSA can be expected to pursue its new agenda through its existing tools, not least the ARROW process and the powers that it has in relation to Pillar 2 capital requirements. Branches of both EU firms and others can expect increased supervision to the extent permitted, particularly in areas where an imbalance between local regulatory oversight and risk is deemed to occur.

Conclusion

Many smaller investment firms will not notice much change in the way they are regulated. However, there will be a significant number of firms whose activities, or the activities of those that they interact with, will put them on a higher regulatory trajectory. These are likely to include, in particular, firms with trading books and those that provide services to hedge funds and other unregulated entities capable of creating systemic risk. They are likely to experience more intrusive regulation with the balance between prudential and conduct of business regulation shifting in favour of the former.