The new financial stability objective – macro-prudential regulation and oversight of the financial system as a whole

Avoiding another financial crisis – the new imperative

The recent crisis highlighted fundamental weaknesses in the private sector financial system, as well as the regime for regulating financial institutions and in economic policies - at both a national and a global level.

The new imperative is for 'financial stability'; the policy debate on how to achieve this goal divides into two areas:

- Macro-economic policy; and
- Macro-prudential oversight.

The former is the preserve of economists; there is much discussion of boom and bust, excessive credit supply and then a dearth of credit, imbalances and the need for tough government action to 'remove the punch bowl' just when everyone is enjoying the party boom. This report will, however, focus on the issues more directly relevant to the prudential regulation of financial institutions.

New institutions and new roles

Internationally the Financial Services Board ('**FSB'**) has taken the lead in reporting to the G20 on macro-prudential issues, but many of the other international bodies are also involved, including the IMF.

At a European level, the European Systemic Risk Board ('**ESRB**') has been established. This is an independent body responsible for conducting macro-prudential oversight of the EU's financial system as a whole and is supported by the ECB.

In the UK, there will be legislation to establish a powerful new macro-prudential authority – the Financial Policy Committee of the Bank of England (**'FPC'**) (which will operate alongside the existing Monetary Policy Committee). Unlike the FSB and ESRB, the FPC will have wide-ranging powers including the ability to require the new regulators – the Prudential Regulatory Authority ('**PRA**') and the Consumer Protection and Markets Authority ('**CPMA**') – to impose additional regulatory requirements on firms.

Click here or see section 3 for a chart of the new international European and UK institutions and their roles.

New objectives

In the UK, the FPC's primary (and possibly its sole) objective will be 'financial stability'. There appears to be no plan to define 'financial stability'; clearly the recent crisis was an extreme case of financial instability with some parts of the financial system on the brink of collapse and the threat of major contagion leading to a broad system melt down. This was avoided by state intervention (to support and, in some cases, to rescue institutions) but this did not avoid a major adverse impact on the 'real economy'. The financial system is seen as having had a malign impact - contributing to or causing a real economy recession, rather than acting, as one might have hoped, as a benign dampener absorbing shocks from the real economy and helping to avoid a severe recession.

The broad idea is that the crisis could have been avoided if the authorities had paid more attention, not only to restraining growth to prevent the economy overheating, but also in overseeing the financial system as a whole. They should have noticed and taken action to address structural weaknesses in the financial system and to stress test the robustness of the system as a whole and its ability to survive adverse shocks.

The expression 'macro-prudential' is used to define an area of policy in pursuit of the overall goal of financial stability; it therefore focuses on the powers/tools to be used to maintain financial stability (or more realistically to reduce the risk of instability). Alongside macro-economic measures (designed to achieve macro-economic stability), the policy aims to improve the overall resilience of the financial system by addressing aggregate risks and vulnerabilities across the system that have the potential to threaten stability. Part of this role is concerned with identifying and measuring risk; the Bank of

England is already doing this is in a limited way with its Financial Stability Reports which are published twice a year[1]. The big difference is that this work will be much broader and deeper, and critically that the FPC will have the powers to implement macro-prudential policy measures (which the Bank of England lacks at present).

To assist national governments and regulators in developing policies that are consistent and mutually reinforcing, the FSB has set out some policy recommendations comprising the following principles:

- Actions that seek to ensure that firms can be resolved safely, quickly and without destabilising the financial system and exposing the taxpayer to the risk of loss;

- The capacity for national authorities to impose, when necessary, supplementary prudential requirements on institutions and/or structural constraints that reflect the greater risks they pose to the financial system;

- More effective supervisory oversight for institutions which may pose systemic risk;

- Robust core financial market infrastructures to reduce contagion risk from the failure of individual firm; and

- A process that provides assurance that all countries have established effective policies to reduce moral hazard risk that are consistent and mutually reinforcing.[2]

New powers and tools

The FSB is largely concerned with policy work and has no direct powers; it relies on other bodies and national governments and central banks to pursue its findings.

The ESRB is mainly concerned with systemic risk analysis and stress testing; it will generally issue warnings and recommendations rather than having any direct legislative powers. It will, however, be an important forum for agreeing macro-prudential measures for the EU and will provide macro-prudential input to the new European Supervisory Authorities ('**ESAs'**). For more information about the ESAs and new European System of Financial Supervision, click here.

The FPC, however, will be given broad macro-prudential powers and a range of tools to implement macro-prudential policy with measures aimed at reducing identified risks. One of the key 'levers' is the imposition of additional financial regulation on regulated firms (such as cyclical capital buffers – see below). The FPC will thereafter have the power to require the PRA (and the CPMA) - which will be responsible for so-called micro-prudential regulation (i.e. the regulation of individual banks, insurers etc.) - to adopt requirements and rules applicable to regulated firms.

There is scope for considerable confusion between macro-prudential and micro-prudential measures; the end result will be that some rules and requirements applicable to firms will have a more direct connection with macro-prudential policy and policymakers. Although the FPC is still to be established, some of these requirements are already in the Basel III pipeline and have been debated by the FSA alongside other additional micro-prudential driven changes such as improved liquidity regulation. The dividing line between pure 'micro-prudential' rules and those derived from macro-prudential policy is far from clear.

The FPC will also have to have a range of other powers to deal with the areas listed above and below; these will be set out in secondary legislation so that new powers can be added as and when necessary.

Current areas of macro-prudential reform and policy debate

The current key areas of macro-prudential reform which are being debated can be grouped under the following headings which are each considered below:

- Additional financial regulation for firms;

- Additional regulation of Systemically Important Financial Institutions ('**SIFIs'**) and restricting the universal bank model;

- Addressing financial institution stress and resolution; and

- Strengthening core financial market infrastructure;

[1] For the latest financial stability report, please see: http://www.bankofengland.co.uk/publications/fsr/2010/fsr27.htm
[2] For the FSB interim report outlining these principles, please see: http://www.financialstabilityboard.org/publications/r_100627b.pdf

Additional financial regulation for firms

This is a key macro-prudential tool. The policy debate in this area is still only just starting but there is already quite a 'shopping list' for the FPC. The 2010 HM Treasury consultation[3] highlighted potential FPC powers to:

- Impose **system-wide** cyclical capital requirements to reduce capital buffers required in a crisis and to be correspondingly tougher in good times;
- Alter risk weights by forcing banks to hold more capital against specific classes of assets if the regulatory authorities feel that exposure to that asset class is too great;
- Set leverage limits to function as a backstop against excessive lending where there are concerns that could not easily be addressed through changing risk weights;
- Force banks to instigate forward-looking loss provisioning through set-aside provisions in order to prepare for future losses when lending is growing quickly;
- Set limits on borrowing, for example through the imposition of haircuts on repurchase transactions for investment banks; and
- Set limits on lending through various regulatory mechanisms.

These tools were also considered in a speech in August 2010 by Charles Bean, Bank of England Deputy Governor for Monetary Policy[4] who talked about pro-cyclical capital buffers and increasing risk weightings, as well as:

- Varying margin requirements as a means of addressing vulnerabilities in the capital markets; and
- Introducing direct constraints on the terms or availability of credit, such as imposing maximum loan-to-value ratios in the mortgage market.

On an international level, the proposals outlined in the December 2009 consultation paper[5] by the Basel Committee on Banking Supervision ('**BCBS**') incorporate policy relating to many of the areas outlined by HM Treasury. The consultation paper (which proposed the new Basel III framework) is intended to strengthen global regulation of banks' capital and liquidity. For more analysis of the Basel III regime (including the full micro-prudential changes) on banks' liquidity and capital, please click here. For analysis of the reform of accounting, stress testing, securitisation and credit rating, please click here.

Additional regulation of Systemically Important Financial Institutions ('**SIFIs**') and restricting the universal bank model

The financial crisis exposed weaknesses in several areas which had previously been 'taboo' subjects; the regulators have now been forced to look into these black holes and are starting to wrestle with some very difficult issues which have been long avoided, including:

- The implicit state guarantee of the financial system and of at least some of its (private sector) firms;
- The recognition that the failure of some firms posed an unacceptable risk of contagion to the broader financial system or of retail depositor flight; and
- The question of how to reduce the risk of failing institutions threatening the system and effectively calling on the state guarantee.

One response has been to look at additional regulation of what have become known as Systemically Important Financial Institutions or SIFIs including those that might fall within the 'too big to fail' catch phrase. The first question the authorities asked was how they would evaluate whether a firm was a SIFI – what criteria should be used?

Defining a SIFI

At the UK level, the FSA Summary of Feedback on Discussion Paper DP09/4 (FS10/2) ('**FS10/2**'), published in June 2010[6], indicates that there is still no consensus about the way in which a SIFI should be defined. The FSA had proposed three

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[3] To view the consultation paper, please see: http://www.hm-treasury.gov.uk/consult_financial_regulation.htm
[4] For the full version of this speech, please see: http://www.bankofengland.co.uk/publications/speeches/2010/speech444.pdf
[5] For the BCBS consultation paper, please see: http://www.bis.org/publ/bcbs164.htm
[6] For the full version of FS10/2, please see: Summary of feedback to the Turner Review Conference Discussion Paper (DP09/4)

factors judged in the context of the impact of a bank failing– size (including a bank whose retail deposits would, if the bank failed, strain the resources of the deposit protection scheme), inter-connectedness (such as the impact of failure on confidence, assets margins and interbank exposures i.e. a potential domino effect) and even the notion that a small firm might, with other similar firms, be 'systemic as a herd'. The majority of respondents agreed that there should not be a SIFI threshold, rather that there should be a scale of systemic importance.

The issue of SIFI definition is also being discussed at an international level, with the FSB taking the leading role. In its June 2010 interim report to G20 leaders[7], the FSB also recognised the importance of a graduated approach to SIFIs based on the risk that they pose to the financial system.

The G20 summit in November 2010 saw the birth of G-SIFIs or Globally Systemically Important Financial Institutions. These are "firms whose disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity". The emphasis here is not only on large assets and liabilities but also on the international nature of the firm, hence the inclusion in Britain's G-SIFI list of Standard Chartered, alongside Barclays, HSBC and RBS. It seems that we may end up with a graduated approach with G-SIFIs (whose failure could have a serious detrimental effect on the global financial system) and national SIFIs (whose demise could threaten the national financial system); the next question may be whether there are any firms (not on the G-SIFI list) that might threaten the European, or Eurozone, financial system – might we see an E-SIFI list?

Can non-banks be SIFIs - will insurers be caught? It is not clear from FS10/2 whether the FSA will seek to include insurers under the SIFI umbrella. FS10/2 merely notes that there was no consensus amongst respondents about this issue; some respondents believed that insurers were not a source of systemic risk due to the illiquid nature of their liabilities, whereas others believed that a major reinsurer could be a SIFI, as if it were to fail it would affect all of the insurers that had reinsured their risk with that reinsurer. There is also no common view internationally; the President of the European Central Bank in November 2009 indicated his belief that insurers could be a significant cause of systemic risk[8], whereas this view has been challenged by the International Association of Insurance Supervisors[9]. For more analysis of the debate about the systemic importance of insurers, click here.

Regulating SIFIs

There is still much work to be done on the definition of SIFIs and G-SIFIs and the formulation of the regulatory regime for these firms. However, the basic principle is more intrusive supervision and more demanding regulation.

FS10/2 indicated that the FSA believes that there is a strong case for applying capital, and possibly liquidity, surcharges to SIFIs, which could be calculated as a continuous and increasing function of measuring systemic importance. The Turner Review has also discussed a greater focus on standalone national subsidiaries of SIFIs, actions to reduce bank inter-connectedness in trading markets, the separation of 'narrow banking' from proprietary trading and recovery and resolution plans (which are dealt with more fully below).

Internationally, the FSB's interim report suggested that all jurisdictions should have in place a policy framework to deal with SIFIs including effective resolution tools that enable the authorities to resolve financial firms without systemic disruptions and without taxpayer losses. The FSB expressly states that they would expect these tools to include a 'going concern' capital and liability restructuring as well as a 'gone concern' restructuring and wind-down measures, including the establishment of a temporary bridge bank to take over and continue operating certain essential functions (see 'Recovery and resolution' planning below).

The FSB interim report seems to pass responsibility for the details of SIFI regulation primarily back to national regulators, but does recommend that FSB members establish an ongoing peer review process to promote national policies to address the risks associated with SIFIs and also to create systems which are 'consistent and mutually supportive'. Following recommendations from the FSB, the G20 conference leaders outlined an agreement which proposes to deal with the danger posed to the global financial system by 'G-SIFIs' which will require national regulators and supervisors to adopt a hard line approach and will require firms to have a higher proportion of loss absorbing equity.

The 'universal bank model' versus 'narrow banking'

In the UK there has been much discussion about the catch phrase 'casino banking' (including a Parliamentary Committee report) – the idea that banks had risked retail depositors money by speculative proprietary trading. Within the coalition government, there are some who seem to favour radical reform which would involve breaking up UK banks which operate on a universal model to separate retail deposit taking from trading and other risky activities. The options were considered by FSA in DP09/4 including the feasibility of so-called the 'narrow banking' model.

This issue – along with other thorny issues considered above and below – is now being considered in the UK by an 'Independent Commission on Banking'- chaired by Sir John Vickers (former Chief Economist at the Bank of England and former Chairman of the OFT) - which will report to the Cabinet Committee on Banking by September 2011. The

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[7] For the interim report, please see: http://www.financialstabilityboard.org/publications/r_100627b.pdf

[8] For the full version of the speech, please see: http://www.ecb.de/press/key/date/2009/html/sp091118.en.html

[9] For the IAIS report, please see: http://www.iaisweb.org/__temp/IAIS_Position_Statement_on_Key_Financial_Stability_Issues.pdf

Independent Commission's terms of reference[10] are very vague and wide-ranging covering macroprudential regulation and competition in the banking sector; the breadth of the terms of reference essentially serves to encourage the Committee to continue the debate undertaken by the Turner Review, the FSA, BoE, TSC and the OFT at a domestic level, and the FSB and the EU internationally. In its Call for Evidence published in September 2010,[11] the Independent Commission outlined the various options for reform including the separation of retail and investment banking, and narrow banking (where retail deposits are 100% backed by safe, liquid assets and which have public deposit insurance).

In addition to looking at potential structural reforms, the Commission is also going to consider various non-structural reforms to regulation but it is uncertain where to draw the line. For example, it envisages a review of the 'living wills' (or Recovery and Resolution Planning) regime, but does not intend to look at the reform of deposit insurance. There is no obvious basis for the Commission to decide how widely to cast its net; indeed the question of whether structural reform is needed, and the form of any such change, may well depend on the effectiveness of new or reformed non-structural measures; effective deposit insurance may well be an important part of the new regime.

It seems unlikely that the Commission can really resolve many of the issues – both structural and non-structural. Many of the potential reforms could probably not be implemented by the UK without some international consensus. UK bank regulation is part of the EU single market regime, which is moving towards even closer integration; the UK would find it very difficult to introduce major structural reforms on its own without EU legislation.

Some commentators see the establishment of the Commission as a way of kicking contentious political hot potatoes, on which there are clearly conflicting views within the coalition, into touch until the new UK, EU and international framework is in place.

On the competition side, the Commission will draw on the OFT's current work in the banking sector. In 2010 the OFT launched a market study on retail banking (click here to read our Law-Now report). The OFT has also launched a review on investment banking (click here to read our Law-Now report).

The US Approach In the US, the new Dodd-Frank Act includes restrictions on proprietary trading under the so-called Volcker rule.

Addressing financial institution stress and resolution

Stress testing and reverse stress testing

The FSA has stated[12] that it expects firms (whether or not they are SIFIs) to engage in dry runs and regular stress and scenario testing that assesses their ability to meet capital and liquidity requirements in stressed conditions. It is also introducing a reverse stress test regime which requires firms to identify events that might cause them to fail and then to work backwards/reverse engineer to take steps mitigate these risks For further information about the requirements on financial institutions to undertake stress testing and reverse stress testing, please click here.

Recovery and resolution planning

In the UK (although discussions on this theme are also taking place at both EU[13] and international level[14]), one of the big 'new ideas' is a requirement on financial institutions to establish and operate Recovery and Resolution Plans ('**RRPs'**). For UK firms, these so-called 'Living Wills' will be subject to a new regime already established by the Financial Services Act. FSA/PRA will set the procedure and rules designed to ensure that in the event of market stress, firms have processes in place to facilitate recovery. In the event that this recovery plan becomes unviable, the authorities will implement the resolution plan: a contingency planning exercise designed to ensure that the firm can be efficiently wound down or, in the new language of this burgeoning area of regulation, 'resolved' as 'a gone concern' in a manner that protects consumers and avoids wider market disturbance.

[10] The terms of reference refer to formulating policy recommendations with a view to:
- Reducing systemic risk in the banking sector;
- Exploring the risks posed by banks of different size, scale and function;
- Mitigating moral hazard in the banking system;
- Reducing both the likelihood and impact of firm failure; and
- Promoting competition in both retail and investment banking with a view to ensuring that the needs of banks' customers and clients are efficiently served, and in particular considering the extent to which large banks gain competitive advantage from being perceived as 'too big to fail'.

To view the terms of reference, please click here: http://www.hm-treasury.gov.uk/d/banking_commission_terms_of_reference.pdf

[11] For the full version of the Call for Evidence Issues paper, please see: http://bankingcommission.independent.gov.uk/bankingcommission/wp-content/uploads/2010/07/Issues-Paper-24-September-2010.pdf

[12] For the FSA policy statement, please see: http://www.fsa.gov.uk/pubs/policy/ps09_20.pdf

[13] In the EU, formal legislative proposals on RRPs have not yet been put forward. Before proposing legislation the EU intends to set up Cross Border Stability Groups, which would develop international standards for the preparation of RRPs for systemically important financial institutions by the end of 2010.

[14] For the Basel Committee's recommendation, please see: http://www.bis.org/press/p100318.htm

Clues from the FSA[15] hint that living wills legislation is set to impact drastically on the financial sector. The minister at the time of the new Act referred to living wills as 'one of the most radical proposals in global financial reform in a century'. Political posturing aside, the question remains, what does the new world of living wills really means for the industry? Already we know that all deposit takers, including all banks and building societies are likely to have to draft RRPs. The global pilot was launched last year and includes six of the major insurance groups (as well as major banking groups such as HSBC and Barclays). In non-bank sectors, the more onerous living wills process is likely to be extended further, possibly under the guise of a firm's systemic importance or PRA regulation. For example, life offices and general insurers (at least the larger ones) are in the regulators sights. Non-bank investment firms will also be caught but the precise scope of each of the new requirements (and the rules themselves) will be subject to consultation in 2011.

Living wills have two potentially onerous and costly roles. The first is a vast exercise in contingency planning. Although recovery plans will be scrutinised by regulators and be subject to their approval, firms will have considerable control over them and be responsible for tackling the host of legal and compliance issues which arise. Due diligence will be required on all the potential difficulties, such as legal barriers from the group structure or negative pledges in contracts, that might impede rapid execution of the plan.

In contrast, the resolution plan will belong to the authorities - who will be responsible for deciding how to effect resolution if failure occurs. The role of the firm here is to examine how resolution options might play out and to be ready to deliver the data and other resources that those involved in the resolution will require.

Firms will be expected to maintain a host of up-to-date business and financial information and data sets (possibly in permanent data rooms) in a form that meets FSA standards. This will include information on the group's legal, operational and business structure and much more besides. RRPs are therefore likely to transform the way in which client and other data is stored. The so-called 'Single Customer View' was announced by FSA in 2009. From the end of 2010, banks must be able to deliver data sets giving the FSCS insured balance for each individual customer across all the different brands of that bank entity.

Removing impediments to resolution may include a requirement to 'insolvency proof' their contracts with key staff and service suppliers, so that an administrator will not lose these resources as soon as he is appointed. A special reserve may be needed to fund the costs of these contracts during the administration. There will be an increased emphasis on internal policemen within financial institutions. For the purpose of establishing and implementing living wills, a new board-level role is planned. The business resolution officer, a sort of in-house funeral director, will be responsible for on-going compliance with the new requirements. This includes the need for management to consider how changes, such as acquisitions, will impact their RRPs. Not only will plans have to be updated; in some cases the potential impact on resolution may prevent the deal taking place at all.

On one level, living wills are a contingency planning exercise on a very grand scale. However, this new regulatory tool has another potentially even more revolutionary role. RRPs are a logical extension of stress testing in that they plan for the contingencies not covered by the stress-testing assumptions. This switch to disaster-mode thinking links to the broader reappraisal of capital and liquidity standards, and the impact of the increased role of contingent capital. The authorities are only just starting to get to grips with many of the lessons from the crisis that fall within the new mantras of macro-prudential regulation and systemic risk. To help them, the authorities will have access to a mass of new information derived from firm and industry level stress testing and the new requirements for reverse stress testing 'back from failure'.

The question is what good this will do. How will the information be used? The living wills process provides an ideal opportunity for regulators to address many of these macro-prudential mechanism brain teaser problems above: the belief that institutions have become, and in future must be prevented from being, too big or complex or inter-connected to fail. The RRP process provides the tool for the regulator to probe these issues without having to devise hard-edged and highly controversial Volcker style rules.

This may be the regulators' instrument of choice because it puts the onus back on each financial institution to prove that it can fail without taxpayers' money or broader contagion being at risk. The Bank of England has stated that in assessing RRPs, regulators must consider whether 'with this structure and business model can I [the resolution authority] achieve a resolution at an acceptable cost' - essentially, would the consequences of an institution failing be so uncertain or dangerous that the authorities might have to mount a rescue with taxpayers' money?

Armed with this mass of new information, the authorities can challenge each firm according to this criteria, looking at issues such as at its business models, structure, scale and risk. From its draft living will, an institution may be judged by the new 'bad cop' FSA to pose too great a risk, on account of its size, complexity or its role within the financial system. In retail sectors, an institution may be challenged if its failure threatens potentially large uninsured consumer losses. As the authorities learned in the recent crisis, financial stability concerns, as well as political pressure, can dictate that the government rescues a failing firm rather than enforcing the principle of moral hazard against the consumer.

For more information about the developments in this area, please click here.

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[15] A speech in February 2010 by Thomas F. Huertas, Director, Banking Sector, FSA and Vice Chairman, CEBS discussed the ways in which living wills might be implemented. For the full version of the speech, please see:
http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2010/0212_th.shtml

It has also been reported that the FSB is considering protective measures such as '**bail-in**' plans, in the event of failure. Such plans may give regulators the power to convert all or part of creditors' hybrid holdings into common stock, which would reduce a bank's debts and build its core capital base to bolster the bank's capital position and perhaps the sector as a whole. For further information about bail-ins, please click here.

Another area in need of urgent reform is **deposit protection**. Current FSCS insurance was inadequate when tested in the crisis. The capacity and coverage of deposit protection and its funding has been debated. It seems clear that some element of pre-funding will be introduced (although it will take time to build the necessary reserves); there are many unresolved issues such as the size of the fund, how it would be invested/deployed, the basis for contributions and whether schemes should operate be at a national or EU level. Perhaps the most difficult question is to what extent a scheme or fund can realistically insure the deposits of large banks; the FSCS unfunded capacity was wholly inadequate and it is difficult to know what capacity might be required if the largest banks are really to be allowed to fail in the next crisis. To read more about the likely changes and reforms in this area, please click here.

Dealing with failures

Following the crisis, the UK adopted a modern resolution regime for banks and deposit takers; the special resolution regime provides the authorities with four key tools:

- The power to direct and accelerate a transfer of part or all of a failing bank's business to a private sector purchaser;
- The power to take control of part or all of a failing bank's business through a bridge bank owned and controlled by the Bank of England;
- The power to place a failing bank into temporary public ownership; and
- A modified bank insolvency procedure to close a failing bank and facilitate fast and orderly payout of depositors' claims under the FSCS or transfer of their insured deposits to a healthy private sector bank.

The FSB and others have considered the difficulties of resolving international banks operating in several/many countries; the lack of modern resolution regimes in many countries and the huge scope for conflict between national resolution/winding up laws are currently major problems which contribute to systemic risk. The Bank of England published a paper in July 2009 on the UK special resolution regime in an international context[16].

Strengthening core financial market infrastructure

Following the Lehman's collapse, the FSB is working on reducing contagion risks if failure does occur, through a strengthening of the core financial market infrastructure. The FSB[17] has indicated that it will be developing recommendations to make clearing requirements more consistent across all G20 jurisdictions, and will issue recommendations to assist in standardisation of contracts. These recommendations are expected in the next report of the FSB towards the end of this year. The IMF also discussed these ideas in its Global Financial Stability Report in April this year[18].

OTC Derivatives Reform in the EU – centralised clearing, standardised contracts and higher capital requirements. The EU is already developing its proposals alongside the FSB work. To read about the proposed EU measures and their impact on firms, please click here.

The impact on regulated firms

These are very early days in the development of macro-prudential policy; no one knows what may eventually emerge from this new 'black box' and the dark arts of macro-economists. Most of the current measures are a direct response to the recent crisis; but we can expect more wide-ranging ideas to emerge. So macro-prudential regulation creates considerable uncertainty about the shape of future regulation.

In the more immediate future, firms need to prepare for some very significant new layers of regulation:

- Potentially significant firms face SIFI classification (perhaps on a variable scale) and a new regulatory regime with additional requirements;

[16] For the Bank of England's special resolutions regimes paper, please see: http://www.bankofengland.co.uk/publications/fsr/fs_paper05.pdf

[17] The direction that the FSB will be working towards in relation to macro-prudential reform was laid out in an interim report produced for the G20 leaders before the Toronto Summit in June of 2010. For the full version of the FSB report, please see: http://www.financialstabilityboard.org/publications/r_100627b.pdf

[18] To view the report, please see: http://www.imf.org/external/pubs/ft/gfsr/2010/01/index.htm

- SIFIs and other deposit-takers and twin-peaks/PRA regulated firms face the prospect of regulation by the Recover and Resolution planning process. The FSA will consult on this in 2011.Click here for more information about living wills;

- The focus on 'universal stress testing' will continue with ever more focus on the risk and consequences of firms failing or getting into difficulty. Capital, liquidity, contingent capital, bail-ins, deposit protection Volcker-type rules, and so on, will all be factored into stress testing across the industry and at a firm level. Firms face a heavy burden both in participating in these exercises and in demonstrating a sufficiently robust position to satisfy a variety of agencies with very risk-adverse objectives and priorities;

- There will be continuing development and change to market infrastructure as the authorities study systemic risk; the first impacts are already being felt with the drive to reduce risk in OTC derivatives markets. Click here for more information;

- There will be ever more burdensome and complicated arrangements to try to deal with financial institutions operating on an international basis. There are many areas (such as cross border resolution) where the risks and problems have been identified but simple solutions are proving more difficult to agree; and

- The UK Banking Commission could produce some very unwelcome and restrictive macro-prudential measures. Firms hope that the UK will hold back from radical reforms unless and until they have international consensus, particularly within the EU.

The timetable

See 'Demise of FSA – the new regulatory regime for financial institutions' for more information on the timetable for UK financial regulation reform.

- The FSA will consult on its Recovery and Resolution requirements in 2011

- The Independent Commission on Banking's report is expected in 2011, in preparation for the lead up to the unwinding of the FSA, which should be completed by 2012.