COUNCIL of MORTGAGE LENDERS

Consultation on financial stability and depositor protection: strengthening the framework

Response by the Council of Mortgage Lenders

to the Tripartite

23 April 2008

Introduction

1. The Council of Mortgage Lenders (CML) welcomes the opportunity to respond to the joint HM Treasury, Bank of England and Financial Services Authority (FSA) consultation on financial stability and depositor protection.

2. The CML is the representative trade body for the residential mortgage lending industry. Its 157 members currently lend over 98% of the residential mortgages in the UK mortgage market.

Overview

Background to the current financial turmoil

3. The events we have witnessed in global debt capital markets since early August have been exceptional. A widespread reassessment of the compensation investors require for bearing risk has followed unexpectedly severe credit losses in the US sub-prime mortgage market. Most US sub-prime loans are packaged into residential mortgage backed securities (RMBS) and sold to investors across the globe, often being repackaged into other investments such as collateralised debt obligations (CDOs). Although this process can disperse risk, it turned out that some investors, including banks, had unexpectedly large exposures.

4. As a result of the emergence of these unexpected losses, the US sub-prime crisis has knocked investors' confidence both in structured finance as a funding instrument and in the leveraged entities that have exposure to structured credit markets or mortgage assets (banks, hedge funds, structured investment vehicles etc.). The loss of investor confidence has gone beyond the US because of concerns about structured finance in general, concerns about the exposure of non-US entities to US sub-prime securities and concerns that some of the problems afflicting the US mortgage market could also apply elsewhere with a lag. There is also a vicious circle at work whereby banks' (we generally use the term banks as shorthand for banks, building societies and other deposit taking institutions) inability to access wholesale funding increases investors' concern about those institutions, which in turn limits their access to wholesale funding.

5. UK mortgage lenders (meaning all those authorised by the FSA for mortgage lending including banks, building societies and non deposit taking lenders) no longer have access to funding through the international capital markets on the terms that previously prevailed. For

many lenders wholesale funds are no longer available at all and for others the price remains, at least for the time being, prohibitive. The extent to which this investor ‘strike’ goes beyond structured finance markets can be seen in the difficulties UK issuers have faced in the covered bond and senior debt markets. The lack of issuance of UK covered bonds, which are arguably the safest instrument for investors given that they combine a claim on the issuing lender and on a pool of ring-fenced assets, illustrates the severity of the funding freeze.

6. The funding shortage is driving a forced deleveraging process in the wholesale financial system which, in the absence of more proactive intervention from the authorities, will be painful and protracted. It is incumbent upon policymakers to help to manage this process to ensure that the integrity of the financial system is maintained and we support the action taken to date by the Bank of England to bolster market liquidity.

7. Given the pivotal role of lending in the economy, the difficulties that lenders are facing in accessing sufficient funding also threatens serious consequences for the real economy. It is already clear that the household sector is now undergoing a forced deleveraging process that mirrors that of the financial sector. The shrinkage of credit availability to households is likely to lead to a rapid readjustment of consumers’ expectations about their financial outlook through its impact on housing wealth and the labour market. In particular the impact on the housing market of a prolonged period of constrained lending could have serious knock-on effects on consumer sentiment and thus expenditure. As consumer spending is the main engine of growth, this has the potential to slow economic growth significantly with potential consequences for the corporate sector. The authorities need to remain mindful of the potential strength of these ripple effects.

8. The emergence of stresses in the US sub-prime market followed an exceptionally long period of economic stability and growth in the world economy. The benign economic conditions of the preceding decade were characterised not only by high growth rates but also by low inflation and low real and nominal interest rates. These conditions favoured the accumulation of debt and consequently the economy has seen the emergence of corporate models built on leverage such as private equity and hedge funds. While policymakers and others may look for scapegoats in the form of expansionist lenders, credit rating agencies or the structured finance markets, they should not overlook the fact that, above all else, we are experiencing a cyclical adjustment following a period of exceptionally positive expectations.

The right policy focus

9. In responding to the consultation, the CML’s main purpose is to address the issues relating to financial stability. We wish to address the issue of how we can avoid bank failures and maintain a stable financial system rather than how to deal with failed banks. The history of banking crises provides one over-riding lesson to policymakers: the longer they wait to intervene once intervention is required, the more expensive that intervention ultimately proves. The Bank of England should always be mindful of this lesson as a counterweight to its focus on minimising the moral hazard of policy interventions.

10. There is already a great deal of work underway internationally looking into the causes of the current turmoil, which is to be welcomed. Much of this work is examining the need for structural changes in the way wholesale financial markets operate, with a particular focus on the structured finance market, and on how financial institutions disclose and use information. The EU Commission for instance has embarked on an ambitious programme of work focussed on:

- Enhancing capital markets transparency for investors, markets and regulators,

- Improving valuation standards, particularly for illiquid assets,
- Improving the functioning of the capital markets and incentive structures,
- Reinforcing the prudential framework and risk management of the banking sector.

11. This work deserves support, and it is important that there is recognition and effective co-ordination between national action and such international endeavours.

12. It is important for the authorities internationally and in the UK to recognise the longer term nature of these initiatives and not to see them as holding out the prospect of addressing the current turmoil in the shorter term. For example, the authorities may conclude that it would be beneficial for the structured finance market to operate with a greater degree of market standardisation. But given the complexity of the issues involved, it would be unrealistic to believe that new standards can be agreed on a sufficiently rapid timescale or that, once agreed, they will have a sufficiently powerful effect on investor sentiment to be an adequate solution to the immediate crisis. Work on correcting the structure of markets is not a substitute for effective action to address current stresses in the financial system. The CML will be please to co-operate with the authorities over longer term measures but the immediate focus must be to promote immediate strategies for re-establishing more normal conditions.

13. We welcome the announcement that the Bank of England will allow banks to swap RMBS for treasury bills for a period of up to three years. Both the term of the facility and the potential scale of funds available suggest that this initiative has the potential to significantly ease the strains in the financial system. But we would encourage the Bank of England to be prepared to alter the price and haircuts of this facility, as well as the range of institutions that can access it, and also to consider other innovative solutions at the earliest signs that the initiative is not having the desired effect.

14. With respect to the range of institutions able to access any funding provided by the Bank of England against RMBS it is important that the Bank’s facility is available to all lenders that are able to lodge eligible security. If the objective is to restore confidence to the financial system, it makes little sense to exclude non deposit taking lenders, whose inability to function normally is restricting the supply of credit to the housing market and having a detrimental effect on confidence across the whole financial system.

Chapter 1 – Introduction and overview

15. The proposals presented in the consultation are aimed at five objectives:

- Strengthening the stability and resilience of the financial system – in the UK and internationally;
- Reducing the likelihood of individual banks facing difficulties – including regulatory interventions and liquidity assistance;
- Reducing the impact if, nevertheless, a bank gets into difficulties – including a new ‘special resolution regime’;
- Providing effective compensation arrangements in which consumers have confidence; and
- Strengthening the Bank of England, and ensuring effective coordinated actions by authorities, both in the UK – including through reforms to the tripartite arrangements – and internationally.

16. The CML does not intend to address directly the issues raised by third and fourth bullets. We would, however, like to voice our support for the position outlined by the British Bankers’ Association (BBA) on these issues in its response to this consultation.

17. The main thrust of our response is twofold:

- To articulate our views on the causes of the current funding market turmoil and the particular difficulties faced by Northern Rock, focusing both on the underlying causes and on the shortcomings in regulation and policy responses that have exacerbated the impact of dysfunctional wholesale funding markets in the UK.
- To respond to the proposals in the consultation for improving the arrangements for addressing financial instability and difficulties at individual banks.

Chapter 2 – Stability and resilience of the financial system

Strengthening risk management by banks

The consultation proposes that:

- **The FSA will intensify its work with banks to improve stress testing in light of recent events.**
- **The authorities will work with international partners to encourage a stronger consensus on the importance of stress testing, in particular at group level and by multinational banks.**
- **The authorities will work to consider whether the stress testing standards under Basel II are sufficiently robust.**

2.1) Do you agree with the actions being taken by the authorities in the UK to improve stress testing by banks?

18. We agree that the FSA should intensify its work with banks to improve stress testing. However, we do not believe that the shortcomings of the FSA's stress testing relate to the basic principles which govern its oversight in this area but rather to a lack of appreciation of the risks attached to banks becoming too dependent on a single funding source and failing to put in place sufficient contingency measures to allow for unexpected interruptions in their normal funding channels. We welcome the FSA's internal audit review of its supervision of Northern Rock which set out a number of recommendations for improvements in the FSA's processes and analysis.

19. Banks benefit from having access to a range of funding sources and of having a range of contingencies, for example, having in place committed funding lines and other facilities that are available when other funding markets freeze up. To qualitatively evaluate the effectiveness of banks' diversity of funding and their contingency plans in funding requires an appropriate level of experience amongst regulatory staff and the FSA must ensure it has the necessary experience. This was recognised in the FSA's audit review.

20. However, we would also warn against an automatic assumption that dependence on wholesale funding is always an additional source of risk. The simple pass through structure of securitisation, for example, allows lenders to match the duration of their liabilities to that of their assets, which can be an important risk mitigant. Some lenders that are dependent on securitisation have also ensured that, in the event that markets are shut, their warehouse funding lines, which fund mortgages awaiting securitisation, also automatically convert into term funding which redeems in line with the mortgage assets. This demonstrates that it is possible to construct wholesale funding strategies that minimise the risk of lender default.

21. It is also worth bearing in mind that while retail deposits are generally a 'sticky' and therefore dependable source of funding, they are not without redemption risk. Lenders also

need to remain mindful of the impact of technological change which is, in any event, changing the characteristics of retail deposits. Internet-based accounts for example appear to be significantly less sticky than traditional branch based accounts.

22. In short, there is a risk of placing too great an emphasis on reliance on wholesale funding as a source of risk and too little on contingencies in funding strategies. An over-simplified analysis of Northern Rock's shortcomings which has gained common currency is that it was simply too dependent on the wholesale funding markets. We would qualify that view by pointing to a lack of contingency planning for disruption to normal funding channels as another important component of Northern Rock's vulnerability and one that the FSA has acknowledged was not fully explored by them.

2.2) Have the authorities correctly identified the issues on which international work on stress testing and risk management should focus?

23. We support the authorities' efforts to encourage international partners to focus on stress testing at a group level for lenders operating across national borders. We also welcome the statement in the consultation that 'It is…important to recognise that some actions aimed at preventing similar bouts of financial turbulence in the future could be counter-productive in addressing the current difficulties in the markets'. Policy makers internationally need to be mindful that actions to encourage individual institutions to be more prudent with respect to liquidity can have perverse effects at a system level. We therefore strongly support the BBA in calling for the FSA to refrain from introducing new quantitative liquidity requirements ahead of any international agreements that may be reached, and instead to focus on the qualitative aspects of liquidity supervision. The FSA should be mindful of the damaging consequences on the market as a whole of its policy of encouraging banks and building societies to increase liquidity.

The consultation proposes that:

- **The authorities will work with international partners to ensure that standards are consistently high across banking groups, and encourage more consistent approaches to liquidity regulation. Given the international nature of financial markets, the authorities will work towards greater consistency in international approaches to liquidity regulation.**

2.3) Have the authorities correctly identified the issues on which the work on liquidity regulation should focus?

24. It is right that the authorities internationally should work more closely to encourage a more consistent approach to liquidity regulation. But any international discussion of liquidity management will need to consider the role of central banks as the ultimate providers of liquidity to the banking system and beyond. Any decision by a bank on what is an appropriate level of liquidity to hold cannot be made without reference to the nature of the money market operations of the relevant central bank. We are concerned about differences in approach to money market operations between central banks, particularly with regard to the breadth of instruments that qualify as eligible collateral, which has a material effect on the competitive position of lenders with access to the money market operations of different central banks.

Improving the operation of securitisation markets

Standard critique of securitisation and the originate/distribute business model

25. The US sub-prime mortgage crisis has triggered an intense focus on securitisation and the so-called 'originate and distribute' business model. It will be important to identify which characteristics of securitisation and of the originate and distribute model have contributed to the difficulties in the US and from this identify what lessons can be learned both in the US and here. However, we believe that much of the comment on this subject to date has revealed quite a superficial understanding. In particular we would question the commonly held critique which claims that:

- In the originate and distribute business model, the originating lender lacks an incentive to ensure that the loans it is originating are of adequate quality.
- An asymmetry of information exists between the originator and the end investor and that this asymmetry is the source of added risk in the system.
- With securitisation there is too long a chain of participants between the originator and the end investor.
- Securitisations lack transparency, undermining the investor's ability to make an informed judgment on risk.

26. Private label securitisation markets (i.e. excluding those operating through a government sponsored agency like Fannie Mae or Freddie Mac in the US), which includes the US sub-prime market and also the UK market, have a structure in which the originator is the first party to take any credit losses that arise unless this 'first loss' is itself sold to investors, which for most UK issuers they are not.

27. Losses accrue to the originator first through 'residual income' (the excess of the mortgage spread over funding and administration costs within the securitisation vehicle) and then through the originator's financial stake in the securitisation vehicle (which usually takes the form of a subordinated loan to the vehicle from the originator). Only once these financial buffers have been wiped out will the investors in the rated tranches face any financial losses.

28. Evidence from the UK experience with mortgage securitisation is revealing. Since securitisation was first introduced in the mid 1980s, we are not aware of a single public rated RMBS tranche defaulting and therefore the real credit risk transference that has taken place has been quite limited. The reason why so little risk transference has occurred is because the securitisations have been structured with sufficient first loss buffers to make the rated tranches relatively safe. But what securitisation does do, to the advantage of the originator, is cap the maximum amount of its potential credit losses and thereby provide, under the Basel I regime at any rate, substantial capital relief.

29. A similar misunderstanding of securitisation relates to the charge that an asymmetry of information exists between the originator and the end investor, leaving the investor at a disadvantage. In an RMBS, the mortgages underlying the bonds are held in a separate legal vehicle and information is provided to the investors by the issuer/originator at the point of issuance and on an on-going basis in respect of loan performance. In a market like the US, which has a high degree of standardisation in underwriting because of the existence of standardised personal credit scores (known as FICO scores) and Fannie Mae and Freddie Mac desktop underwriting, it is hard to argue that the lender has important information about the borrow that is hidden from the investor. In any event, if the originator carries the first loss, they have no incentive to generate loans that they believe have a high probability of defaulting.

30. However, for loans introduced through an intermediary (mortgage broker or the like) there does seem to be an asymmetry of information between the intermediary and the lender, but this exists regardless of whether the lender intends to hold the loan on balance sheet or securitise it. Intermediaries tend to be remunerated on volume of business and not on the subsequent performance of loans, meaning that their incentives with regard to loan quality are not that closely aligned with lenders or RMBS investors. There may be a material difference in this respect between the US and UK as UK intermediaries are regulated by the FSA. However, FSA reviews have raised questions about intermediaries' standard of advice. So policy makers should bear in mind that intermediaries is the main source of asymmetry of information in the mortgage chain rather than that between originator and investor.

31. In the case of the main UK lenders that securitise, the mortgages placed in their securitisation pools are a representative cross-section of their overall mortgage business. In other words, they do not differentiate between the mortgages that are securitised and those held on their balance sheet, so investors are not disadvantaged by being at arms length from origination process.

32. The claim that there is a long chain of participants between the originator and the end investor is also not accurate for RMBS transactions. In these transactions there is an issuer/originator which holds the first loss risk in a vehicle established by them which issues public tranches of RMBS to investors. Where an RMBS is sold from one investor to another the purchaser has the same access to information as the seller. Where added complexity has arisen is in the CDO market, where RMBS are repackaged into new securities. This does create another link in the chain and we believe the authorities would be right to be concerned about the complexity and opacity of CDO structures but this should not taint their view of basic RMBS structures.

33. One of the main criticisms that has emerged of securitisation transactions is that they lack transparency. Structured finance markets do lack standardisation as the features and terms are designed to suite the differing needs of numerous issuers and investors. And information on RMBS transactions is not always as accessible as it might be. But when it comes to transparency (investors having access to information on the assets backing a transaction and the structure of the transaction), RMBS is a highly transparent product. Investors in an RMBS have a far clearer overview of the assets and cash flows that underpin their investment than an investor in a traditional corporate bond has.

The real nature of the problems with securitisation and the originate and distribute model

34. If the above arguments about the shortcomings of the securitisation process (originators' lack of concerned about loan quality, asymmetry of information, lack of transparency and too long a chain of market participants) are not the problem, what is? To answer this question one needs to examine the different influences on the lending decision between an originate and distribute lender and a balance sheet lender.

35. A balance sheet lender makes a loan and holds it on its balance sheet until it redeems. It holds it at book value unless an impairment charge is deemed necessary and it must hold capital against the loan. By contrast, a lender operating the originate and distribute model requires limited capital (as a non-depository firm it is not covered by the Basel capital regime and in any event has a limited balance sheet). Where it retains rated tranches or other instruments in the securitisation besides first loss pieces, a rise in the market value of these instruments creates capital which can be deployed straight back into the lending business, further increasing the leverage of the business.

36. Without an effective capital constraint, such lenders tend to operate as origination machines. If investor demand for their RMBS is high this will be taken as a signal to expand origination. In short, the originate and distribute business model is significantly more pro-cyclical than the balance sheet lending model. This pro-cyclicality is further exacerbated where accounting rules require the lender to recognise the market value its first loss interests in its securitisations, as this makes the lender's capital even more pro-cyclical.

37. Investor demand itself plays a key role in the tendency of the originate and distribute model to be highly pro-cyclical. It was investors, not issuers, who bid up the price of sub-prime RMBS relative to other investments. This was a judgment about risk, and as is so often the case, a long period of economic growth and stability led investors to become unduly relaxed about risk. Investors in US sub-prime RMBS were fully aware of the nature of the mortgage products, with most adjustable rate mortgages carrying heavily discounted initial teaser rates. They were also aware of the elevated level of house prices in many parts of the US. Investors' failure to appreciate the extent to which the US mortgage upswing was a cyclical phenomenon was one of the main causes of the current crisis.

38. The opposite is now the case with a general loss of investor confidence independent of credit quality or the performance of the underlying assets, which in the UK continue to perform well. The crisis is thus one, first and foremost, of market liquidity, resulting from the sharp contraction of the universe of investors able or willing to buy the securities.

39. Policymakers should bear in mind the above arguments when formulating policies to address the perceived weaknesses of securitisation as a funding instrument or the perceived weaknesses of the originate and distribute business model. That is not to say that the authorities should not be engaged in helping the industry to simplify and standardise structures or ensure that investors have the best information. But policy does need to be developed with the recognition that many of the perceived weaknesses have limited validity.

Accounting and valuation of structured products

The consultation proposes that the authorities will work with their international counterparts to ensure that:

- **Firms' valuation approaches are consistent with the relevant accounting standards and the CRD/Basel II prudent valuation guidance; and**
- **Accounting standards require adequate disclosure about the uncertainties around valuations, their significance for the entity and how these risks are being managed.**
- **The authorities will also encourage the markets to find ways to increase transparency of valuation methodologies and, to the extent appropriate, move towards greater standardisation of methodologies for valuation.**

2.4) Do you agree with the actions taken by the authorities to encourage full and consistent valuation and disclosure by banks?

40. It is important that firms' valuations do reflect the uncertainties that exist around a particular spot price at one point in time. Recognition needs to be given to the fact that reductions in liquidity may not only reduce valuations but also increase the uncertainty around these valuations.

41. However, careful consideration needs to be given to increasing transparency of valuation methodologies and to any attempt by regulators to increase the standardisation of valuation methodologies. In markets where one type of purchaser, banks for example,

predominates, there is a risk that a valuation methodology monoculture can create greater price instability through its effect on trading decisions. The existence of a range of valid valuation methodologies for a particular asset should not necessarily be considered to be detrimental to firms or to the market.

2.5) Have the authorities correctly identified the issues on which international work on accounting and valuation of structured products should focus?

42. The authorities internationally need to re-examine the requirement for lenders to use mark-to-market valuations to ascertain whether these requirements are appropriate. In securities markets where banks account for a significant proportion of purchases in normal market conditions, the requirement to use mark-to-market accounting can create significant pro-cyclical ‘feedback’ effects, where strong demand raises the market price of securities which provides banks and other firms with additional profit and capital, which is likely to encourage further buying, adding further upward pressure to prices. The same cycle can work in reverse as we have witnesses recently.

43. Thus, rather than providing greater transparency the requirement to use mark-to-market valuations can distort market prices by injecting excessive pro-cyclicality into the market. However, this is not purely as accounting issue. Some institutions that have been active purchasers of RMBS, such as hedge funds and money market funds, are by their nature mark-to-market and they too have added to the pro-cyclicality of prices. But for banks and other lenders, accounting treatment needs to adequately differentiate between securities that are held for short term liquidity purposes and those that are held with the intention of being retained to maturity. The more difficult it is made for banks to record securities at book value, the more pro-cyclical their businesses become.

Credit rating agencies (CRAs)

44. In examining the role of CRAs in structured credit markets, the consultation identifies several key issues as follows:

- The risk of conflicts of interest since the CRAs are paid by the issuer, and in particular, the provision of paid advice by CRAs on the design of securitisation issues.
- The remuneration structure, with payment made only when the issue is being prepared. This payment is designed to cover on-going monitoring costs as well, but there may be insufficient incentive for the CRAs to carry out effective post-issuance monitoring.
- The informational content of ratings, covering only credit risk assessments and not liquidity and market risk.
- Lack of full explanation of all the key assumptions underpinning the rating analysis.
- Differences in rating definitions between CRAs.
- Over-reliance on ratings by investors and a lack of appreciation of the informational content of ratings.

In the consultation it is proposed that:

- The authorities will work with international counterparts in the FSF and the EU to look at the role of CRAs in structured finance. The authorities will also support the work of the International Organisation of Securities Commission’s (IOSCO) taskforce on CRAs, which has recently been reviewing the applicability of its code of conduct for CRAs to structured finance business.

- The authorities will keep the development of investor practice in relation to structured products under review to determine if further measures are needed to assist markets to achieve an appropriate outcome.
- The authorities will consider the implications for investors in structured products of the recommendations of the advisory groups established in September 2007 by the US President's Working Group on Financial Markets to improve best practice in the operation of hedge funds and the hedge fund working group in the UK chaired by Sir Andrew Large.

2.6) Have the authorities correctly identified the issues on which international work on credit rating agencies should focus?

45. The authorities have identified appropriate issues for further examination. But they should also pay close attention to the impact of the economic and credit cycle on ratings and examine whether it is possible for CRAs to build into their models more explicit allowance for cyclical risks. In the rating of US sub-prime RMBS, the CRAs did not fully appreciate the extent of the cyclical risks. They did not appreciate the extent to which underwriting standards and concerns about borrower affordability had slipped. Nor did they take sufficient account of the potential impact of a reversal of positive cyclical trends (for example in house prices or ability of borrowers to remortgage).

46. The authorities should also pay close attention to the role of CRAs in the rating of CDOs as opposed to RMBS. Much of the losses that have been associated with US sub-prime RMBS have actually accrued through CDOs, which were often designed to maximise credit ratings where the credit strength of the underlying assets was not of the highest order.

47. In their work on CRAs, the authorities must not lose sight of the responsibility of investors to understand the products they are buying. A CRA's assessment of future performance is always an opinion and it must be incumbent upon investors to undertake sufficient analysis to be able to form their own opinion on the quality of the assets they are buying.

2.7) Do you agree with the Authorities' proposals to improve the information content of credit ratings?

48. We do not support a broadening of the information content of credit ratings to include an assessment of potential future liquidity or price volatility. This step would unnecessarily complicate and confuse the role of the CRAs, and involve a very different skill set to that needed to evaluate timely payment of capital and interest.

2.8) Do you agree with the authorities that the preferred approach to restoring confidence in ratings of structured products is through market action and, where appropriate, changes to the IOSCO Code of Conduct on Credit Rating Agencies?

49. We believe that market action will gradually work to restore confidence in the ratings of structured products and that amendments to the IOSCO Code of Conduct is the appropriate way to address changes that might be deemed necessary.

Transparency of banks and exposure to off-balance sheet vehicles

In the consultation it is proposed that the authorities will work with their international partners in the FSF and the EU to identify whether:

- **there remain incentives under the CRD/Basel II framework for banks to minimise their regulatory capital requirements by holding assets in SIVs and other funding vehicles; and**
- **if so, whether this might reduce the total amount of regulatory capital in the financial system below the level that the authorities consider desirable.**
- **The authorities recommend that the IASB considers in particular whether reputational risks are properly taken into account in decisions about consolidation. In conducting their review, the IASB should take into account that banks themselves are likely to learn lessons from recent events and change their behaviour accordingly, for example, in relation to reputational risk.**

2.9) Have the authorities correctly identified the issues on which international work on banks' exposure to off-balance sheet vehicles should focus?

50. It is right that the authorities work with their overseas counterparts to identify whether the Basel II framework provides for a proper recognition of banks' exposure to off balance sheet vehicles. However, as the Basel II rules only became fully operational at the start of this year it would be wrong to assume that the new regime is inadequate. We agree that the best way to address any deficiencies that might be found with Basel II in this respect is through the prudential rules that apply to banks and not through the direct regulation of funding vehicles.

51. However, the authorities do also need in parallel to take a holistic approach to the oversight of leverage in the financial intermediary sector. This means monitoring closely the size and composition of the financial intermediary sector, included unregulated entities such as hedge funds, and analysing risks across the sector. The wholesale financial system has changed significantly over the past 10 years in ways that are not well understood. But what is clear is that the system has become more internationalised, leveraged and complex. The potential risks that these changes pose to systemic stability are becoming clearer and regulators, who have previously struggled to keep up with the speed of innovation, must redouble their efforts to maintain an in-depth understanding of the financial intermediary sector, the entities it comprises and the instruments it uses.

Chapter 3 – Reducing the likelihood of a bank failing

Regulatory interventions

3.1) To what extent do the FSA's range of existing powers reduce the likelihood of failure of a bank, and under what circumstances would they not be effective?

52. As the consultation document makes clear, the FSA already has wide ranging powers to deal with deposit taking firms where it feels that they may fail to satisfy their threshold conditions or there is a threat to consumer interests. The FSA can oblige bank management to take a particular course of action under section 45 of FSMA using an own initiative variation of permission (OIVOP). The lesson of events at Northern Rock was not that the FSA has insufficient powers but that it failed to exercise the powers it has.

53. The CML is not commenting specifically on the 'special resolution regime' (SRR) proposals contained in the consultation. However, we do not believe it is appropriate for the FSA or the authorities more generally to use a SRR as a threat to ensure compliance with an OIVOP. The SRR should be restricted to those cases where the regulator has formed a judgment that there is no viable alternative for the firm.

3.2) Are the FSA's existing powers, and in particular the application of them, clear, and how could they be further clarified?

54. We do not think that there is a problem around the clarity of the FSA's powers. But the FSA's own audit review recognised short-comings in their application and we welcome the FSA's willingness to address these.

3.6) Do you agree with the proposal for a new and flexible regime for payment systems oversight and, if so, how should its scope be defined?

55. Oversight of the payment system should fall under a single body rather than being split between the Bank of England and the FSA. Given its existing position within the payment system, the natural body to undertake the regulatory oversight function is the Bank of England.

Liquidity assistance and disclosure

Disclosure of liquidity assistance

3.8) To what extent is the current provision to register charges at Companies House relevant to banks? Do you agree that it is appropriate to amend it?

56. Given that the registration requirement does not provide a comprehensive view of charges over banks' assets because it does not includes certain charges, we would support the disapplication of the regime for fixed or floating charges on land.

3.9) Should any exemption for banks only apply to receipt of ELA, or should there be a more general exemption for all types of lending?

57. We would support the disapplication of the registration requirement where the charge is being granted to the Bank of England regardless of whether it was granted in respect of the provision of emergency liquidity assistance (ELA).

3.10) Would extending the 21 day period be a viable alternative proposition?

58. We see little merit in extending the period banks have to register charges as an alternative to altering the requirement where the Bank of England has taken the charge.

Protection for the Bank of England

3.12) Do you agree that the Bank of England should be provided with statutory immunity for any acts or omissions which relate to its role in providing financial stability and central banking functions?

59. We would be supportive of the Bank of England being given statutory immunity in respect of these activities.

3.14) Do you agree that funds provided by the Bank of England should be exempted from calculation of building societies' wholesale funding?

60. We support the position of the Building Societies' Association (BSA) that funds provided by the Bank of England should be exempted from building societies' wholesale funding calculations as it would help to ensure as level a playing field as possible between different types of depository institution.

Chapter 4 – Reducing the impact of a failing bank

61. The emphasis in our response is on providing a clear view on why we believe the financial system has experienced the stresses that it has since last summer and on how policymakers can ensure that their response is adequate in the short and longer term, that the system is returned to health and that the appropriate lessons are learnt. We therefore do not propose to comment directly on the issues raised by Chapter 4. Instead we would like to voice our support for the BBA's response in respect of the issued addressed in Chapter 4.

Chapter 5 – Consumer confidence and compensation arrangements

62. Given our emphasis on the need for a framework that supports a robust financial system, identifies banks that are at risk and ensures that regulatory action is taken to prevent bank collapses, we do not propose to respond in detail on depositor protection arrangements. However, we would like to stress our support for the BBA's response in this area.

Chapter 6 – Strengthening the Bank of England

63. **The government proposes to legislate to formalise the Bank of England's role in the area of financial stability and to give its Court a formal role in overseeing the Bank of England's performance in this area.**

6.1) What are the benefits of formalising in statute the Bank of England's role in the area of financial stability, and giving its Court responsibility for overseeing its performance in this area?

64. We believe that it would be beneficial to balance the Bank of England's statutory responsibility on price stability with a statutory responsibility for financial stability. Placing the Bank of England's responsibility for monetary policy on a statutory footing has provided clarity and transparency. We believe that this has directly enhanced the credibility of UK monetary policy, contributing to a marked improvement in the UK's inflation performance both in absolute terms and relative to other advanced economies.

65. Formalising the Bank of England's role in the maintenance of stability of the financial system as a whole could provide a similar improvement in clarity and transparency. It would also act as an important counterweight to the Bank of England's focus on price stability. The current framework has not been tested through a period of recession. Neither has it been tested through a period, such as that we are now faced with, that combines rising inflationary pressure with slower growth and financial instability.

66. One concern is that, with a statutory objective on price stability but without a similar objective on financial stability, an asymmetry exists that will see the Bank of England focusing disproportionately on price stability. Without the clarity that a statutory responsibility conveys, the risk is that the Bank of England may not give equal weight to the remit to deliver financial stability. This asymmetry caused little concern in the benign conditions of the last 10 years but might be exposed as a more serious shortcoming of the current framework in less benign market conditions.

67. Any statutory responsibility for financial stability should provide clarity not only as to the precise objectives but also the tools that the Bank of England can deploy to achieve these objectives. Bank rate is the key instrument by which the Monetary Policy Committee (MPC) can influence monetary conditions, economic activity and expectations. Given the subservience of Bank rate to the policy objective of price stability, a statutory responsibility

for financial stability is likely to require the use of the Bank of England’s role as liquidity provider to the banking system and beyond, through its open market operations, standing facility and lender of last resort facility. The Bank of England will need to be given the maximum amount of flexibility with regard to its provision of liquidity to allow it to respond flexibly and innovatively to different market crises.

68. More thought needs to be given to who should oversee the Bank of England’s performance in maintaining financial stability. If the Court is given this responsibility, the Governor and Deputy Governors will share responsibility for oversight of their own actions, which reduces the accountability of the process. A possible alternative is a Committee of the Non-executive Directors at Court. This would ensure that the assessment of the Bank of England’s performance was seen to be at least independent of the Bank’s executive officers.

69. **To support the Bank of England’s enhanced statutory role in financial stability, the government proposes legislation to amend the provisions governing the size and composition of the Court. The Bank of England also intends to modernise the arrangements for meetings of the Court.**

6.2) To what extent would the proposals improve the ability of the Court of the Bank of England to oversee the Bank’s performance, including its proposed enhanced role in the area of financial stability?

70. We would support changes to the governance of the Bank of England to reduce the number of Directors and to specify that the chair should be an independent Director. We support the proposal that non-executive appointments should be made with a view to ensuring that Court has the relevant expertise to oversee the Bank of England’s performance, particularly its performance in maintaining financial stability. It would be especially important to ensure that non-executives had the appropriate expertise with regard to financial stability if they alone had responsibility for the oversight function as we suggest above.

Chapter 7 – Effective co-ordination

Co-ordination in the UK

71. **The Authorities intend to apply some of the lessons from the operation of COBR to the working of the tripartite arrangements.**

72. We believe that the memorandum of understanding needs to provide a greater degree of clarity as to the respective roles of the members of the tripartite. This needs to include clarity on the provision of leadership to prevent a situation where matters can ‘fall between the cracks’ amongst the tripartite. However, this does not necessarily mean that the methods used in COBR should be applied to the tripartite arrangement.

73. A distinction needs to be drawn between normal and crisis situations with the authorities ensuring that the appropriate resources can be made available when required. The events at Northern Rock highlight the paramount importance that the authorities must attach to effective communication to the general public. A key element of any crisis response, which must be carefully planned in advance, is the management of the message provided to the media and the public.

74. **The FSA and the Bank of England will consider the scope for greater combined initiates to develop common understanding, building, for example, on existing co-operation through the Bank of England’s Financial Stability Board.**

75. We support the development of mechanisms for sharing information between the FSA and the Bank of England that improve the Bank's knowledge of individual institutions when there is concern that their situation may pose risks to financial stability. We also support a closer working relationship between the FSA and Bank of England through joint thematic studies on issues such as stress testing and deepening co-operation in respect of the Bank's Financial Stability Board.

76. **The Authorities also propose to clarify responsibilities within the Memorandum of Understanding for decisions around providing support to firms – in particular emergency liquidity assistance.**

77. We support the idea that the Memorandum of Understanding should explicitly state that the Bank of England has responsibility for the general provision of liquidity. However, the events at Northern Rock do not call into question the clarity of the Memorandum of Understanding in this respect so much as raise questions about when it is appropriate to use general liquidity provision to avert the need for the use of emergency liquidity assistance for individual firms.

78. We agree with the Bank of England's view that the provision of a modest quantity of extra liquidity after the wholesale funding markets froze in August 2007 would not have made a difference to the outcome at Northern Rock. However, given that Northern Rock's funding difficulties were the result of pressures facing the wholesale funding markets in general, the Bank of England could legitimately have taken the decision to supply substantial additional funding once it was recognised that the debt capital markets were behaving abnormally.

79. We also agree that in future there should be a greater expectation that the Bank of England should be more directly involved with individual firms if it has been made aware that the firm believes that it may need emergency liquidity assistance.

7.1) To what extent will the proposals enable an improved handling of a financial crisis?

80. We support the recommended changes to the tripartite's operational arrangements and the Memorandum of Understanding as outlined above and believe that they should help to improve the handling of financial crises. However, we would emphasise that the events at Northern Rock do not directly call into question these aspects of the tripartite arrangement. Rather they demonstrate firstly that there was a supervisory failure to appreciate Northern Rock's vulnerability to a funding market closure.

International co-operation

81. **The Authorities will work with international counterparts to pursue changes to improve the effectiveness of the Financial Stability Forum (FSF).**

82. Cross border co-ordination between policymakers and central banks has been inadequate during the current crisis with undesirable effects, where the relative competitive position of firms has been affected by their access to different central bank windows. We therefore urge governments to explore whether closer co-ordination can be agreed as a priority. We also agree with the proposal to give the FSF a high level oversight role and a role in developing mitigation action. We think that the FSF's role in international crisis management should be strengthened.

83. **The Authorities propose that the IMF considers how to improve further the focus of its financial sector surveillance.**

84. We support the idea that the IMF should work more closely with national regulators and the FSF to identify that key potential strains in the global financial system. We support the idea that the IMF should work with national authorities to ensure that its recommendations are given a sufficient profile.

85. **The Authorities propose that the FSF and IMF enhance their co-operation to bring together the intelligence gathered from IMF surveillance and from FSF members.**

86. It is sensible to encouraged increased co-operation between the FSF and IMF to provide a possible early warning system for global financial risks. Any framework should encourage national authorities to take any such early warnings seriously.

87. This response has been prepared by the CML in consultation with members.