

Financial Markets and Regulation

The Turner Review: A Verbose Attempt at Curbing the Cycle

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Summary

This article explores the 28 recommendations posed by the Turner Review to ensure that the current economic crisis does not occur again. It sets them within the context of the debate on economic procyclicality, noting that, in economic history, financial crises are the main method of promulgating financial regulation and, furthermore, that economic history is shaped by the economic 'boom and bust' of the procyclicality of industry. The Review is largely criticized by the author because of manner in which it aims to curb the economic cycle and, in turn, capitalism. This paper then explores the FSA Discussion Paper 09/2 which was published on the same day as the Turner Review and is to be read in conjunction with the Review. It deals with the 'Regulatory Response to the Global Banking Crisis'. Finally the author evaluates reaction to the Review.

Introduction

Over the last 18 months, the UK, and most of the world, have been suffering from an economic crisis. Economic crises are not uncommon, yet this crisis has caused much furore. Admittedly the crisis, some would say, is one of the worst in living memory, yet others reassure society that the crisis will not be as bad as the American 1929-33 depression.

Within financial/economic crises, regulatory changes follow in close pursuit and this crisis, in this respect, is no different. We have seen already the Banking (Special Provisions) Act 2008, the Banking Act 2009 and now we have a review of the banking industry (the Turner Review) to decide on what regulation should be enacted. This is in addition to the Discussion Paper 09/2 issued by the Financial Services Authority (FSA) on the same day as the Review.

The Turner Review outlines 28 recommendations and four discussion points. It is a lengthy, verbose and technically complicated document. The first part of these joint papers will examine and comment upon these recommendations. The second part of the paper will then explore the FSA Discussion paper. It will analyze the industry's feelings towards the Review and Discussion Paper. A pervasive argument throughout the paper is that in every economic system there are times of economic boom and economic bust.

The cyclical nature of the economic system is not a new observation. It is part of the capitalist state. What the Turner Review recommends is largely to curb this cycle to ensure there are no extremes of the cycle and to limit the movement within the economic lifespan. To do so is straying close to curbing capitalism and the free economic state.

The Turner Review

The Turner Review ('the Review') was published on 18 March 2009. It contains 28 recommendations within 13 areas. There are also four discussion points that have been raised for consideration and consultation. The Review is said to take a long-term approach and is in no way a means of countering the current short-term economic crisis. It should be read alongside the Discussion Paper 09/2 published by the FSA on the same day. There are four chapters contained in the Review.

Chapter 1 describes the current economic crisis and tries to identify why it occurred. This chapter is technically complex and, at 40 pages long, often misses crucial elements of the economic crisis. It largely concentrates on the statistical factors that can explain the crisis. To put it simply and condense 40 pages, the crisis was caused by the evolutionary cycle of the financial system reaching a point where the only option was to go down. There are multifaceted and complex intangibles that add weight to the collapse of the cycle, causing it to occur in such a dramatic fashion. Banks and bankers are criticized for ignoring warning signs, and taking large risks to reap the rewards of large bonuses. The Review steadies itself in the belief that easy access to credit and mortgages by low or marginal groups were also to blame. It also commiserates itself that, although the UK is suffering an economic crisis, it was largely spurred on by the collapse of the subprime market in the US. The knock-on effect caused the crisis. Overall, chapter 1 blames a superfluous number of people and objects. It forgets that this sophisticated economic system is rather revolutionary, and in historic terms is still in its infancy. It ignores the fact that economic systems and their respective legislation are built on a history of economic crises and successes. Basically, the Review ignores the fact that the cycle of economics, the economic boom and bust, is organic. It is what happens. What is recognized is that the highs and lows of the cycle can never be as high or as low again.

If we look at banking history we see a strong correlation between the growth of industry (within the Industrial Revolution) and the growth of banks. They are inter-related. The Industrial Revolution allowed capitalism to flourish. With capitalism, we see the growth of society. Without the banking industry being a explorer into the financial unknown, how can industry grow in the same manner as in the Revolution? What advances can be made without risk? Does curbing the cycle mean curbing capitalism? Or will a new type of growth and capitalism emerge from the embers of this current crisis?

The Review's recommendations are as follows.

- Capital adequacy, accounting and liquidity
- Institutional and geographic coverage of regulation
- Deposit insurance

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Financial Markets and Regulation

- UK bank resolution
- Credit rating agencies
- Remuneration
- Credit default swap (CDS) market infrastructure
- Macro-prudential analysis
- FSA supervisory approach
- Firm risk management and governance
- Utility banking versus investment banking
- Global cross-border banks
- European cross-border banks

These recommendations deal with aspects of ensuring quality and quantity of capital within the global banking system. Regulation that is still due to be enacted (Basel II) should be enacted, so that procyclicality does not occur. In other words, regulation should be through the cycle of economics rather than at the high and low points of the cycle. Furthermore, a countercyclical capital adequacy regime should be imposed and a disciplined backstop should be in place to stop excessive growth. This curbing of growth and the flattening off of the cycle of economics is worrying for the growth of the industrial world and for capitalism. Another recommendation, and also the most worrying, is to ensure the regulatory and supervisory coverage should follow the principle of economic substance not legal form. In the first area, the recommendations were largely to curb the economic procyclic cycle, this informs us that economic foundations are better than legal ones for regulation. Another recommendation is that limits and guarantees for the protection of retail depositors are put in place, with a further recommendation to ensure that more consumers are financially aware of the economic system.

Discussion Paper 09/2

The Discussion Paper ('the DP') underpins the Turner Review. It contains further documentation on the 28 recommendations posed by the Review. It reiterates the historical background of the crisis and the possible causes of it identified in the Review. At 219 pages, it is verbose in the extreme.

The DP puts forward five aims that the Financial Services Authority (FSA) wishes to achieve. These are:

1. The global banking system is better capitalized and more resilient to liquidity shocks throughout the business cycle;
2. The regulatory framework in general, and its capital component in particular, are explicitly countercyclical;
3. Supervisory crisis management and resolution arrangement for cross-border financial service groups are effective and reflect the interests of host countries as well as those of the home State;
4. Any material risks to financial stability posed by unregulated activities or firms are identified and controlled to the extent possible; and
5. Macro-prudential and other risks to financial stability are identified at both the international and national levels and effective action is taken to mitigate them.

The DP does not aim to prompt decisions by regulators but to initiate discussion. It also states the importance of the role of international regulators in creating a stable global economic system. The DP stresses that the overall aim is to create a 'global banking system that is sufficiently well capitalized to withstand the stresses to which it may become subject to'. It is suggested that this global regulatory approach begins closer to home with an EU regulator to oversee the regulation of the financial systems within the Member States. Sections 3-13 pose questions to industry relating to the regulatory approach that needs to be taken.

Overall the DP is clearer, though much lengthier than the Turner Review. Although the author is of the opinion that some of the anti-cyclical recommendations are misplaced, she does acknowledge the need for reform and change. However, it is her belief that a knee-jerk reaction and kowtowing to political pressure is not the answer. The next section in the paper examines the industry's response to the Review and the recommendations contained in the DP.

Industry reaction

After having identified three areas of the likely cause of the financial crisis – macro-economic imbalance; financial innovation of little social value and important deficiencies in key banking capital regulation – the Review sparked many comments.

Lord Turner states that the recommendations challenge the underlying intellectual philosophy of regulatory and economic approaches. He calls for there to be not only pan-European cooperation but that this cooperation should become a global platform for consensus in financial matters. He states that the changes are profound and the emerging economic system will be unlike any that we have seen before.

One of the major criticisms of the Review is that it does not recommend the separation of banking functions, i.e., retail and investment. Vince Cable (Liberal Democrat shadow chancellor) says that the recommendations are little more than a watered down (if verbose) summary of policy changes.

Rob MacGregor (Unite) agrees and states that the recommendations are more rhetoric than substance. He, like Cable, acknowledges the need for change but suggests that Lord Turner has failed to recommend changes that would actually help the system. Rather, recommendations have been posed that are detrimental to the overall mechanisms of the economy and society.

John Cridle, CBI deputy director-general, is pleased that Lord Turner took this cautious approach and believes that wide-ranging reforms at this stage are not the path to follow. He points to the debacle surrounding Sarbanes-Oxley as a case in point.¹

Richard Saunderson (CE Investment Management Association) states that the recommendation paves the

¹ For a discussion of Sarbanes-Oxley see Peter Yeoh, 'The Sarbanes-Oxley Act 2002: Time for Some Tinkering' (2007) 28 BLR 90.

Financial Markets and Regulation

way for future reforms and that what is called for is a return to simple banking.

What is acknowledged by commentators is that the economic crisis does need attention and reform will follow, and that the Review sets out a path for future reform, albeit in a verbose and overly complex way.

However, the regulators are in a difficult position. Crisis has occurred and history tells us that reform is required. It is also part of human nature to try to fix the problem and stop it from happening again. For regulators, their job is marred by political pressure. Politicians must be seen to act. We can see this by the public backlash against many investment bankers. The FSA, within days of publishing the Review and the Discussion Paper, published another paper reviewing the remuneration of financial services employees. Public pressure, as we can see, affects regulation. This, on its own, is not a bad thing; in fact it epitomizes democracy. But finance and economics are complicated and a knee-jerk reaction to regulation, legislation, supervision and policy is not best placed, especially in an economic crisis.

Conclusion

As lawyers and regulators, we can learn a lot from history. This economic crisis is teaching us lessons that we can use when creating new regulations and laws. As lawyers, we are in a privileged position to know the historical background to the financial services regulation and that is has been reaction to economic crises in the past. We can also accept that in economics there are peaks and troughs, highs and lows, boom and bust. That economics is cyclical is part of our ideology. However, the Review aims to flatten the cycle, to ensure that there will not be the highs and lows that have helped shape out society. Without the boom in the Industrial Revolution there would not have been a Revolution. What is of concern is that if we adopt these safety measures and allow the cycle to be flattened, what other positive possibilities could we as a society miss out on. Life is about ups and downs, what matters is how we cope with them.