

## **Commentary: Turner Report Reactions Are a Vector for Regulatory Reform**

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A few months ago, I wrote about the “Turner Report” produced by the Financial Services Authority (FSA), roughly the SEC’s counterpart in London. When the FSA first released the Turner Report, comments were solicited generally from interested persons, and specifically from approximately 80 institutions believed by the FSA to be affected by the proposed regulatory reforms. In September, the FSA published the results of this “consultation.”

The Turner Report was an early effort to write a comprehensive analysis of the ongoing financial crisis and provide recommendations for regulatory reform. It was issued in late March, in anticipation of the G-20 summit in London, before other regulators got around to issuing their own analysis. As a result, its cogent analysis and recommendations have been the basis of much of the early work produced by the G-20’s Financial Stability Board (FSB). Composed of regulators from each of the G-20 powers, the FSB is charged with producing recommended regulations that can be adopted by all of the G-20 nations. For example, most of the proposed regulatory reforms that were submitted to the U.S. Congress by the Obama Administration in May flowed from the FSB’s recommendations and were first proposed in the Turner Report.

However, despite its immediate and pervasive influence within the regulatory community, the Turner Report’s conclusions and proposals were controversial and inspired negative reactions from just about everyone else. The newly released comments highlight some of the fault lines in the global effort to craft a regulatory response to the financial crisis.

In the United States, our first reaction to the efforts of the FSB is to wonder whether the FSB itself is a good idea. Should the regulatory policy of the United States be driven by negotiations with foreign nations? If Pat Buchanan hears about this, I expect to be treated to another of his rants about the virtues of “economic patriotism,” demanding a stop to international regulatory cooperation in the name of boosting the competitive advantage of U.S. firms. Comments to the United Kingdom proposals, however, clearly show the fallacy of economic patriotism.

The concern that trumped all others in the published comments was that the regulatory proposals in the Turner Report would not be adopted by other nations

(most especially the United States). Thus, the comments argued that adoption of regulatory reform in the United Kingdom would reduce the global competitiveness of the United Kingdom's financial institutions: economic patriots in the United States would make Great Britain's financial institutions "economic patsies." The FSA took great pains to assure the public that, in most cases, regulatory reforms would only be instituted if it were clear that other members of the G-20 were adopting convergent regulations. The FSA pointed to the work of the FSB and particularly to the legislative proposals introduced by the Obama administration in May, as evidence that most of the Turner Report's proposals were on their way to adoption on a global basis. So, it seems that if we are to have any effective regulatory response to the global financial crisis, economic patriotism is out of the question; we will all have to be "economic Musketeers."

Global regulatory convergence, however, can never be perfect. It goes without saying that there are enormous differences of regulatory philosophy within the G-20, even among close allies like the United States and the United Kingdom. For example, respondents to the Turner Report urged that the FSA should not be involved in issues of accounting. That concern seems extraordinary to us in the United States, where fully half of the SEC's staff is composed of accountants, and the SEC for all practical intents and purposes regulates accounting policy for financial services.

There are also differences in regulatory structure. The FSA has supervisory regulatory authority over banks and insurance companies, so its rules generally are intended to apply uniformly to a broader universe of regulated entities. In the United States, four different banking agencies supervise banks, and each of the 50 states regulates the insurance industry locally. That means that the United States has a harder time assuring uniformity of regulation. Moreover, this is a moving target. The Conservative opposition party in the United Kingdom has announced that if they win the next election as expected, they intend to remove regulatory supervision of banks from the FSA and return it to the Bank of England, repudiating an earlier reform by the Labor Party. In the United States, the Congress currently is contemplating legislation that would streamline the supervision of banks in a single agency. Political parties often shuffle the regulatory deck upon taking power because structural differences among regulators impact regulatory policies.

Differences in regulatory philosophy also were highlighted in the responses to the Turner Report. Respondents criticized its lack of faith in market forces for establishing the value of marketable securities. In the United Kingdom, as well as the United States, marketable securities currently receive favorable treatment in determining a firm's capital for regulatory purposes. The theory used to be that the securities could be instantly transformed into cash if there were calls on a financial institution's capital. The Turner Report proposed to change this metric and treat holdings in marketable securities in much the same way as less liquid assets. This

proposal, if adopted, would have a dramatic impact on funding through access to wholesale debt markets.

The FSA pointed out that debt securities turned out not to be as liquid as previously believed. One feature of the panic that surrounded the collapse of Lehman Brothers is that sellers of debt securities were unable to find buyers, rendering some very large financial institutions immediately insolvent. Moreover, it is still the case that there are widespread valuation differences for the same or similar debt securities, which makes it very difficult for both regulators and investors to compare the financial health of different financial institutions.

In the United States, the regulatory philosophy tends to have lots of faith in market forces, and the regulators focus on increased transparency as a means to increased market efficiency. Thus, regulatory efforts are being made to increase market transparency by increasing the market disclosures produced by “dark pools.” The SEC has announced significant initiatives to examine internalization of order flow and other equity market structure issues. However, the equity markets are a small pimple on the back of the large elephant that comprises the debt markets. Debt markets are also among the least transparent markets on the planet. Trading in the debt markets is almost entirely over the counter and conducted through dealers who internalize all order flow. They are, in essence, a collection of massive and fragmented dark pools.

What is the U.S. regulatory effort in dealing with debt markets? In keeping with its philosophical bias toward fostering transparent markets, the SEC from time-to-time attempts to encourage exchange trading of debt securities in an effort to shed some light into these dark pools, so far with little success. The Turner Report simply, and perhaps more realistically, accepts darkness in the debt securities markets as a fact of life. But acceptance of murky, and likely inefficient, markets also implies that debt securities should not be entitled to favorable regulatory capital treatment. The response to that proposal in the United Kingdom shows that this is a very bitter pill for the financial services industry to swallow.

It is remarkable to me that banking and securities regulation has become part of international diplomacy. But, there are no good alternatives. If, as economic patriots, we seek to favor U.S. institutions in financial services regulation, other nations also will need to be economic patriots, resulting in a regulatory race to the bottom. The result would be one global financial crisis after another, which is unacceptable on any level.

The ramifications of this shift to global regulatory cooperation, and the accompanying changes in regulatory philosophy, are staggering to contemplate. Looking into my crystal ball for a vision of the future, it seems inevitable that the cultural differences that distinguish the people of the United States from other

nations will narrow. We are being forced to adopt the more jaundiced view of markets that informs European regulatory policy. But other G-20 nations may also be forced to grudgingly accept the more limited view of the role of government that predominates here in the United States.

It is difficult to see farther down this path, but it is very long and winding.

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