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21 Great Winchester Street, London EC2N 2JA

Tel: 020 7382 0900 Fax: 020 7382 0901 E-mail: mail@traderisks.com

The Baron Turner of Ecchinswell
Chairman
The Financial Services Authority
25 The North Colonnade
Canary Wharf
London
E14 5HS

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Dear Lord Turner

The legacy role of banks in non-bank lending and hedging

Banks have traditionally provided funding and hedging acting as principals. The financial crisis has critically reduced banks' appetite for risk, thus often reducing their role in several traditional investment banking functions to that of 'matched brokers'. Matched brokers don't need capital, so banks should face considerable competition in situations where they are acting in a pure agency capacity. However, the reality is that because of their extensive client base of borrowers dependent on bank funding, banks are able to use this dependency to reduce or eliminate competition for the provision of equity and debt capital markets services and hedging products, even when acting purely in a matched broking capacity.

One clear example of this anti-competitive behaviour is the maintenance of "standard fees" for equity and debt issuance, even when banks do not take any principal risk. A second example is banks' ability to extract very large profit spreads, sometimes as high as 30 basis points from mid-market, on long term (30-50 years) inflation swaps where banks simply pass through the inflation risk directly from borrowers to investors rather than warehousing the risk on their own balance sheets for any period of time.

Furthermore, some borrowers believe that by awarding capital markets and derivative business to their own lending banks, they can achieve a better deal on their bank borrowings. There is no evidence that supports this belief. In fact, TradeRisks sees situations on a regular basis, where borrowers pay considerably higher all-in funding and hedging costs as a direct result of following this approach.

The lack of competition increases funding and hedging costs for borrowers, which in turn has a direct negative effect on economic growth. However, the 'product bundling' approach used by banks to reduce competition also has the effect of reducing risk and return (i.e. price) transparency on lending, which in turn restricts the efficiency of markets by preventing other investors from entering these markets. Only very large and sophisticated investors have the sufficient structuring and analytical skills to be able to disentangle these bundled products in order to ascertain the true price levels that a market can offer them. If other investors are not attracted to a market because the little



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credit that clears does so at opaque levels (e.g. because the returns are not made on funding but on the associated derivatives and capital markets transactions), then the financial markets will remain in crisis.

We envisage two possible areas where the authorities, the investors, and the corporate borrowers themselves can encourage non-bank lending and hedging channels. The first is for the authorities to call a competition enquiry into the role of banks in non-bank lending and hedging, (i.e. the role of banks when acting as matched brokers without underwriting any material risk). The second is for investors to demand, and for corporates to implement, greater disclosure of execution costsⁱ for funding and hedging transactions. We believe the disclosure of execution costs is a corporate governance issue which would not be resolved by imposing a regulatory requirement on banks to disclose profit information in the form of a spread, for example. Such disclosures by banks would be subject to straight forward manipulation, and are likely to be very difficult to translate into a meaningful execution costs measure that we believe is essential. Furthermore, it is vital that corporates calculate their execution costs independently of any information provided by banks. The disclosure of execution costs by corporates should convince borrowers that the bundling of financial products will never work to their advantage, which should foster greater transparency and financial markets where fewer transactions clear at opaque levels.

Yours sincerely

Alex Pilato
Chief Executive
TradeRisks Limited

ⁱ i.e. the market value (with cashflows discounted at mid-market rates and vols) of the new financial instrument(s), minus the market value of the replaced financial instrument(s), if any, minus any cash amounts received /(paid), if any.