PARLIAMENTARY DEBATES

HOUSE OF COMMONS
OFFICIAL REPORT
GENERAL COMMITTEES

Public Bill Committee

FINANCIAL SERVICES (BANKING REFORM) BILL

WRITTEN EVIDENCE

PUBLISHED BY AUTHORITY OF THE HOUSE OF COMMONS
LONDON – THE STATIONERY OFFICE LIMITED

PBC (Bill 130) 2012 - 2013

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Contents

The Law Society of England and Wales (FS 01)

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Written evidence

Memorandum submitted by The Law Society of England and Wales (FS 01)

General Points

1. The Law Society of England and Wales is the independent professional body, established for solicitors in 1825, that works globally to support and represent its 166,000 members, promoting the highest professional standards and the rule of law.

2. The Society is a body whose members' have extensive experience of advising financial institutions, businesses of all shapes and sizes and consumers. These measures will directly affect the client base of a number of the Society's members.

3. The Society is also a body with 11,000 member firms, who are predominantly small or medium-sized businesses, but whose members also include a significant number of large international businesses. The banking arrangements, funding and investment options of our member firms will be directly affected by the proposals.

4. Reform of the banking sector should be focussed on achieving three principle objectives:

4.1. increasing the stability of the UK financial system;

4.2. enhancing the competitive position of the UK; and

4.3. reinforcing the rule of law i.e. reform should be consistent with the fundamental legal principles of clarity, certainty and predictability.

5. The Bill – in 19 clauses – sets out the broad framework for reform of British retail banks, most saliently in relation to:

5.1. the placing of the ring-fence;

5.2. loss-absorbency requirements;

5.3. the procedures for implementing the secondary legislation; and

5.4. depositor protection.

6. Most relevantly for this written evidence, the Bill proposes to amend the Financial Services and Markets Act (FSMA) 2000 and the Insolvency Act 1986 in order to affect the changes the Government desires.

7. A large portion of the Bill is concerned with giving HM Treasury powers to enable them to bring forward future regulations which, for example, will set out the details of the ring-fence. This makes it difficult to comment in detail on the full impact of the proposals until the secondary legislation has been studied. Such example secondary legislation as has become available raises a number of concerns. Examples of which are set out on page 11 of this briefing.

8. The Society considers that the Bill is being passed through Parliament too quickly and that the basis for granting the Treasury significant powers has not been fully discussed nor a convincing argument made for the need for such sweeping powers.

9. The following discusses some specific clauses of the Bill, outlines the Society's concerns in relation to each and, where it is possible to do so suggests amendments which will help ameliorate some of the concerns set out, if adopted. However, these cannot address the fundamental unease that this form of legislation produces.

10. This evidence discusses the following issues:

10.1. the ring-fencing proposals;

10.2. bail-in

10.3. depositor preference; and

10.4. the powers the Bill gives to the Treasury to amend the legislation

10.5. an example of the sort of problems that specimen secondary legislation reveal.

Clause 4: The Ring-Fence

What the Bill proposes

11. The Bill proposes to insert a number of new sections into Part 9B of the FSMA 2000. In particular setting out:

11.1. the definition of a ring-fenced body' (s142A);

11.2. the core activities of a ring-fenced body (s142B);

11.3. the core services (142C);

11.4. excluded activities (142D); and

11.5. wide ranging powers for HM Treasury to make adjustments to these rules including the imposition of prohibitions (142E).

12. It is important to get the ring-fence right. The consequences of not doing so could be significant in the long-run for the banking sector, the City and the wider UK economy.

Concerns with s142

13. The Society holds the following concerns relating to s 142:

13.1. the need for a balanced ring-fence;

13.2. the extent of the powers given to HM Treasury by the Bill, which appear almost wholly unfettered, so the legislation could end up having effects not envisaged at this time and thus not taken into account by the economic impact assessment: as these could be very damaging for the future not only of UK regulated banking, but for bank customers, especially business customers, and for the recovery of the UK economy, the lack of any check or balance is highly regrettable;

13.3. the scope of activities permitted to ring fenced banks and the wider effects of these proposals;

13.4. the two-purposes test relating to what should be regarded as a 'core activity'.

The need for a balanced ring-fence

14. The Society is concerned the current proposal does not get this balance right and an adjustment to the model of ring-fencing may result in a better balance between the different objectives.

15. The ring fence proposals focus on the role of the ring-fenced bank in serving individual customers, but traps smaller businesses in ring-fenced banking and raises a series of problems for larger businesses with regards to using ring-fenced banks. This is because the ring fence has been placed so as to make it difficult for ring-fenced banks to meet the needs of larger customers fully. It appears to treat retail banks as something akin to a building society: but one of the primary functions of a high street bank is to serve the needs of business, especially as regards money management, including transfers and receipts, netting of accounts, foreign currency needs and exposures, trade finance, payroll provision and working capital needs. While some of the specimen secondary legislation shows a reluctant recognition of some of these factors, the overall picture is one of a highly constrained business model operating as far as possible only domestically, constrained in its relations with non-EEA entities and with all other types of financial institutions, that will struggle to serve their business customers, especially those growing overseas business outside the EEA or operating in currencies other than sterling.

16. The ring-fence has to be a proportionate measure to the problem it is trying to resolve. It has to fairly balance what are sometimes competing objectives. The Bill needs to tread the line that produces a balanced result which is good for the UK economy: it is a reform whose effects will be felt for generations and getting it right deserves the utmost care, in order to avoid and disproportionately negative impacts on the competitiveness of UK banks, their customers and the wider UK economy.

17. In the current Bill:

17.1. S142B(2) establishes that accepting deposits is the irreducible minimum core activity, subject to some qualifications set out in 142B(2), (3) and (4).

17.2. S142B(5) enables the Treasury to expand the number of core activities, subject to the requirements of s142B(6).

17.3. S142D sets out the excluded activities. In other words what activities ring-fenced entities cannot carry out. It also enables the Treasury to add further types of activities (beyond dealing with investments as principal) to the excluded activities list. S142D will also enable the Treasury to create exceptions to the excluded activity of dealing with investment as principal. Exercise of authority is subject to a two part test.

Impact of the ring-fence

18. The current proposals do not take sufficient account of the wider context and the limitations placed on the effectiveness of the ring-fence proposals for example, by other laws. The Society believes these limitations include:

18.1. EU Single Market rules (and other international trade agreements). These man that banks from competitor Member States will be able to sell retail banking services to UK customers and not be subject to the same ring-fencing regime (these banks will not face the additional cost of the ring-fence or the restrictions on the types of services they can offer);

18.2. the effect of significant penetration of some parts of the UK retail banking sector by banks from other competitor countries (in particular other EEA Member States) might be to increase systemic risk for the UK economy as banks outside of UK regulatory jurisdiction take larger shares of the UK market and 'import' the

risks from other banking sectors. In the event of the failure of such a bank the UK would not be in a position to manage the impact on the UK economy, except by negotiation: for example in the failure of the Icelandic Banks, the UK had to carry the cost of keeping UK depositors whole, in the recent failure of the Laiki Bank of Cyprus special arrangements have been made with the UK subsidiary of the Bank of Cyprus. These are relatively small failures, compared with the impact that would be felt on the failure of a much larger bank from a major EU economy: yet these will be better placed to offer business customers a seamless service, than any UK bank after ring-fencing.

18.3. further complexity and cost will be added if the EU comes forward with its own proposals to split wholesale (investment) banking and retail banking. There is some risk UK banks could end-up being split three ways (although it is our view that it seems more likely that EU banks will be allowed to continue universal provision with the competitive advantage outlined above). The EU proposals are to split off proprietary trading and market making, which are clearly risky. Yet UK non-ring-fenced banks will be able to carry out these activities in the same entity that will serve much of the banking needs of larger corporates on account of the positioning of the UK ring-fence. A three-way split would have serious additional negative consequences for the competitiveness of UK banks with knock-on effects for associated sectors which supply services to the UK banking industry.

18.4. the ring-fence could also result in increased institutional instability, because it will narrow the business model of affected banks, making them less resilient to ‘shocks’, and force them to offer very similar services to each other on very narrow margins.

19. Further, the ring-fence model proposed in the Bill could have deleterious affects on competition in retail banking in the UK. For example:

19.1. the ring-fence will ‘cut across’ important banking services which customers can currently access through one bank. This is especially important for business customers, who will suffer from not being able to access a full range of services from their retail bank; for smaller customers it may be that these services are unavailable or unaffordable, because they cannot split their limited available collateral so as to meet the requirements of their bank and a third party provider. This would have a long term adverse effect on the economy by stunting the ability of these smaller businesses to grow and exposing them to additional risk;

19.2. it will adversely affect the incentives to enter the retail banking market and create barriers to expansion by challenger banks. As noted above, the retail banking business model would be as constrained as that of a building society: the same pressures that have led to consolidation in that sector and the unsustainability of smaller players could be expected to follow in retail banking. In a sector where competition is often considered inadequate, this would be a counter-productive consequence of the reforms;

19.3. ring-fencing (in conjunction with overly strict credit exposure limits) may lead to some banks exiting the retail sector, to merge with other retail banks or to restructure, so as to transfer business to subsidiaries elsewhere in the EU;

19.4. highly restrictive rules governing the activities which ring-fenced banks can carry out could impact negatively on product innovation and product availability, especially for smaller and medium sized business customers;

19.5. increased costs, coupled with a narrower business model and client base (due to the ring-fencing model envisaged) could impact on the ability of the bank to benefit from economies of scale and scope including the ability to share some back-office operations with the rest of the group. In the medium to long-term this incentivises consolidation. The consequence may therefore be less competition in the sector rather than more and job losses and branch closures.

Placing of the ring-fence

20. In light of the concerns raised above the Society believes that the reverse ring-fence proposed to the EU by the Liikanen report, shutting out the “casino” activities from retail banking, but otherwise allowing banks to serve the needs of business and personal customers, a much better starting point.

21. This would leave all other activities within the purview of the non-ring-fenced entity. The Society considers that this would ameliorate some of the possible problems outlined above. For example:

21.1. such a change would leave retail banks less vulnerable to shocks because their business model is unlikely to be as narrow as under the Government’s proposals;

21.2. it is better for customers, who will be able to access a much greater range of services from the one bank and not have to go to different institutions for different types of banking needs;

21.3. if UK banks can offer a wide range of banking services they will be at less of a competitive disadvantage against banks from competitor countries who may be using the ‘passport’ system to enter the UK retail banking market.

22. In particular, the economic pluses and minuses of the two models have not been evaluated and that there has been very little preparatory material in the UK that suggests the points made above have been considered to any great degree. The Society urges the Bill Committee to insist that this work is done and to insist that the

Bill incorporates a provision that recognises that the long-term health of the economy has to be given weight alongside the other objectives of the Bill.

23. As a general principle the Law Society would support a Bill which legislated for a clearer set of rules up-front. This would create much more certainty as to the limits of the ring-fence now and place limits on its extent in the future, thus helping banks considerably in terms of planning their compliance activities and future business operations.

24. It would also enable Parliament to have a better idea of what the effects are likely to be of the legislation, something which currently is not clear.

Powers for the Treasury

25. The Society is concerned that some of the clauses in the Bill are too broadly drafted. They give the Treasury significant discretion. The consequences of those wide-ranging powers are difficult to know at this stage but there is cause for concern over what they might be. For example, the Society is concerned that there may be consequences for the freedom of some banks to contract under non-EEA laws or deal with non-EEA persons, in ways that may be in breach of the UK's international obligations.

26. Specific measures that would result in restrictions on banks contracting under non-EEA laws were envisaged in the consultative White Paper published earlier this year by HM Treasury[1]. While the way the Bill is drafted does not suggest any specifics in this area yet, any such measures which came forward, under one of the enabling powers in the Bill would be a matter of concern.

27. Such a measure would be a disproportionate and damaging response to concerns which could be resolved in other ways. For example, to overcome the concern that a non-EU court might not recognise a transfer order under the Banking Act 2009 in respect of a in the course of a resolution of a failed ring-fenced bank (which the Society hopes will not be a frequent occurrence), it is not necessary to forbid all ring-fenced banks to enter into contracts under non-EEA laws, only to require that such contracts contain a contractual recognition of such orders where they are of a material nature.

Regulated activity

28. The Financial Markets Law Committee (FLMC) has recently suggested the reliance on cross-reference to the concept of a 'regulated activity' is problematic . As the FMLC highlights, the definitions being drawn upon in the Bill are taken from the FSMA (Regulated Activities) Order 2001. The definition, they write, '…is subject to numerous exclusions and qualifications, as well as certain overlapping provisions under the Financial Instruments Directive (2004/39/EC)…' . The Society concurs with the FMLC that this may not be the most appropriate method to define excluded activities because '…there will be limited correlation between regulated activity and the proprietary dealing activities sought to be prohibited within the ring-fence' .

29. The Society supports the FMLC when they suggest that it may make more sense to legislate for an '… authoritative consolidated instrument setting out the current definition of 'investments'…' .

30. This proposal makes particular sense in light of our earlier suggestion of putting the ring-fence in a different place, but would be applicable in any event, to ensure clarity and comprehensibility of the restrictions.

Core activities

31. Finally, the Society also concurs with the comments made by the FMLC regarding s142B and the provisions regarding 'Core Activities'. In particular that the two purposes set out in s142B(4) are unclear:

31.1. there is no definition of what an '…appropriate degree of protection for the depositors concerned…' is; and

31.2. the second purpose set out in 142B(4)(b) is '…obscure and arguably satisfied where the deposit taking activity is question is capable of transfer to a private sector purchaser or bridge bank…' .

32. The two purposes need to be made clearer, with a much tighter definition of 'appropriate protection' as this will be the basis on which new regulations are proposed.

33. In addition, the second purpose would benefit from being made clearer, in particular aligning it with existing legislation on bank resolution. Or at least establishing the minimum requirements in terms of what 'protecting the continuity…' means in the context of the Bill.

Clause 4: Loss Absorbency Requirements

What the Bill proposes

34. Clause 4 of the Bill proposes to insert a new section, 142M, into the FSMA 2000. It sets out a range of enabling powers allowing the Treasury to make provisions regarding the ability of the PRA and FCA to require

[1] '*Banking Reform: delivering stability and supporting a sustainable economy*' can be accessed from the Treasury website, here: http://www.hm-treasury.gov.uk/d/whitepaper_banking_reform_140512.pdf

ring-fenced banks to issue particular debt instruments and/ or ensure a ring-fenced entity's debt contains debt of a particular type.

35. These proposals appear to allow the Treasury and regulators to require ring-fenced banks to issue bail-inable debts at some point in the future, as a tool to enhance the loss-absorbing capacity of UK retail banks.

The Bill should be amended

36. The Society believes the Bill should be amended to reflect the fact that bail-in has a number of problems, notably:

36.1. it is not always consistent with principles of good law; and

36.2. its operation can have a number of negative consequences for institutions and the banking system as a whole.

Avoiding front-running EU rules

37. The Society welcomes the fact that the Financial Secretary to the Treasury Greg Clark has suggested that the Government's intention is to wait for EU proposals on bail-in. This reduces the likelihood of confusion and overlap between two bail-in regimes – a UK one and an EU one – and complicated transition periods, once the latter is introduced.

38. Not front-running EU measures will also mean the inevitable negative consequences of an increase in the cost of capital for UK banks will be somewhat mitigated, vis-a-vis competitor banks in other EU Member States.

39. However, the proposals contained in the draft Resolution and Recovery Directive are highly problematic in themselves and bail-in still has some inherent problems.

Impact on the cost of capital

40. Bail-in, for example, will mean that those willing to give credit to a ring-fenced bank will likely demand more security (including higher rates of interest) to reflect the increased risk.

41. Ideally, a framework setting out the principles governing such measures (if they have to be introduced at all) should be agreed multilaterally, by the G20. This would ensure a true level playing field for the UK's internationally focussed banks.

Issues of clarity and certainty in the law

42. The powers in the Bill – if exercised – could compel UK banks to offer and hold bail-inable debt. In the Society's view this type of sweeping authority raises a number of concerns regarding adherence to the principle of certainty and clarity in the law. These are principles lie at the heart of free contract. The Society is concerned that this fundamental aspect of the UK's legal system may be diluted, if such a power (as proposed) is passed into law.

43. A bail-in instrument is only compatible with the principles of certainty, clarity in the law and free contract if it only applies where:

43.1. this is expressly agreed by the investor(s) at the time of issue of the relevant instrument;

43.2. or it is contained in the relevant contract;

43.3. there is no compulsion; and

43.4. investors are clear about the treatment that shareholders and creditors will receive at the time of investment. As proposed it would potentially have a retrospective effect

44. The provisions in the Bill do not meet these tests and therefore the Society urges that they are amended.

The practical consequences of bail-in

45. Bail-in is also problematic for practical reasons. Bail-in may spread problems rather than containing them and lead to a bank in trouble 'going under' rather than helping save it.

46. Diluting the position of bondholders and creditors in this way risks increasing the cost of capital for ring-fenced banks, as they will likely demand more security (including a higher rate of interest) to reflect the increased risk.

47. Therefore the Society considers that if bail-in is going to be applicable to debt instruments, then the:

47.1. types of instruments that should be bail-inable should be limited

47.2. those instruments that are should not be bail-inable at the instigation of any regulator but only through agreement between the ring-fenced bank and the relevant counter-parties; and

47.3. the possibility of bail-in should be clear up-front before contracts are entered into.

Proposed amendment

48. The Society suggests that s142M be amended in the following ways:

48.1. Orders made in relation to the powers granted to HM Treasury by s142M should be made under the 'Super Affirmative' procedure. Please see below for more details.

48.2. Amend s142M(1) 'The Treasury may by order make provision about the exercise by either regulator of its functions under this Act, as far they are (apart from the order) capable of being exercised in relation to a relevant body, so as to require the relevant body, after issuing clear reasons to the relevant body -'.

48.3. Amend s142M(1)(b) to say '...to ensure any part of the relevant body's future issued debt consists of debt owed by it in respect of debt instruments, or debt instruments of a particular kind'.

48.4. Delete 142M(2)(c).

48.5. Amend 142M(3) to say 'Debt instrument means – (a) a bond, (b) equities, (c) loan stock,...'.

48.6. Add a provision to ensure that only future debt instruments can be affected, unless they are already contractually 'bailable': such issues are commonly called 'co-cos'.

Rationale

49. The amendments suggested are intended to narrow the range of the powers of HM Treasury to make orders in this area. This will ensure bail-in can only be applied to those instruments that it is most appropriate for and ensure compatibility with key legal principles of clarity and certainty in the law.

Clause 9: Depositor Preference

50. The Society has a number of concerns about depositor preference in principle, as well as the practical consequences which may result from its operation.

What the Bill proposes

51. Clause 9 establishes the principle of depositor preference in insolvency law by amending Schedule 6 of the Insolvency Act 1986. This means that up to the deposit protection limit depositors are preferred creditors in cases of bank bankruptcy.

Double protection is unnecessary

52. The Society's first concern is that most deposits are already protected by the Financial Services Compensation Scheme. This system ensures the banking industry collectively guarantee deposits up to the £85,000 limit and those depositors have to be paid out or given access to their deposits within a very short timescale. Typically this is achieved by the FSCS being funded by the Bank of England to pay another bank or to fund a bridge bank to take over the deposit obligations, so that depositors can access their money.

53. The effect of depositor preference in the winding up of a failed bank is thus not to help depositors at all, but to enable the FSCS or Bank of England 'standing in the shoes' of the preferred depositors to be paid out ahead of all other creditors. As that means 'they will probably be paid in full, the FSCS will not need to make any claim on the banking industry and it is they who will benefit at the expense of ordinary creditors.

Bankruptcy is a zero-sum event

54. Bankruptcy – for creditors – is a zero-sum game. Depositor preference will mean that other creditors, who under normal bankruptcy circumstances would expect to have some claim on an insolvent institutions assets are more likely to lose out.

55. These other creditors would include SMEs and other vulnerable individuals, for example, who may have been supplying the bank with goods and services, companies who have lost the money they held with their bank to pay suppliers and employees (in the worst case these businesses will have failed as a result of their bank failing) and individuals in the course of moving house.

56. Introducing the proposed depositor preference will effectively cut across the fundamental principle in UK insolvency law of fairness between unsecured creditors in order to protect the banking industry from liability and cut the carrying costs for the Bank of England. We do not believe the case for preference is not made out.

Impact on the cost of capital

57. Finally, depositor preference will increase the cost of capital for ring-fenced banks as it will lead to creditors adding an additional risk premium to the amounts they are willing to lend, to make up for the fact that they will not be treated equally in an insolvency.

58. In a small number of instances it may mean some potential creditors not being willing to enter into relationships with ring-fenced banks at all and are reluctant to place deposits with them.

59. The proposal is at odds with the importance that the Independent Commission on Banking placed on the ability of ring-fenced banks to access corporate deposits, to assist their capital base and ensure they were able to meet the borrowing needs of customers.

Proposed amendment

60. Deletion of Clause 9 of the Financial Services (Banking Reform) Bill.

Rationale for amendment

61. The Society does not consider that there are any significant benefits to depositor preference, when a compensation scheme already exists, compared to the likely costs, as outlined above i.e.:

61.1. the unnecessary overlap it creates with regards to the FSCS;

61.2. the negative consequences for other creditors; and

61.3. the impact on the cost and availability of funding for ring-fenced banks.

Clause 4: Affirmation Procedure In Relation To Certain Orders Under Part 9B

What the Bill proposes

62. The Bill sets out proposals to ensure that orders exercised under section 142A, B, D, E, I and M are done in normal circumstances through an affirmative procedure, which requires a draft order to be laid before Parliament and approved by each House (142N(2)(a)).

Alternative approach

63. The Society firmly believes that orders made under this Bill *all* need to be subject to the 'Super Affirmative' procedure, which requires the Minister to have regard to representations, resolutions of either House and recommendations of relevant Committees made within 60 days of laying the order.

Leaving too much to secondary legislation

64. The Society welcomes the fact that the Government propose to have some element of scrutiny and affirmation given to future orders by Parliament, but remains concerned that the Bill leaves too much to secondary legislation in general, in a very complicated area.

65. The extensive use of secondary legislation increases uncertainty for banks, groups containing banks and consumers as well as inhibiting planning and compliance and increasing the transition costs of the policy .

Full scrutiny is vital

66. Legislating in relation to banking issues is complex and deserves full consultation with input from expert opinion and those who will be affected by any secondary legislation as well as Parliamentary scrutiny. The consequences of poor rules in this area are potentially very significant for the competitiveness of the banks (a major UK industry), the City and the wider UK economy.

67. High levels of scrutiny fit with the spirit of the recommendations of the Parliamentary Commission on Banking Standards that: '...there be a period of three sitting months between the second reading…and the committee stage during which period, in line with the Government's better regulation practice, all of the principle statutory instruments are subject to formal public consultation' .

68. Further, it would be entirely unreasonable to expect Parliament to undertake detailed and informed scrutiny of the Bill and related orders on complex issues without having the opportunity to consider consultation responses from a wide range of interested and expert stakeholders.

69. The Society believes that the Bill should be explicit in requiring secondary legislation to be brought forward on the basis of the tests set out in s3 of the Legislative and Regulatory Reform Act 2006 i.e. the need for legislation, proportionality and a fair balance of interests.

Proposed amendment

70. Amend 142N(2)(a) '...a draft order of the order has been laid before Parliament and approved by a resolution of each House...the Super Affirmative Resolution procedure, set out in s18 of the Legislative and Regulatory Reform Act 2006, has been followed...'

71. Insert new sub-section 142N(2)(c) '...and the Minister is satisfied that the tests set out in s3 of the Legislative and Regulatory Reform Act 2006 are met in relation to the need for the relevant order and a statement to Parliament, explaining that they have been met, has been made'.

Rationale for amendment

72. The Bill and the secondary legislation elements in particular are complex. They need extensive scrutiny by Parliamentarians and input from outside experts. Only with such extensive examination of the details can

all the possible implications of each piece of secondary legislation be appraised. This will help ensure that any disproportionately negative consequences this legislation may result in are likely to be minimised.

Model/Sample Secondary Legislation

Concerns

73. While there is not enough room to embark on a detailed critique in this evidence with regards to the sample secondary legislation produced by the Treasury, the Society believes those example drafts make clearly the case for detailed Parliamentary Scrutiny.

74. The example dealing with excluded activities provides an example of the unintended consequences that can emerge from legislating speedily in this complex area. Following the high level recommendations of the Independent Commission on Banking, it provides that ring-fenced banks cannot deal with insurance companies[2]. The only exceptions relate to derivative transactions in the bank's treasury functions and aspects of letters of credit arrangements for customers.

75. This has some negative consequences, for example:

75.1. a ring-fenced bank is forbidden to insure its property against normal risks such as fire, theft etc., both with a commercial insurance provider and with a "captive" such as large groups often use in self-insurance arrangements.

76. As it is proposed that ring-fenced banks should not have subsidiaries and that there should be strict limits on dealing with group companies on the other side of the ring-fence, there are additional obstacles to self-insurance and to accessing group resources in that regard.

77. While the Society is confident sensible amendments will be introduced to enable ring-fenced banks to make the same types of prudent insurance arrangements as are open to other businesses, this illustrates the work that needs to be done to achieve appropriate legislation. In addition, it should be noted that this rule:

77.1. would seem to prevent a bank acting as an agent of an insurer in relation to products it cannot sell to customers itself; and

77.2. force insurers to bank only with non-ring-fenced banks.

78. Another illustration arises in relation to the alternative model secondary legislation defining customers which UK regulated non-ring-fenced banks must not deal with[3].

79. The proposal in relation to individuals is that they must place and retain at least £250,000 in assets with the non-ring-fenced bank before they can access its more sophisticated services. This would operate as a severe limitation on freedom of enjoyment of property and free movement of capital and income, forcing the individual to put very substantial sums of money in a single place for long periods of time, even if that is inefficient.

80. EU law does not allow such limitations and the first version of this legislation avoided this pitfall. The Markets in Financial Instruments Directive[4] (MiFID) provides rules which banks use to recognise "sophisticated investors" by the value of their assets wherever held, which could readily be used without introducing any of these restrictions. The current concepts of a 'professional client' and an 'eligible counterparty' are articulated in Rules 3.5 and 3.6 of the FSA's Conduct of Business Sourcebook (*COBS*) and include, in each case, distinct sub-categories of automatic (*per se*) and opted-up (elective) clients.

81. Using MiFID definitions has the significant advantage of being a definition which regulated firms have applied since 1 November 2007 and in relation to which they should already have effective customer on-boarding procedures and processes[5].

82. The Society considers that it would be appropriate (and would strike the right balance) to apply the professional client and eligible counterparty definitions for non-MiFID business in order to define the population of customers who would have the option of having their deposits held by non-ring-fenced UK regulated banks.

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[2] Clause 6 of the Draft Statutory Instrument: *'Banks and Banking - Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 201'* sets out the transactions a ring-fenced entity is prohibited from entering into. It can be accessed here: http://www.hm-treasury.gov.uk/d/draft_excluded_activities_and_prohibitions_order_070313.pdf

[3] Article 3 of the draft statutory Instrument: *'Financial Services and Markets – Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 201'* defines a core deposit for the purposes of the Bill and what is not considered a core deposit. The subsequent definitions of High-Net-Worth-Individual and SME and the relevant obligations banks have to check their status are set out in Clauses 4 and 5. Article 9 sets out the steps a non-ring-fenced body must take if it is holding if it is holding non-core deposits but must be treated as such. The draft SI can be accessed here: http://www.hm-treasury.gov.uk/d/alternative_draft_ring_fenced_bodies_and_core_activities_order_180313.pdf

[4] 2004/39/EC

[5] For more information please see the Law Society response to the Treasury's consultative White Paper: '*Banking Reform: delivering stability and supporting a sustainable economy*', which can be accessed from the Law Society website.

83. There are many other issues arising from the first efforts at drafting subsidiary legislation, but we believe the above are sufficient to make the case for very much enhanced Parliamentary scrutiny.

April 2013

Memorandum submitted by Neil Jeffares (FS 02)

SUMMARY

- The depositor priority provisions set up by clause 9 of the Financial Services (Banking Reform) Bill 2012–13 represent a fundamental threat to the safety of banking in the UK, and combine unfairness with structural instability.
- The provisions raise serious questions of mis-selling unless understood by the public.
- But if understood, they will make it impossible for deposit-taking and transactional business to be conducted effectively. This will be counterproductive to the UK financial services industry and to the growth prospects of the UK economy.
- The retrospective effect on existing fixed term deposits may be unconstitutional.

ABOUT THE AUTHOR

1. I am a retired investment banker. This submission is made in a personal capacity.

BAILING IN AND BANK FAILURE

2. Everyone now understands that the providers of bank capital must be at risk in the next collapse if the "too big to fail" phenomenon is to be effectively challenged. As Lord Turner put it in evidence given by to the Banking Standards Commission (27 February 2013), there is "a [new] philosophy that we are going to accept in future that the actual failure of a bank – provided that it happens in a smooth fashion…with rapid payout of insured deposits – is not a regulatory failure."

3. Clause 9 will make it quite impossible to meet Lord Turner's proviso if the ordinary users of banking services – businesses and individuals whose balance exceeds the Financial Services Compensation Scheme ("FSCS") limit of £85,000 on any day – are lumped in with shareholders, management and bondholders.

BAILING IN AND SUBORDINATION OF DEPOSITS

4. Under clause 9, which amends insolvency law on preferential debts, uninsured depositors are not merely to be bailed in, but they are to be subordinated to the claims of the rest of the banking industry whose rights to recover their FSCS contributions are to become preferential debts and thus given priority. The effect is that on liquidation, an uninsured depositor is likely to receive nothing, even where a bank's asset quality might conceivably have been quite good and where the payout to senior creditors with *pari passu* treatment would have been high.

5. Here is a simple example. Suppose a bank has £100 of assets (all unpledged for simplicity), funded by £3 of equity, £90 of insured deposits and £7 of uninsured deposits. Its assets then shrink by say 10% (a level exceeded by HBOS's 2008 loan book) to £90, and it is wound up. Under current rules the uninsured depositors will get back (7/97)x90 or 93p in the £ (the same rate as the FSCS, who have had to pay out the smaller depositors in full), while under the new rules the FSCS lays first claim on the £90 assets having paid out that amount to the smaller depositors, and nothing is left over for the uninsured depositors.

6. The arithmetic is a little more complicated when secured interbank funding is involved, but the same principle applies – the recovery rate for uninsured deposits will be significantly adversely affected, the beneficiaries of this being other banks. In essence anyone placing an uninsured deposit with a UK bank will have a risk analogous to a subordinated bond for which the banks would normally have to pay a coupon of say 7–10%, while the deposit pays no more than an FSCS guaranteed level of 1–2%.

EFFECTS ON DEPOSITORS AND BANKS

7. If this bill is enacted in its present form, it is only a matter of time before banks will find it impossible to raise deposits over £85,000 in the traditional manner. Large corporates will move their funds overseas and the damage to the UK economy and growth prospects will be incalculable.

8. You cannot run a modern economy where banks cannot be trusted to handle transactions as small as this limit. You cannot expect small businesses, charities or retired people with modest savings to "be responsible for monitoring and managing the risk associated with their investments" (as Greg Clark has suggested in a letter to my MP) by, presumably, performing credit analysis of the banks before placing deposits: even knowledgeable customers cannot do this (the regulators themselves failed), not least since Government policies have compounded the obscurity of bank financial information by continuing to allow banks to borrow from one another secured, while retail depositors cannot negotiate such protection. In practice depositors, unlike shareholders, have no votes, and cannot influence behaviour by changing management. Nor is the threat of moving their deposit realistic in an industry that offers inadequate competition.

Retrospective impact and mis-selling

9. Another deeply unsatisfactory aspect of this proposal is its retrospective effect. Many will have placed substantial, unbreakable fixed term deposits with UK banks before the legislation was mooted. They will have done so in the legitimate expectation, following Northern Rock, that whatever the legal position, *Realpolitik* would require support for retail depositors. There is ample evidence that this belief was rational. For example, in 2010 a High Court judge (Henderson J in Alliance & Leicester) said "It will be recalled that, when Northern Rock was on the point of collapse in September 2007, the government stepped in to guarantee deposits of any size with that institution, and I find it difficult to envisage circumstances where similar steps would not be taken in the future." And while the Chancellor signalled the new philosophy in evidence to the Banking Standards Commission in November 2012, Sir Mervyn King's comments to the same committee indicated that he thought that the depositors of a large bank could not in practice be bailed in.

10. Despite the explosive political implications of the Government introducing a measure that favours banks over customers, astonishingly the press has not so far picked up on this. That will of course change the moment any UK bank gets into difficulties, and we will see endless newspaper articles drawing parallels with Cyprus etc. From that point the effects I describe in paragraphs 7 and 8 above will inexorably unfold. But until press coverage changes and the public fully understand that they are taking a 7–10% risk for a 1–2% return, deposits may continue to be placed on what I considered to be a fraudulent basis.

11. It may be that, consistent with the attitudes set out in paragraph 9 above (and see paragraph 16 below), Parliament considers that clause 9 will not in practice be applied in the resolution of a major UK bank. No doubt the Chancellor feels there is some advantage in retaining the discretion as to whether or not to bail out depositors in such banks, fearing perhaps that any clear statement of policy would be "gamed" by the industry, but it is profoundly unsatisfactory for the fortunes of millions of people to remain at the whim of an individual in a crisis rather than determined by clear rules established by Parliament without a gun to its head and consistently applied whatever the situation.

12. What is clear is that if clause 9 is enacted in its present form, but no steps are taken to warn business and retail customers that uninsured deposits are effectively "junk", the Government itself will be guilty of the most major mis-selling scandal ever, dwarfing PPI. (It is irrelevant that the losses incurred by depositors have not yet materialised. Risk has a price and, as with PPI, mis-selling has occurred if you sell risk for the wrong price even if the catastrophe does not eventuate.) If such warnings were issued, the breakdown of the deposit-taking business would inevitably follow.

13. That is the central flaw in this proposal: it can only be contemplated in a miasma of confusion about executive intentions and policies for bank resolution. Once that policy is made clear, the disastrous consequences of these depositor priority provisions will be apparent to all.

Parliamentary debate and commission recommendations

14. In the 26 March debate, Greg Clark responded to Chris Leslie's question about the position of uninsured depositors by pointing out the need to place the burden of default on one or other class of creditors, but he also stated that "it is absolutely our intention to ensure that other subscribers bear the responsibility for bailing in banks, should they fail in future, rather than depositors." But unless there are provisions for much more radical change to the leverage and capitalisation of banks, the priority of deposits will remain a crucial factor in the recovery rate for uninsured deposits in the resolutions which are now seen as inevitable.

15. Since Government rejected the Vickers Commission's leverage proposals, it is difficult for them to claim that clause 9 follows Vickers's recommendations since Mr Clark argues that the provisions go together. The Parliamentary Commission on Banking Standards wisely recommended further investigation of this point.

16. Mr Clark's 26 March statement quoted in paragraph 14 above does however reinforce the point that the Government continue to try to reassure depositors that it is "business as usual", with the implication that they have little to fear. For the reasons stated above I regard this ambiguity as profoundly unsatisfactory.

April 2013