House of Lords
House of Commons

Parliamentary Commission on Banking Standards

Banking reform: towards the right structure

Second Report of Session 2012–13

HL Paper 126

HC 1012

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Report, together with formal minutes

Written and oral evidence is available on the Commission's website, www.parliament.uk/bankingstandards

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Parliamentary Commission on Banking Standards

The Parliamentary Commission on Banking Standards is appointed by both Houses of Parliament to consider and report on professional standards and culture of the UK banking sector, taking account of regulatory and competition investigations into the LIBOR rate-setting process, lessons to be learned about corporate governance, transparency and conflicts of interest, and their implications for regulation and for Government policy and to make recommendations for legislative and other action.

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The Lord Archbishop of Canterbury (Non-Affiliated)
Mark Garnier MP (Conservative, Wyre Forest)
Baroness Kramer (Liberal Democrat)
Rt Hon Lord Lawson of Blaby (Conservative)
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John Thurso MP (Liberal Democrat, Caithness, Sutherland and Easter Ross)
Lord Turnbull KCB CVO (Crossbench)

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The Reports and evidence of the Commission are published by The Stationery Office by Order of the House. All publications of the Commission (including press notices) are on the Internet at http://www.parliament.uk/bankingstandards.

Commission staff

The following parliamentary staff are currently working for the Commission:

Colin Lee (Commons Clerk and Chief of Staff), Adam Mellows-Facer (Deputy Chief of Staff), Richard McLean (Lords Clerk), Lydia Menzies (Second Clerk), Lucy Petrie (Second Clerk), Robert Law (Commission Specialist), Jay Sheth (Commission Specialist), Gavin Thompson (Commission Specialist), James Abbott (Media Officer), Tony Catinella (Senior Committee Assistant), James Bowman (Senior Committee Assistant), Claire Cozens (Senior Committee Assistant), Katherine McCarthy (Committee Assistant), Daniel Moeller (Committee Assistant), Baris Tufekci (Committee Support-Assistant), Ann Williams (PA to the Chief of Staff) and Danielle Nash (Committee Support Assistant).

The following staff are currently on secondment from outside of Parliament to work for the Commission as Commission Specialists:

Amélie Baudot, Paul Brione, Suvro Dutta, Oonagh Harrison, Zoe Leung-Hubbard, Julia Rangasamy, John Sutherland, Greg Thwaites and Elizabeth Wilson.

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Footnotes

In the footnotes of this Report, references indicated by 'Q' and followed by a question number refer to oral evidence taken by the Commission. Transcripts of this oral evidence and oral evidence taken by the Commission's panels are available at http://www.parliament.uk/business/committees/committees-a-z/joint-select/professional-standards-in-the-banking-industry/publications/.

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Report

1 Introduction

1. Structural reform represents a crucial building block for establishing a safer and more secure banking system in the United Kingdom. This Commission, in its First Report, concluded that partial structural separation of the kind proposed initially by the Independent Commission on Banking (ICB) and subsequently, with modifications, by the Government in its October 2012 draft Financial Services (Banking Reform) Bill could bring significant benefits for public policy and for banking.[1] We recommended a number of steps to strengthen the proposed legislation and to increase its chances of being effective, as well as other measures to enhance the stability of the banking system as a whole.

2. On Monday 4 February, the Government presented to the House of Commons the Financial Services (Banking Reform) Bill.[2] The Government published alongside the Bill a policy paper on Banking Reform incorporating its response to our First Report.[3] The Government's policy was supported by a speech that morning by the Rt Hon George Osborne MP, Chancellor of the Exchequer,[4] an answer that afternoon by Greg Clark MP, Financial Secretary to the Treasury to an urgent question in the House of Commons,[5] and a speech by the Rt Hon Vince Cable, Secretary of State for Business, Innovation and Skills on Wednesday 6 February.[6]

3. In our First Report, we considered the policy context of the Government's reform proposals, assessed the case for a 'ring-fence' to secure greater protection for the core retail activities of the banking sector alongside other structural reform options, described how the Government proposed to give legal effect to such a ring-fence and proposed additional measures for inclusion in the Bill. This Report:

a) considers the Government's response to our First Report in relation to the most significant recommendations in that Report;

b) provides (in the Annex to this Report) a summary of each recommendation in our First Report, the Government response and relevant legislative changes; and

c) provides amendments to facilitate debate in the House of Commons and House of Lords on legislative recommendations in our First Report not yet reflected in the Bill.

4. In preparing this Report, we have drawn upon oral evidence taken as part of our wider continuing work on banking culture and standards, most notably that from Sir John Vickers, who chaired the ICB, from Martin Taylor and Bill Winters, who were members of

1 Parliamentary Commission on Banking Standards, First Report, HC (2012–13) 848 and HL Paper 98 of Session 2012–13 (hereafter cited as First Report), para 93. The Report was published on 21 December 2012.

2 Financial Services (Banking Reform) Bill, [Bill 130(2012-13)] (hereafter cited as Financial Services (Banking Reform) Bill)

3 HM Treasury and Department for Business, Innovation and Skills, *Banking reform: a new structure for stability and growth*, February 2013, Cm 8545 (hereafter cited as *Banking reform*)

4 HM Treasury, Speech on the Reform of Banking by the Chancellor of the Exchequer, Rt Hon George Osborne MP, 4 February 2013 (hereafter cited as Chancellor's Banking Reform speech)

5 HC Deb, 4 February 2013, cols 23 - 34

6 Department for Business Innovation and Skills,, Speech on Banking by the Secretary of State for Business, Innovation and Skills, Rt Hon Vince Cable MP, 6 February 2013 (hereafter cited as Speech by Secretary of State for Business, Innovation and Skills on 6 February)

the ICB, from the British Bankers' Association (BBA) and from individual banks directly affected by the proposals. We also commissioned Philip Davies, formerly a Parliamentary Counsel and now a consultant legislative drafter, to prepare amendments arising from our legislative recommendations, which are set out in the Appendix to this Report. We publish these amendments while recognising that further work will need to be undertaken on how best to give legislative effect to our recommendations. The Commission is most grateful to all those who assisted with the work leading to this Report, including specialist advisers Bill Allen and Professor Geoffrey Wood.[7]

7 Bill Allen and Professor Geoffrey Wood declared interests, relevant to the Commission's work, on 29 August 2012. Declarations of interest are available at http://www.parliament.uk/business/committees/committees-a-z/joint-select/professional-standards-in-the-banking-industry/formal-minutes/ The Commission has also appointed other Specialist Advisers in relation to other aspects of its work.

2 Reinforcing the ring-fence

Introduction

5. In our First Report, we found convincing evidence on the benefits of structural reform, not only on grounds of financial stability but also for its potential to change the culture of banks for the better—an area not examined by the ICB.[8] We identified a number of challenges that a new structural framework for banks would face.[9] In the light of these challenges, we concluded that the proposals for the ring-fence as they stood at the time the draft Bill was published in October 2012 might well not be sufficient to achieve the Government's policy objectives.[10] We reflected upon the advice from the Chancellor of the Exchequer, and Sir Mervyn King, Governor of the Bank of England, not to miss the opportunity created by a measure of agreement on implementing a ring-fence.[11] Accordingly, we set out a series of measures to reinforce the ring-fence in order to increase the prospect of it proving durable in the long-term.[12] The Commission's approach was welcomed by Sir John Vickers, who supported the approach of increasing the durability and permanence of the ring-fence.[13]

6. In its response the Government has agreed with our view that "it is essential to ensure that the framework is robust, and not susceptible to erosion over time".[14] The Government has also agreed "that further steps should be taken to ensure that the ring-fencing framework stands the test of time".[15] **The Commission welcomes the Government's acceptance of the principle that its proposed framework for ring-fencing requires reinforcement. In this chapter, we consider progress in relation to our main suggestions with this aim in mind.**

Electrifying the ring-fence

The rationale for electrification

7. The analysis which we undertook of the approach of banks towards their regulation, and the likely response of regulators and of politicians, led us to conclude that there was a significant risk that the effectiveness of the ring-fence would be eroded over time. In reaching this view we were influenced by the evidence of Paul Volcker, former Chairman of the US Federal Reserve, about the US experience with bank structural reforms in the past and the possible permeability of the ring-fence.[16] The US has twice endeavoured to establish a far greater degree of organisational separation than is envisaged under the ring-

8 First Report, para 45

9 First Report, paras 63–78

10 *Ibid*., para 94

11 *Ibid*., paras 79, 91

12 *Ibid*., para 126

13 Qq 2562, 2571

14 *Banking reform*, para 2.12

15 *Ibid*.

16 First Report, para 84

fence, as early as the National Bank Act of 1866,[17] and again—in the aftermath of the Wall Street Crash—in the Glass-Steagall Act of 1933. Both of these attempts were eventually frustrated, by banks establishing investment affiliates to get around the prohibition,[18] and by bank lobbying which led to the repeal of key provisions of the Glass-Steagall Act in 1999.[19] Drawing on evidence from the Governor of the Bank of England, we identified a risk that banks would view the new framework and the rules that flowed from it as basis for negotiation rather than a line in the sand.[20] The Financial Secretary to the Treasury has observed that "the history of financial regulation shows that banks have been able to discover ways of circumventing the rules".[21] Drawing on a phrase in our Report,[22] the Secretary of State for Business, Innovations and Skills has said:

> the Commission rightly raised concerns about the banks' future behaviour. There is a risk that, when the banks regain, as they surely will, their reputation for alchemy—for turning base metal into gold—they may be tempted to "game" the ring-fence, perhaps by constructing complex instruments. These instruments might technically be classed as retail banking products and – in practice – fail to respect the spirit of ring-fencing.[23]

8. Our intention in our specific proposals for 'electrification' of the ring-fence was to create a significant new disincentive for banks seeking over time to test the ring-fence with a view to undermining its effectiveness. This disincentive was in the form of powers to enforce full institutional separation at the level of individual banks or the sector as a whole. We concluded:

> Additional powers are essential to provide adequate incentives for the banks to comply not just with the rules of the ring-fence, but also with their spirit. In the absence of the Commission's legislative proposals to electrify the ring-fence, the risk that the ring-fence will eventually fail will be much higher.[24]

9. Sir John Vickers did not see it as inevitable that banks would seek to test the ring-fence, but acknowledged that "they might well do so" and that it was thus "a risk that one would want to guard against very seriously and effectively".[25] He considered that the proposals for

17 The 1864 National Bank Act, which created the OCC and the federal bank charter, from the beginning had limitations on banks' abilities to engage in non-banking activities, which in effect limited them and ring fenced them prior to US deposit insurance. Prior to that various States that had organized banking charters (such as New York) had similar provisions.

18 Most banks created affiliates. Two examples were National City Bank in 1911 and Chase National Bank in 1917 who both created affiliates able to transact securities business their 'parent' banks were precluded from.(National City was a New York state chartered bank and Chase was a National Bank (and accordingly subject to the National Bank Act): Stock Exchange Practices, Report of the Committee on Banking and Currency 1934, pp 156, 159.

19 The Gramm–Leach–Bliley Act, also known as the Financial Services Modernization Act of 1999, was enacted on 12 November 12 1999. It repealed part of the Glass-Steagall Act of 1933, removing barriers in the market among banking, securities and insurance companies that prohibited any one institution from acting as any combination of an investment bank, a commercial bank and an insurance company. With the passage of the Gramm–Leach–Bliley Act, commercial banks, investment banks, securities firms, and insurance companies were allowed to consolidate.

20 First Report, paras 132 - 133

21 HC Deb., 4 February 2013, col 33

22 First Report, para 78

23 Speech by Secretary of State for Business, Innovation and Skills on 6 February

24 First Report, para 163

25 Q 2563

electrification would "further reinforce the chance of ring-fencing working".[26] He also thought that it would increase the chance of it working "for longer. It is a question of durability and permanence."[27] He emphasised that the powers could be a "credible threat" to influence bank behaviour without needing to be used.[28] The Chancellor has now accepted the rationale for electrifying the ring-fence:

> We're not going to repeat the mistakes of the past. In America and elsewhere, banks found ways to undermine and get around the rules. Greed overcame good governance. We could see that again— so we are going to arm ourselves in advance. In the jargon, we will 'electrify the ring-fence'.[29]

The first reserve power

10. Our First Report recommended two distinct reserve powers, the first of which would enable the regulator to take steps that could lead to a specific banking group affected by the ring-fence being required to divest itself fully of either its ring-fenced or its non-ring-fenced bank.[30] This power could thus be exercised in respect of an individual bank (or more than one if necessary) while retaining the benefits across the sector as a whole of diversification, with different banking models continuing to operate alongside each other, thus taking account of the case for such diversification made to us by Sir John Vickers in October.[31]

11. The possible impact of this reserve power, and the issues raised about the circumstances in which it might be exercised, were raised by both Anthony Browne, Chief Executive of the BBA[32], and Martin Taylor.[33] Sir John Vickers also stressed the need for checks on the exercise of the power.[34] In our First Report we outlined proposals on how the first reserve power might work, and also several safeguards, which were:

a) A stipulation that the regulator could only commence the process if it felt there was a significant risk to the objectives of the ring-fence;

b) A provision that the power would not be exercisable before the first independent review of the effectiveness of the ring-fence (an independent review which we discuss in the next section of this Report);

c) A requirement for the regulator to give a banking group early notice of any intention to use the reserve power;

d) The appointment of an external reviewer to consider the relationship between the banking group concerned and the regulator;

26 Q 2562. See also Q 2566.

27 Q 2567

28 Qq 2564, 2566

29 Chancellor's Banking Reform speech

30 First Report, para 165

31 *Ibid*., para 157

32 Q 2460

33 Q 2885

34 Q 2564

e) A right of appeal in relation to the exercise of the power; and

f) A Treasury power to override implementation.[35]

12. In its response, the Government has agreed with us that "a reserve power to require an individual banking group to move to full separation of retail and wholesale activities could be a powerful additional tool for the regulator to ensure the independence of a ring-fenced bank".[36] The Chancellor of the Exchequer told us in February that he viewed this reserve power as probably "the most powerful tool" the regulator would have.[37] The Government has agreed to amend the Bill to include provisions giving the regulator the power to enforce full separation between retail and wholesale banking in a specified group. It also stated that it would establish "strict statutory conditions [...] setting out the circumstances in which this power can be used, tests that must be met and factors the regulator must take into account before deciding to require a group to separate".[38] The Government has also indicated that Treasury approval would be required for such a requirement. The Government has announced that it would bring forward an amendment to the Bill to include the necessary provisions.[39] The Government has not referred specifically to our proposal relating to the involvement of an external reviewer to examine the relationship between the regulator and the bank concerned before the power is exercised, but the Financial Secretary to the Treasury confirmed that the amendment would reflect the Commission's recommendations.[40]

13. When our First Report was published in December, the Chief Executive of the BBA, Anthony Browne, was reported as saying that "the threat of banks being broken up was causing uncertainty, and making it harder for them to raise money which could then be loaned to small firms".[41] In evidence in January Anthony Browne said that he had been seeking to make a wider point about regulatory uncertainty, but reiterated that regulatory uncertainty made it harder for banks to raise capital.[42] When the Government's response was published in early February, Anthony Browne was again reported as expressing almost identical views as in December: "This will create uncertainty for investors, making it more difficult for banks to raise capital, which will ultimately mean that banks will have less money to lend to businesses"[43]

14. In view of the significance of the potential concern about the impact of the measure on bank capital raising, we explored it further with witnesses in the New Year. Both Sir John Vickers and Martin Taylor were unpersuaded by the argument that electrification

35 First Report, paras 165–168

36 *Banking reform*, para 2.22

37 Q 4309

38 *Ibid*.

39 *Ibid.*

40 First Report, para 167; HC Deb, 4 February 2013, cols 26 - 27

41 "Bank reform plan 'could hit homeowners'", *Evening Standard*, 21 December 2012,standard.co.uk

42 Q 2458

43 "Chancellor warns banks over-ring-fencing", *ITN News online*, 4 February 2013, itn.co.uk

increased uncertainty, given that its intention was to ensure that the ring-fence operated properly.[44] Sir John said:

> The only way I can see it increasing uncertainty is if banks intend to play around the boundary, flirting with it.[45]

15. In view of the fact that the BBA purports to represent banks and to lobby on their behalf and that its principal source of funding is from the banks directly affected by the ring-fence proposals, we were keen to seek the views of individual banks. We asked António Horta-Osório, Group Chief Executive, Lloyds Banking Group, whether he agreed with the BBA's opposition to electrification. He replied:

> We were not notified about those comments, which I think were made by the CEO of the BBA in his name. I support electrification, like I supported ring-fencing. As you know, we were the only bank publicly to support ring-fencing. The reason why I support your proposal is that, if we think that for society as a whole it is better to have ring-fencing, both from a financial stability point of view and from a cultural point of view, I absolutely agree that you should have strong enforcement and strong incentives in order for that to happen.[46]

Both Sir David Walker, Chairman of Barclays and Douglas Flint, Executive Chairman of HSBC, also indicated that they supported the proposal for the first reserve power, the latter saying:

> In the event that it is judged that participants are circumventing or frustrating the purpose of the ring-fence, it seems to me quite reasonable for there to be a sanction.[47]

In evidence to the Treasury Committee, the next Governor of the Bank of England, Dr Mark Carney, also indicated his support for the first reserve power.[48]

16. **The Commission finds it surprising that the Chief Executive of the British Bankers' Association should adopt a policy position which has no public support from the major banks most directly affected by the ring-fence.**

17. **The Commission sees no merit in the proposition that the first reserve power will create uncertainty for banks or put at risk their attempts to raise funds for lending. That power will be a source of uncertainty only for those minded to take actions that conflict with the objectives of the ring-fence. For all other banks, for regulators, for Parliament and the public, it will be a source of greater certainty about the effectiveness of the ring-fence. The Commission welcomes the Government's commitment to amend the Bill to provide for a reserve power to break-up a bank that seeks to flout the ring-fence.**

44 Qq 2570, 2882

45 Q 2570

46 Q 3421

47 Qq 3518, 3766

48 Uncorrected transcript of oral evidence taken before the Treasury Committee on 7 February 2013, HC (2012-13) 944, (hereafter cited as HC (2012-13) 944), Q 135

18. **We consider it important that the regulator's powers to break-up a bank should be exercisable only after consideration of the regulator's relationship with the bank by an independent reviewer. It is also important that the reviewer should be independent of Government. We welcome the Financial Secretary to the Treasury's commitment to give careful consideration to our specific proposals on the conditions on the exercise of this power. Amendments J and K in the Appendix are intended to provide an early opportunity for the House of Commons to consider further this reserve power and the appropriate limits upon its exercise. We would also envisage a specific timetable relating to the exercise of the powers, to be determined at the outset.**

19. We have also considered whether it would be appropriate in certain circumstances for the reserve power to create a complete split between a ring-fenced bank and an investment bank to be supplemented by a specific regulatory power to require banks to cease certain, specified activities. We note that, under the prospective EU Recovery and Resolution Directive, the regulators are expected by the Government to be given "substantial powers to require reorganisations", but this power is only to be exercisable in the context of achieving resolvability.[49] We envisage a power that would be exercised to secure protection for the cultural position of ring-fenced activities by removing specified activities from within a particular bank that posed a cultural threat rather than a threat to resolvability. **We recommend that the Government make explicit provision in the Bill to enable the regulator to require a bank to divest itself of a specified division or set of activities which would fall short of the full divestment required under the first reserve power. We envisage that this power would be subject to limits on its exercise similar to those of the first reserve power.**

The independent review mechanism

20. Although the Government has accepted the principle of the first reserve power, it has not yet been convinced of the case we set out for a statutory independent review mechanism. In our First Report we concluded that the review of the ring-fence envisaged in the draft Bill was too narrow. We recommended both an annual review of the operation of the ring-fence by the Prudential Regulation Authority (PRA) and a regular independently-led review—the first after four years, and every five years thereafter—of the ring-fence's effectiveness.[50]

21. The periodic independent reviews represent a crucial part of the architecture for implementation of the reserve powers that we recommended. The first reserve power, to which we referred in the previous section, would not be available to the regulator until after the completion of the first such review.[51] The second reserve power for full separation across the banking sector as a whole, which we consider in the next section, would only be exercisable following recommendations of such a review.[52]

49 *Banking reform*, para 2.25

50 First Report, paras 164, 171–172

51 *Ibid.*, para 166

52 *Ibid.*, para 171

22. The Government has accepted that the PRA should be required to conduct annual reviews of the operation of the ring-fence,[53] and has made provision for this in the Bill.[54] The Government has said that it will review the ring-fence and its effectiveness on a continuing basis,[55] and the Bill provides for the PRA itself to carry out reviews of the ring-fence every five years.[56] In its response to our Report, the Government did not address the case for an independent and external review of the kind we recommended, but in oral evidence in February the Chancellor of the Exchequer told us that he would be "very happy" to consider an independent review of the overall effectiveness of the ring-fence.[57] He said that his concerns had been about a review being tasked specifically with considering the case for full separation.[58]

23. The case for a statutory, periodic and independent review was made in evidence rehearsed in our First Report, notably that from the Governor of the Bank of England.[59] In subsequent evidence, Sir John Vickers supported the proposal for a "serious periodic review", suggesting that it should also consider the allied measures on capital and loss absorbency.[60] Sir David Walker also emphasised the importance of any review of the ring-fence before any changes were made being "independent": "if it is an independent review after a period of time, I don't see how we could object to that".[61] Douglas Flint also supported the proposition:

> I think it would be remarkable if everybody who has been involved in this process is able to anticipate everything that might arise from the operationalising of the ring-fence over the next three to five years. I actually think that the first independent review might be earlier than five years, because problems, if they arise on either side of this application, will probably arise quickly in its operation, rather than later. So I think maybe three years afterwards would be a good first time.[62]

24. **The Government's proposal for the periodic review to be conducted by the regulator is wholly inadequate. Such a review conducted by the regulator would be little different in character from the regulator's annual report and could amount to no more than a case of the regulator marking its own examination paper. The creation of a periodic independent review arrangement is crucial to the balance that we sought to strike between giving regulators the tools they need to do their job effectively and giving Parliament, the public and the banks affected confidence that there will be independent constraints upon the exercise of those regulatory powers. One of the strengths of the banking industry (as well as one of its weaknesses) is its capacity for innovation. The new framework must be subject to regular periodic, independent review to ensure that**

53 *Banking Reform*, para 2.24

54 Bill 130, cl. 6 (amending Schedule 1ZB to FSMA)

55 *Banking Reform*, para 2.24

56 Bill 130, cl. 4 (new section 142J)

57 Q 4312

58 Q 4311

59 First Report, para 170

60 Q 2568

61 Q 3519

62 Q 3767

that framework keeps pace with innovation in the banking sector as well as the experience of the operation of the ring-fence. We welcome the Chancellor of the Exchequer's indication that he is happy to consider the case for an independent review. We urge the two Houses of Parliament to support our proposal for an independent review; Amendment N in the Appendix enables the two Houses to debate and reach a decision in principle on this proposition.

The second reserve power

25. Alongside our proposal for a group-specific regulatory power to enforce full structural separation, we recommended that the independent review should be required to assess the case for a move to full separation across the banking sector as a whole.[63] To strengthen the hand of the review in considering this issue, we recommended that legislation to give effect to any such recommendation should be included in the Bill now before Parliament.[64]

26. The Government has rejected the case for a reserve power at this stage for full structural separation. The Government advances several grounds for that rejection. First, it contends that passing such legislation would entail the Government pursuing a "different policy" from that contained in the Bill, a policy which in the Government's view would be based on the assumption that the ring-fence might fail, when the Government does not itself believe that the ring-fence will fail.[65] Second, the Government argues that "it is not necessary to legislate now for a reserve power to abandon ring-fencing at some point in the future", because this is a decision best made by Government and Parliament at the time.[66] Third, it contends that it would be wrong for the final decision on whether to bring in such a radical change to be in the hands of the regulator rather than for Government and Parliament.[67]

27. **The Government has been at pains to make the case against the provision for full separation being implemented on the say so of the regulator. The Government has erected a straw man which it has then successfully demolished, because we made no such recommendation in our First Report. Instead, we envisaged that the legislative provisions would be brought into force only in the light of the recommendations of the independent review.**

28. **The Commission continues to believe that statutory provision for full separation should be included in the Bill now before Parliament. Amendments L and M in the Appendix facilitate debate and decision in principle on this proposition. The power would not be available to be implemented until after the case for full separation across the sector had been considered by an independent periodic review of the effectiveness of the ring-fencing framework which had come to a recommendation to that effect. The view of the regulator would be of great importance in such consideration, but we would expect the decision to implement full separation across the sector to be a matter for Government and Parliament. We have therefore made provision for the amendments**

63 First Report, para 171

64 *Ibid*., paras 164, 171

65 HC Deb, 4 February 2013, col 27; *Banking Reform*, para 2.23

66 *Banking Reform*, para 2.23

67 *Ibid*., para 2.23

which give effect to full separation across the sector as a whole to come into force only after an affirmative resolution in both Houses.

Objectives in primary legislation

29. The draft Bill set out a proposed 'continuity objective' for the regulator—in almost all cases the new PRA—in discharging its functions in relation to the ring-fence. This objective was defined as "protecting the continuity of the provision of core services", a term itself defined by reference to the management of retail deposits and associated payments and overdraft facilities. Drawing on evidence from regulators and others, we concluded that the proposed objective did not adequately reflect the stated objectives of the underlying policy, relating to absorbing losses, reducing the costs and difficulties of resolution and curbing incentives for excessive risk-taking. We recommended that these underlying objectives be reflected in the relevant statutory provisions and that the relationship between the continuity objective and other regulatory objectives should be clarified.[68]

30. The Government has now agreed that "the objectives of ring-fencing should be fully reflected on the face of the Bill and that the relationship between the PRA's continuity objective and the regulator's other objective should be clarified".[69] To achieve the latter end, the Government has amended the Bill to make the continuity objective part of the PRA's general objective—promoting the safety and soundness of the institutions that it regulates—so that it is one means by which the PRA advances that general objective.[70] According to the Government, "as a result of this change, it should be clear that ensuring continuity of (ring-fenced) core services is a central pillar of the PRA's general objective, and not an additional obligation".[71] The Government has revised its formulation of the continuity objective in an endeavour to reflect the ICB's three objectives for ring-fencing and set out its reasons for its approach.[72] **The Commission welcomes the Government's clarification of the relationship between the continuity objective and the PRA's general objective, and the steps it has taken with regard to the formulation of the continuity objective. We invite the two Houses of Parliament to examine the Government's changes alongside Amendments A to D in the Appendix, which we consider adhere more fully to the ICB's objectives for ring-fencing.**

Delegated powers and scrutiny of secondary legislation

The approach of the draft Bill and the associated risks

31. The draft Bill was primarily an enabling Bill, seeking the powers that would enable the Treasury to implement its proposed policy through secondary legislation.[73] Although some of the key concepts to give effect to the ring-fence were included in the proposed primary

68 First Report, paras 127–130

69 *Banking reform*, para 2.14

70 *Banking reform*, para 2.14; Bill 130, Clause 1; FSMA, section 2B(2)

71 *Banking reform*, para 2.14

72 *Banking reform*, para 2.15; Bill 130, Clause 1 (inserted subsection (3)(c) of section 2B of FSMA)

73 First Report, para 117

legislation, these were to be subject to qualification and adaptation through the exercise of delegated powers. We pointed out that this enabled very different policy outcomes, some of which might be quite distinct from the Government's stated policy, to be delivered through the same statutory vehicle.[74] We concluded that the heavy reliance on secondary legislation left open too many questions of significant policy importance, creating uncertainty for the regulators charged with making the framework operational and for the banks required to operate within it. In consequence, the jury was still out on whether the Government would implement the letter and the spirit of the ring-fence as then proposed.[75] We recommended a number of specific steps to redress the imbalance that might flow from the Government's proposed approach, the main ones of which we consider in this section.

Consideration of initial proposed secondary legislation in draft

32. During the initial phase of our inquiry the Government committed itself to producing the principal draft secondary legislation before the House of Commons Committee stage and to publish all draft secondary legislation later in 2013.[76] We recommended that the principal draft secondary legislation should be published at the same time as the Bill, and that there should be a pause of three sitting months between the publication of the Bill and the commencement of Committee stage.[77] In its response to our First Report, the Government has restated its previous commitment in slightly more specific form:

> To assist Parliamentary scrutiny of the Bill, the Government will by the Bill's Commons Committee stage publish drafts of the principal statutory instruments, including those establishing the scope of the ring-fence, the de minimis exemption from ring-fencing, the specific prohibitions on ring-fenced banks, and the precise conditions for exemptions.[78]

In answer to an urgent question the same day, the Financial Secretary to the Treasury went slightly further, stating that "Drafts of the principal statutory instruments to be made will be made available to the House before Second Reading".[79] **The Commission notes with disappointment that even the 'principal' secondary legislation was not available at the time of publication of the Bill as we had recommended, but welcomes the commitment to publish it before Second Reading.**

Conditions on the exercise of certain delegated powers

33. We expressed particular concern about the delegated powers to exempt a class of institutions from the requirements of the ring-fence and to change the definition of an 'excluded activity'—one that ring-fenced banks cannot conduct. The proposed condition was framed as a negative test—relating to the likelihood of a significant adverse effect on the provision of core services—whereas we recommended that exemptions be permitted

74 *Ibid*., paras 57–58

75 *Ibid*., paras 122–123

76 *Ibid*., para 115

77 *Ibid*., 124–125. We accepted that the pause could be two months in the event that the Bill was published after the February recess, an eventuality which has not materialised.

78 *Banking reform,* para 2.10

79 HC Deb, 4 February 2013, col 24

only if they did not pose a risk to the continuity objective and provided a significant economic or financial stability benefit.[80] In response the Government has agreed that the tests should be "tough" and indicated that it "will consider further amendments to ensure that the tests deliver the policy intention".[81] **The Commission welcomes in the Government's commitment in principle to consider toughening the tests for the exercise of delegated powers for exemptions from the ring-fence. We believe that the specific tougher tests we proposed in our First Report are the right ones. We commend Amendments E and F to assist in parliamentary consideration of that recommendation.**

Parliamentary scrutiny

34. One way in which concerns about the extent of delegated powers can be allayed is by making provision for effective parliamentary scrutiny. In November, the Chancellor of the Exchequer accepted the need for proper scrutiny.[82] However, under the draft Bill, almost all of the powers to determine and then amend the location of the ring-fence were proposed to be subject to the weakest form of scrutiny—the negative resolution procedure. We supported the assessment of the Delegated Powers and Regulatory Reform Committee that the Government's justification for its proposed approach was unsatisfactory, and recommended that the key delegated powers should be subject to the affirmative resolution procedure.[83] In order to reduce the risk of the ring-fence being undermined over time, we devised a set of measures to ensure that subsequent proposals to amend the secondary legislation governing the ring-fence were subject to full consultation and parliamentary scrutiny by an ad hoc committee of the two Houses of Parliament before they took final form, except in urgent cases.[84]

35. In its response, the Government has again accepted the need for proper scrutiny of secondary legislation, and the Bill has been amended to provide for the affirmative resolution procedure in respect of the powers we identified.[85] In November, the Chancellor of the Exchequer told us that, "if this Commission recommends further ways of scrutinising that secondary legislation, of course I will be very willing to listen to it".[86] The Government has made clear its intention to "publish all secondary legislation for consultation where possible".[87] However, the recommendations we devised to ensure greater transparency for secondary legislation which could move the ring-fence have been rejected by the Government in a single sentence: "The Government does not consider that an additional Parliamentary scrutiny process is necessary".[88] **The Commission remains firmly of the view that the considerable scope for moving the location of the ring-fence through the exercise of delegated powers necessitates enhanced parliamentary scrutiny.**

80 First Report, paras 134–135

81 *Banking reform*, para 2.16

82 First Report, para 115

83 *Ibid*., paras 141–146

84 *Ibid*., paras 150–152

85 *Banking reform*, para 2.18

86 First Report, para 115

87 *Banking reform*, para 2.32

88 *Ibid*., para 2.20

We invite the two Houses of Parliament to consider Amendment I in the Appendix which seeks to give effect to our proposals and which additionally provides that the Chair of the Treasury Committee should be the chair of the ad hoc joint committee.

3 Specific issues on ring-fence implementation

Ring-fenced banks acting as principal in the sale of derivatives

36. In chapter 10 of our First Report we considered some specific issues on the implementation of the ring-fence, including some where proposed Government policy was at odds with the proposals of the ICB. Of these issues, the most vexed and complex related to the sale of derivatives. The ICB recommended that ring-fenced banks should not themselves take on exposures arising from the sale of derivatives, and concluded that the best way to secure this was by requiring ring-fenced banks to act as agents for products sold by others, rather than acting as principal. The Government took a different view, arguing that ring-fenced banks should be able to sell simple derivatives, but soliciting this Commission's views on the matter.[89]

37. We identified a number of prudential and conduct risks associated with the sale of derivatives, such that the sale of derivatives within the ring-fence posed a risk to its success. We accepted that there might be a case in principle for permitting the sale of derivatives within the ring-fence, subject to three conditions:

i) There were adequate safeguards to prevent mis-selling;

ii) 'Simple' derivatives could be defined in a way that was limited and durable;

iii) There were limits on the proportion of the bank's balance sheet that could be taken up by derivative products.

We recommended early consultation on a proposed definition of 'simple' derivatives and a cap on the gross volume of derivative sales by ring-fenced banks.[90]

38. Giving evidence in January, Martin Taylor was more forthright on the potential problems of the sale of derivatives within the ring-fence than he had been previously. He argued that, if ring-fenced banks held exposures resulting from derivatives on their balance sheet, resolution would become "more difficult straight away".[91] It would also result in some trading business within banks benefiting from the cheaper funding likely to be available to ring-fenced banks. A prohibition would be an easy rule to write; anything short of that would open the door to problems, being "the kind of unforced error that we will really regret".[92] Summing the matter as he saw it up, he said:

> I can't see the point of having a fence round the chicken coop, electrifying it to keep the foxes out and then inviting a family of tame foxes to live inside it [...] My views on this have hardened, and I think that, if you allow derivatives inside the fence, you

89 First Report, paras 174–175

90 First Report, paras 191-195

91 Q 2934

92 *Ibid.*

> weaken it, and even with the electrification proposals, you end up somewhere worse off than Vickers mark 1.[93]

39. Sir John Vickers told us that he remained sceptical as to whether a practical definition of 'simple' derivatives could be arrived at, while accepting that, if it could, the concerns which underlay the ICB's recommendations might be allayed in part.[94] However, he reminded us that the sale of derivatives had been part of the expansion of UK banks into riskier fields in the decade before the crisis.[95] He thus remained concerned that the sale of derivatives by ring-fenced banks could act as the thin end of a wedge leading to the problems of less resolvable banks and greater counter-party risk among the banks that ring-fencing was designed to reduce.[96]

40. Bill Winters, another member of the ICB, noted that our support for the inclusion of derivatives within the ring-fence had been very conditional.[97] He went on to identify the potential problems from a burgeoning derivatives trade within the ring-fence:

> Derivatives, particularly as they become more complicated, provide all sorts of avenues for banks—or corporations for that matter—to effectively move around value and cash from one place to another in ways that cannot easily be tracked.[98]

As to whether 'simple' derivatives could be effectively defined, he replied:

> There will be simple derivatives, of one form or another, inside the ring fence in any case, because there have to be for the treasury operations of the bank, otherwise we would be forcing them to take imprudent risk, which no one is suggesting. The question is: can regulators properly police this concept of "simple" or the underlying motives? I say that it will be difficult, but not impossible. The alternative is to say, "You simply cannot manage your risk, either for yourself or for your customers inside the ring fence", which would be the wrong conclusion in my opinion.[99]

He supported the concept of a gross cap if it could serve as a trigger point for heightened supervision and provided that the level of the cap were not set in stone.[100]

41. The Financial Secretary to the Treasury has acknowledged the provisional nature of the conclusions in our First Report on derivatives:

> The Commission expressed the interim view that it was reasonable [...] for simple derivatives to be provided from within a ring-fenced bank. However, it wants to reflect further on whether any of its inquiries into the culture of banking may have implications for that. We will await its conclusions.[101]

93 Q 2885

94 Q 2574

95 Q 2576

96 Q 2574

97 Qq 3678 - 3679

98 Q 3678

99 Q 3679

100 Q 3680

101 HC Deb, 4 February 2013, col 34

In its response to our Report, the Government has agreed that ring-fenced banks might be permitted to sell certain simple derivatives subject to strict safeguards. The Government has undertaken to ensure that our recommendations on safeguards are reflected in the secondary legislation that would be made available by the Commons Committee stage of the Bill.[102] We assume that this includes our specific proposal for a gross cap. **The Commission will consider the draft secondary legislation relating to the definition of simple derivatives when it is published. We will wish to satisfy ourselves as to whether the Government has come forward with proposals for a concise and enduring definition of simple derivatives which respond adequately to our other recommendations for safeguards, including a gross cap, before deciding whether to support the sale of derivatives within the ring-fence in our final Report.**

42. Our First Report identified the need, in the event that simple derivatives were to be sold within the ring-fence, for continuing transparency and accountability on the matter. We recommended that the regulator be required to report annually on the extent and nature of the sale of derivatives within the ring-fence, including the effects of any changes to secondary legislation proposed by a future Government.[103] The Government has not responded to this specific recommendation, and the reporting requirements on the new regulator in relation to the ring-fence are couched in more general terms.[104] **We commend to both Houses the provisions of Amendment O in the Appendix, which would facilitate more transparent regulatory oversight of any sale of derivatives within the ring-fence.**

The de minimis requirement

43. The Government also departed from the ICB recommendations in proposing a 'de minimis' exception to the ring-fence for institutions with retail and SME deposits below a certain value. We concluded in our First Report that this exemption for smaller deposit-taking institutions represented a sensible compromise between maintaining financial stability and encouraging new entrants to the banking industry. We recommended that the factors to be taken into account in setting or revising a de minimis requirement should appear on the face of the Bill, and that these factors should include effects on competition and on new entrants to the market in particular. We also proposed that the regulator should report annually on developments affecting the appropriateness of the level of the threshold.[105]

44. The Government has arguably accepted that the criteria for judging the de minimis exemption should be clearly specified, but maintained that the Bill "already achieves this clarity" as a result of the requirement that any exemption should not be likely to have an adverse effect on the continuity of core services. The Government has nevertheless agreed to amend the Bill to include an additional requirement to have regard to the impact of the de minimis exemption on competition.[106] The Government has not referred to our

102 *Banking reform*, para 2.30

103 First Report, para 194

104 Bill 130, Clause 6 (amendment of paragraph 19 of Schedule 1ZB to FSMA)

105 First Report, paras 196–200

106 *Banking reform*, para 2.34

recommendation of a regulatory report on the level of the exemption. **We welcome the Government's commitment to refer specifically to competition as a factor in determining the level of the de minimis threshold. We commend Amendment P in the Appendix which gives effect to this in a way which refers specifically to new entrants and Amendment Q which provides for annual reporting by the regulator on the developments affecting the appropriateness of the level of the threshold.**

Independence and governance of the ring-fenced bank

45. While the main decisions on the precise position of the ring-fence were to be determined by delegated legislation made by the Treasury, the draft Bill proposed that the rules for the extent of separation between the ring-fenced entity and the rest of the banking group and of the former's independence—the 'height' of the ring-fence—should be set by the regulator.[107] This approach caused concern to the prospective regulators, who told the Commission that this laid them open to challenge to a far greater degree than if they operated under a mandate set with Parliamentary authority. Having concluded that the proposals represented a delegation too far, we recommended that the parameters for the rules on the height of the ring-fence should be set by the Government in the relevant provisions of the Bill or in secondary legislation subject to parliamentary approval.[108]

46. The Government has responded positively to both these recommendations. It has agreed that "regulators should be given greater guidance on the face of the statute to assist them in making rules to implement ring-fencing and in particular in setting the height of the ring-fence" and has amended the Bill accordingly.[109] The Government has also indicated its intention to create a power to clarify the parameters further through secondary legislation.[110] **The Commission welcomes the steps the Government has taken to enable a clearer parliamentary mandate for the height of the ring-fence to be provided for the regulator in setting rules. To facilitate early parliamentary consideration of the principle of parameters for the rules being set by parliamentary means, Amendments G and H in the Appendix make provision for the additional delegated power to which the Government has agreed in principle.**

47. In addition to the principle of the mandate with parliamentary authority, we considered carefully ways in which the ring-fenced bank could be able to operate effectively as an independent entity within a wider banking group. Andy Haldane identified several ingredients for the requisite independence:

i) Separate governance;

ii) Separate risk management;

iii) Separate balance sheet (treasury) management;

107 First Report, paras 61–62

108 *Ibid*., para 139

109 *Banking reform*, para 2.10; Bill 130, Clause 4 (new section 142H)

110 *Banking reform*, para 2.17

iv) Separate remuneration structure and human resourcing.[111]

Sir John Vickers added independence of capital and liquidity to this list. The Chancellor of the Exchequer subsequently endorsed what he dubbed the "Haldane principles" with Sir John's addition.[112] We recommended that these elements of separateness be required in the initial secondary legislation to set parameters for the ring-fence rules.[113]

48. The Government has arguably gone further than we recommended, seeking to reflect the 'Haldane principles' on the face of the Bill. The relevant proposed new section of FSMA has been expanded to specify the areas in which operational and economic independence must be established.[114] According to the Chancellor of the Exchequer, the effect of these changes is to provide that:

- "Your high street bank will have different bosses from its investment bank";
- "Your high street bank will manage its own risks, but not the risks of the investment bank"; and
- "The investment bank won't be able to use your savings to fund their inherently risky investments".[115]

We strongly support the Government's decision to place on the face of the Bill some of the key parameters for ensuring the operational and economic independence of ring-fenced banks.

49. Even if the directors of a ring-fenced bank are different from those of an investment bank, we noted in our First Report that a tension would continue to exist between the duties that directors of the ring-fenced banks would owe to that entity and their duties to the parent company and through them to shareholders. We recommended that the Government insert within the Financial Services and Markets Act 2000 (FSMA) a legal duty on boards of directors to preserve the integrity of the ring-fence.[116] This recommendation was welcomed by Sir John Vickers.[117] We also recommended that the Government "set out, in its response to this Report, a full account of how directors would be expected to manage the relationship between such a duty and their duties to the shareholders".[118]

50. In response, the Government has agreed that independent governance was "an essential part of ensuring the legal, economic and operational independence of ring-fenced banks from their wider corporate groups". [119]The Government has agreed to amend FSMA to ensure that a director of a ring-fenced bank will always be an approved person under

111 First Report, para 217

112 *Ibid*.

113 *Ibid.*, para 224.

114 *Banking reform*, para 2.17; Bill 130, Clause 4 (section 142H(5) of FSMA)

115 Chancellor's Banking Reform speech

116 First Report, para 222

117 Q 2578

118 First Report, para 223

119 *Banking reform,* para 2.27

that Act, so that any such director "who is knowingly concerned in a contravention by a ring-fenced bank of any of the ring-fencing obligations [...] or ring-fencing rules [...] will be subject to the full range of the regulators' disciplinary powers (which may in serious cases include lifelong suspension and/or [...] very large fines".[120] The Government has also provided an account of its assessment of the legal position of directors, contending that the duty to comply with ring-fencing rules was compatible with the wider fiduciary duty, but has undertaken to take account of any further recommendations we make in relation to directors' liability and sanctions.[121] **The Commission welcomes the explicit provision in the Bill to enable the regulator to assign legal responsibilities on directors of ring-fenced banks in relation to its independence. We will consider further steps that might be appropriate in this area in our final Report.**

Relationship between the ring-fenced bank and the holding company

51. In evidence last year, Sir John Vickers, Martin Taylor and the FSA all made the case for there being a power to prevent a non-ring-fenced bank directly owning a ring-fenced bank. This was not supported by Barclays or Santander, but we found the case for prohibiting such a 'parent-child' relationship persuasive. We recommended accordingly that "the regulator be given the power to require a sibling structure between a ring-fenced and non-ring-fenced bank, with a holding company".[122] Sir John Vickers in his evidence in January said that "the standards and cultural issues that have come to light" since the ICB reported had made him re-think the idea that an investment bank should be enabled to own a ring-fenced bank. He supported our proposal to give the regulator a reserve power to require a sibling structure between those entities.[123]

52. The Government has agreed that the corporate structures of banking groups should not undermine the effectiveness of the ring-fence, or the resolvability of the bank, but pointed to the first reserve power and to the forthcoming powers under European legislation to require reorganisations necessary to achieve resolvability as relevant enhancements of the regulatory toolkit. In consequence, "the Government does not at this stage believe it necessary to provide for further powers (beyond those recommended by the ICB) to restrict groups' corporate structure".[124]

53. **The Commission finds it disappointing that the Government should seek to fall back on the original position of the ICB on a possible 'parent-child' relationship between an investment bank and a ring-fenced bank when the Chairman of the ICB has moved on from that position. Sir John Vickers has emphasised the problems of culture and standards which have come to the fore since the ICB reported as reasons for now supporting a prohibition on such a relationship, as have we. The Chancellor of the Exchequer, too, has stressed the need for independence of ring-fenced banks from investment banks, yet seems curiously reluctant to implement a straightforward**

120 *Banking reform*, para 2.27; Bill 130, Clause 5 (amending section 59 of FSMA)

121 *Banking reform*, paras 2.28, 2.27

122 First Report, paras 225–228

123 Q 2578

124 *Banking reform*, para 2.25

structural reform to buttress it. We invite the two Houses of Parliament to consider Amendment R, intended to give the regulator a duty to require a ring-fenced bank to be owned by a holding company.

Liabilities

54. In our First Report we highlighted the risk, however small, that the creation of ring-fenced banks might be used as an opportunity to shift liabilities between entities within a group in an artificial way and recommended that the regulator be required to set rules to prevent this.[125] In its response, the Government has indicated that it views this as sufficiently unlikely as to need no further safeguard.[126] **Given the evidence that we have received about the capacity of the banking sector for creative accounting alongside restructuring in the past, we believe that even a small risk should, where it has been identified, be addressed through legislation. We invite the two Houses to consider further whether adequate safeguards are in place to prevent artificial redistribution of liabilities when a ring-fenced entity is created; Amendment S in the Appendix provides an opportunity for debate on this matter.**

55. The potential artificial distribution of liabilities also gives rise to another concern, about the scope for a bank providing that fines relating to conduct outside the retail banking sphere, for example in relation to LIBOR manipulation, should be met by a ring-fenced bank. **We consider it vital that the allocation of fines for conduct issues prior to the establishment of the ring-fence is addressed by the Treasury and the regulator prior to the implementation of the ring-fence. We consider that there may be a case for the regulator being given a duty to approve any such allocation. We therefore recommend that the Government, in its response to this Report, set out its views on this matter.**

125 First Report, para 230

126 *Banking reform*, para 2.50

4 Capital and loss absorbency

Introduction

56. It is easy for legislators to succumb to the lure of legislative action, and assume that the main structural changes to be embodied in the new legislation represent a self-contained solution to the systemic risks to the banking system. In our First Report, we made clear that the limits of legislative action must be properly understood and that the specific proposals for ring-fencing would need to judged alongside other measures flowing from the ICB recommendations, a number of which do not necessarily require a domestic legislative response. In particular, we emphasised that:

- Ring-fenced banks must not be seen as beneficiaries of a Government guarantee, and it needs to be understood that the policy is designed to ensure a continuity of critical banking services, not a safety net to prevent individual banks failing;[127]
- There will remain substantial systemic risks associated with banks outside the ring-fence and outside the UK;[128]
- The ring-fence is a necessary component of reform, but not sufficient, and has to be considered alongside measures to improve loss absorbency, as well as wider measures to address the problems of institutions that remain too big to fail.[129]

57. In its response, the Government has stated that regulatory objectives in this area apply to "core services in the UK, not to individual institutions".[130] The Government has also confirmed its recognition that "ring-fencing will not solve all of the problems in the financial sector" and had to be seen alongside other reforms.[131]

58. Sir John Vickers characterised the recommendations of the ICB as envisaging a series of buffers for banks that posed a wider risk to the economy, including capital requirements and bail-in as well as structural reforms.[132] In this chapter we consider the Government's response to our recommendations in these areas.

Bail-in

59. One of the most debilitating aspects of the banking crisis of 2007 to 2009 from the point of view of the taxpayer was that the bank creditors who had benefited from the good years did not bear any of the loss when things turned bad. 'Bail-in' amounts to a set of legal changes giving the authorities powers to impose losses on creditors of a failing bank. It would apply to non-ring-fenced banks as well as ring-fenced banks and is seen by the Bank of England as being crucial to effective resolution of a failing bank without recourse to the

127 First Report, paras 102–104

128 *Ibid*., paras 25, 103, 104, 107

129 *Ibid*., paras 99, 107

130 *Banking reform*., para 2.7

131 *Ibid.*, para 2.8

132 Q 2596

public purse.[133] The development of an effective bail-in regime was a key recommendation of the ICB, which has been supported by other witnesses.[134] We concluded:

> An effective and credible bail-in tool would represent a major step towards eliminating the implicit guarantee and ensuring that the costs of resolving a failing bank are not borne by the taxpayer. It is notable that bail-in is at the heart of the resolution strategies currently being designed for large systemically important banks, and will remain important even after the ring-fence is introduced.[135]

60. We nevertheless pointed to the difficulties of establishing a new bail-in regime. It would first be tested under stressed conditions, when politicians and regulators would face pressure to resort to the better-understood tool of taxpayer bailout. In order to provide assurance that the new system would not be a "paper tiger", we recommended that the Bank of England should be required to report annually on the development and subsequent operation of bail-in.[136] We also called for the Government to make provision for such a regime at UK level in case progress on European legislation stalled.[137]

61. In evidence in January, Sir John Vickers emphasised the novelty of bail-in:

> The idea that bank bondholders might take a loss is new territory. It is very uncertain. It is a new world.[138]

He saw advantages in engaging bondholders through a bail-in regime, because they were likely to be more attentive to downside risks than holders of equity; he thought that there was a reasonable prospect of a market for bonds subject to bail-in developing.[139] On our recommendation for legislation at national level, he agreed that it would be worthwhile to implement such changes "in any event" given the UK's position as the most important financial centre in Europe, but remained confident about the prospects for a satisfactory agreement at European level.[140]

62. Dr Carney told the Treasury Committee that he saw an effective bail-in regime as "critical", but not "decisive":

> In other words, it does not assure that the taxpayer is not on the hook but it is essential to have a credible bail-in regime, and further, it is highly desirable to have identifiable tranches of bail-in-able debt. It does not have to be from the class of debt but identifiable tranches of bail-in-able debt in sufficient size to address historic experience of banking shocks in order to provide market discipline that will make the full power of the instrument be felt.[141]

133 First Report, paras 233, 106

134 *Ibid*., paras 233 - 235

135 *Ibid., para* 236

136 *Ibid*., para 242

137 *Ibid*., para 245

138 Q 2597

139 Qq 2598, 2614

140 Qq 2599 - 2601

141 HC (2012-13) 944, Q 130

He was confident that developments internationally were moving in the right direction, but emphasised the importance of some form of reporting if confidence in the development of bail-in started to be shaken.[142]

63. In its response, the Government has agreed about the importance of an effective and credible bail-in power. It has emphasised the importance of international cooperation to ensure effective actions across borders in a crisis, to reduce the opportunities for regulatory arbitrage and to minimise the risks of UK banks being at a competitive disadvantage.[143] The Government has said that it remains confident about the prospects for progress at European level.[144] While accepting the appropriateness of Parliament having assurance about a bail-in regime's effectiveness and credibility, the Government has placed reliance on reporting by international institutions rather than the Bank of England.[145]

64. **An effective bail-in regime is widely-acknowledged as having a crucial role in insulating the taxpayer from losses in future banking crises and ensuring that bondholders bear their share of the downside risk when banks get into trouble in the future, and therefore pay greater heed to the conduct and performance of banks. The Commission is disappointed by the Government's reliance on reporting by international institutions and by its reluctance to consider the benefits of regular reporting at national level on progress (or the lack of it) in this area. We are similarly disappointed by the Government's apparent rejection of the case for a domestic legislative initiative as a safety net in the event that progress at European level proves inadequate. This is a particularly concerning signal in the light of the number of other important reforms which currently depend on action at a European level, a matter to which we will return in our final Report. The Commission invites the two Houses to consider Amendments T, U and V in the Appendix, which facilitate debate on these crucial matters.**

Primary Loss Absorbing Capital (PLAC)

65. The ICB stressed the importance of banks being able to absorb losses by having sufficient 'Primary Loss Absorbing Capital' 'PLAC' – that is, equity and potentially loss-absorbing liabilities. A bank could continue to operate provided its losses did not exceed its PLAC, so the larger its PLAC, the more resilient it would be. The ICB proposed a requirement that large ring-fenced banks and UK-headquartered global banks issue the equivalent of at least 17 per cent of their risk-weighted assets (RWAs) in the form of PLAC, made up of (i) equity, (ii) non-equity capital and (iii) (to reflect the fact that short-term liabilities are less reliable as loss-absorbing capacity) those bail-in bonds with a *remaining* term of at least 12 months.[146] The Government accepted this recommendation of the ICB, using a broadly similar definition of PLAC, proposing to give effect to it through European

142 *Ibid*.

143 *Banking reform*, para 2.40

144 *Ibid*., para 2.41

145 *Ibid*., para 2.42

146 First Report, paras 247 - 248

legislation supported by a power in the Bill to instruct the regulators on how to impose debt requirements on banks.[147]

66. In our First Report, we expressed concern about the range of the powers the Government was proposing Parliament grant to the Treasury to direct the regulator in relation to the PLAC requirements.[148] In its response, the Government has agreed to remove the power to direct the regulator by reference to specific banking groups and to make relevant secondary legislation subject to the affirmative resolution procedure.[149] **The Commission welcomes the Government's decision, in line with our recommendations, to revise and limit the Treasury's proposed powers over the regulator in relation to loss-absorbency requirements.**

67. The ICB recommendation was intended to create a requirement above and beyond internationally-agreed capital requirements on UK-headquartered banks with global operations because of the possible exposure of UK taxpayers in the event of a failure of those operations. Members of the ICB have accepted the logic of an exemption for non-EEA assets if the entities holding those assets are separately resolvable without posing a risk to UK financial stability or the UK taxpayer, but Sir John Vickers and current and prospective regulators emphasised that the burden of proof for any exemption should be on the bank, not the regulator.[150] We recommended that the legislation

> place the burden of proof for any exemption from PLAC requirements on the bank seeking the exemption, rather than on the regulator. This would mean that the regulator would only grant an exemption if a bank had demonstrated to the regulator's satisfaction that there was no risk to stability, rather than merely if the regulator could not show that a risk existed, providing a greater level of protection to the taxpayer. This should include the bank showing that the resolution authorities in the areas in which they operate outside the EEA would assume lead responsibility for resolving the operations in those overseas territories in the event of the bank's failure, in order to protect the UK taxpayer. The decision on whether to grant an exemption should be made by the regulator with reference to clear objectives, although in all cases it will need to involve an exercise of judgment by the regulator. Decisions should be subject to the same review and appeals processes as any other decision by the regulator. The existence of exemptions should be publicly disclosed.[151]

68. In its response, the Government has accepted that there might be merit in our proposal to place the burden of proof on the bank, "provided that the regulator exercises its judgement in a reasonable way". The Government has agreed to publish a draft of the secondary legislation to set the framework for this exemption.[152]

69. We asked Douglas Flint whether HSBC supported our proposal for the burden of proof to lie on the bank and he replied:

147 *Ibid.*, para 249

148 *Ibid.*, paras 262 - 263

149 *Banking reform*, paras 2.43 – 2.45

150 First Report, paras 250 - 257

151 *Ibid.*, para 258

152 *Banking reform*, para 2.44

> On reflection, yes we do. It is clearly going to be a dialogue between the institution, the regulator and the Treasury. The ultimate risk lies with the Treasury, because in the event that the institution does bring risk from overseas to this country, it is the Treasury that ultimately will have to consider what proportion, if any, of that it will bear. As the contingent risk is with the Treasury, it seems to me that it is perfectly reasonable to ask the institution to demonstrate why there is no risk. I think what we would say is that because of the sensitivity and the considerable judgment involved, the test should be one not of absolute risk, because absolute certainty is never going to be possible as you look far into the future, but of reasonably foreseeable risk in that the deliberation should take place, in our view, at the institutional level at board level and at Government level in the highest levels of the Bank of England, the Prudential [Regulation] Authority and, indeed, the Treasury. The judgments will be just as much about the people of whom assurances are being sought as about the detailed facts and figures that will be presented by us as an institution and by other institutions that are affected.[153]

He agreed that the regulatory judgement should be made at a senior level and that it was desirable for a reference to reasonably foreseeable risk to appear in statute.[154] **We agree with HSBC that the judgements with respect to the burden of proof would need to be examined by the regulators at the highest level. We welcome the broad measure of support for the proposition that the burden of proof for any exemption from PLAC requirements should rest with the bank in question, subject to a requirement for the exercise of a high-level judgement by the regulator based on reasonably foreseeable risks. We invite the two Houses to consider Amendment W which seeks to give effect to this. In addition to our original recommendations, Amendment W also makes provision for any PLAC exemption to be reported to Parliament.**

The leverage ratio and risk-weightings

70. Equity holders bear the cost of any losses up to the value of the equity in the bank, and holders of bail-in bonds also suffer if the total losses exceed the bank's equity. Bail-in bonds are new and their ability to bear losses in a crisis is untested, so that imposing a minimum requirement on the level of equity in a bank is a more certain and tested safeguarding method. The strength of the equity buffer can be measured in two ways: the ratio between capital and RWAs ('the capital ratio') and the total amount of capital as a percentage of total un-weighted assets ('the leverage ratio').[155] The setting of capital and leverage ratios is in the first instance a matter for an international authority, the Basel Committee on Banking Supervision. The next instalment of those international capital rules (Basel III) is due to be given effect in the EU through a forthcoming Capital Requirements Directive and Regulation. As part of this process, capital requirements will be higher than under Basel II.[156]

153 Q 3769

154 Qq 3770 - 3771

155 First Report, paras 280 – 285. For a short definition of RWAs, see First Report, para 247

156 *Ibid*., paras 284 - 285

71. One of the weaknesses of the capital ratio is that it relies on the calculation of RWAs, which, in the case of larger banks, is in part of a matter for the banks themselves. In December, we highlighted evidence that RWAs represent the fraying threads of the capital ratio safety net, because of the subjectivity and variability of measures of RWAs.[157] This view has been strengthened by a report published by the Basel Committee on Banking Supervision in January 2013 which notes significant differences across individual banks in the average risk weighting of trading assets which are not attributable to differences in their inherent riskiness alone. One factor in the differences is the fact that the current Basel framework allows banks to choose different historical data periods to calculate value-at-risk or use different methods to arrive at a regulatory capital figure.[158]

72. Partly in response to concerns about the effectiveness of risk-weightings, the ICB recommended that the leverage ratio should rise in line with the proposed increase in the capital ratio under Basel III, so that the leverage ratio for UK banks would be 25 times rather than 33 times. This recommendation was rejected by the Government, which proposed to adhere to the international leverage ratio.[159] Having noted that high leverage was a significant contributor to the crisis, we concluded:

> The Commission considers it essential that the ring-fence should be supported by a higher leverage ratio, and would expect the leverage ratio to be set substantially higher than the 3 per cent minimum required under Basel III. Not to do so would reduce the effectiveness of the leverage ratio as a counter-weight to the weaknesses of risk weighting.[160]

We also recommended that the Financial Policy Committee (FPC) be given responsibility for setting the leverage ratio earlier than currently planned, that special transitional arrangements be put in place for building societies given the relatively low risk weighting of many of their assets and that the Bank of England be required to provide an annual assessment of the progress of risk-weighting.[161]

73. In evidence in January, Sir John Vickers stressed his continued support for a higher leverage ratio of 4 per cent by the end of 2018, and supported the recommendation that the FPC be given the power, as did Martin Taylor.[162] Bill Winters was also forthright in his support for a limit of 25 times leverage, having previously been sceptical about the value of that ratio as a method for limiting bank exposure.[163] He agreed that there might be a case for specific treatment for institutions such as building societies on which the leverage ratio acted as the primary binding constraint, although he noted that such an effect might itself give pause for thought about the calculation of RWAs, bearing in mind that the building society model was not always low risk.[164] He acknowledged that a higher leverage ratio

157 *Ibid*., paras 286 - 290

158 Bank for International Settlements, *Regulatory consistency assessment programme (RCAP) – Analysis of risk-weighted assets for market risk*, January 2013, p 6

159 First Report, paras 286, 294

160 *Ibid.*, para 294

161 *Ibid*., paras 295 - 296

162 Qq 2572, 2888

163 Q 3676

164 Qq 3676 - 3677

would increase the cost of capital for banks, but thought that such a cost being borne by shareholders or by consumers was worthwhile in the context of the "value that we get as a society from having safer banks".[165]

74. Giving evidence to the Treasury Committee, Dr Carney has also pointed to the value of a higher leverage ratio as a backstop for inappropriate risk weightings, while recognising the specific considerations that might apply to building societies.[166] Although he emphasised that the precise leverage ratios for Canadian banks were not directly comparable to those under consideration in a UK context, he viewed lower leverage as a crucial factor in the relative strong performance of Canadian banks during the financial crisis.[167] He said that it was "essential to have a leverage ratio as a backstop to a risk-based capital regime".[168]

75. In its response to our Report, the Government has expressed concern about the proposition that a leverage ratio should be "the primary capital constraint on banks, rather than a backstop to risk-weighted capital requirements", and has re-stated its opposition to "the case for permanently raising the leverage ratio beyond the Basel III standard".[169] The Government has stated that it continues to envisage providing the FPC with "a time-varying ratio direction-making tool, but no earlier than 2018 and subject to a review in 2017 to assess progress on international standards".[170] In view of the ongoing international work to review risk-weights, the Government has rejected the case for a UK-specific assessment.[171] In oral evidence in February, the Chancellor of the Exchequer called for "caution" in considering the case for acting unilaterally in relation to leverage ratios.[172] He re-stated the Government's view that a 4 per cent leverage ratio might serve as a "front-stop" rather than a "back-stop" for some "lower risk institutions".[173] He offered to share with the Commission some of the representations that the Treasury had received on the likely impact of a 4 per cent leverage ratio.[174]

76. **The changes to capital ratios, proposed as a result of the international capital rules under Basel III and the revised Capital Requirements Directive that will flow from it, will not adequately address the problems of risk-weightings. The framework for risk-weighting under Basel II was profoundly flawed, permitting certain banks to rely on their own subjective and variable risk-weighting methodologies as a basis for weakening their capital buffers, when they should have been strengthening them. There are already signs that many of these flaws will be carried through into the Basel III framework. We are therefore particularly disappointed that the Government has rejected the Commission's proposal for an annual assessment by the Bank of England**

165 Q 3677

166 HC (2012 – 13) 966, Q 128

167 *Ibid*., Q 129

168 *Ibid*.

169 *Banking reform*, para 2.37

170 *Ibid*., para 2.38

171 *Ibid*., para 2.39

172 Q4321

173 Q 4320

174 Q 4324

of progress of work to improve risk-weighting. We invite both Houses to consider the proposition set out in Amendments X and Y in the Appendix which would require there to be such an assessment.

77. **The historic and prospective ineffectiveness of risk-weighting makes leverage ratios at the appropriate level all the more important as a backstop. The case for leaving the leverage requirement unchanged at 33 times when the capital requirement on banks is to be increased in line with the ICB's recommendation is therefore extremely weak. The Commission remains wholly unconvinced by the case made by the Government against a higher leverage ratio for UK banks by reference to international requirements. We propose to consider this further in our final Report.**

5 Wider reforms and our final Report

78. In our First Report we expressed scepticism about the Government's apparent conviction that getting the proposed Bill on the statute book in 2013 was the best way to ensure all primary and secondary legislation to implement the ring-fence was in place by May 2015. We emphasised that it was vital that there was a full opportunity for parliamentary scrutiny of the Bill itself and for consideration of crucial proposals for secondary legislation in draft, and emphasised that "the primary concern of Government, Parliament, regulators and the affected institutions should be on getting the new legislation right".[175]

79. If this applies to the Bill as it stands, it applies in equal measure to the provisions that are likely to be added to the Bill. In its mid-term review, the Government has made the following, welcome commitment:

> We will introduce any necessary amendments to legislation arising out of the Parliamentary Commission on Banking Standards, including any necessary new criminal offences and associated penalties.[176]

The Government has also made clear that it intends to use the Bill now before the House of Commons for giving effect to legislative proposals arising from this Commission's work.[177]

80. In his speech on 4 February, the Chancellor of the Exchequer encouraged us to "come forward with far-reaching proposals" relating to professional standards and culture.[178] The Secretary of State for Business, Innovation and Skills has also suggested that "root-and-branch reform of the banking sector is inevitable".[179]

81. When this Commission was first established, we were required to report on the draft Bill before Christmas and on other matters "as soon as possible thereafter". In view of the intensity of our evidence-gathering processes and the number of new issues that have arisen in the course of our work, we now consider it likely that we will produce our final Report by mid-May 2013. If we adhere to this timetable, the Government will need some time to consider our recommendations and to bring forward the necessary amendments to the Bill. In its response, the Government has not shown signs of any new flexibility on the timetable for the Bill,[180] but the Chancellor of the Exchequer has referred to the Bill's becoming law by early February 2014.[181] **The Commission considers it essential that the timetable for the progress of the current Bill through both Houses of Parliament allows adequate time not only for the full scrutiny of the current content, but also for the addition of provisions to give effect to the recommendations in our final Report. We**

175 First Report, paras 12, 112 - 125

176 HM Government, *The Coalition: together in the national interest: Mid-Term Review*, January 2013, p 13

177 First Report, para 9

178 Chancellor's Banking Reform speech

179 Speech by Secretary of State for Business, Innovation and Skills on 6 February

180 *Banking reform*, para 2.9 – 2.10

181 Chancellor's Banking Reform speech: "I'm sending the legislation to the House of Commons today and I expect them to be passed by Parliament this time next year".

welcome the Chancellor of the Exchequer's implied acknowledgement that Royal Assent in 2013 is no longer appropriate. We recommend that the report and third reading stages in the House of Commons do not take place before the Summer.

82. **The Commission is encouraged by the positive tone of the Government's response and by the steps it has already taken or agreed to take to give effect to the recommendations of our First Report. This augurs well for the Government's actions in response to our final Report. There is, however, still a long way to go if the legislation now before the House of Commons is to provide legislative impetus for a transformation of the UK banking system. The Bill as presented to the House of Commons represents not the beginning of the end for the necessary reform process, but the end of the beginning.**

Conclusions and recommendations

Reinforcing the ring-fence

1. The Commission welcomes the Government's acceptance of the principle that its proposed framework for ring-fencing requires reinforcement. In this chapter, we consider progress in relation to our main suggestions with this aim in mind. (Paragraph 6)

The first reserve power

2. The Commission finds it surprising that the Chief Executive of the British Bankers' Association should adopt a policy position which has no public support from the major banks most directly affected by the ring-fence. (Paragraph 16)

3. The Commission sees no merit in the proposition that the first reserve power will create uncertainty for banks or put at risk their attempts to raise funds for lending. That power will be a source of uncertainty only for those minded to take actions that conflict with the objectives of the ring-fence. For all other banks, for regulators, for Parliament and the public, it will be a source of greater certainty about the effectiveness of the ring-fence. The Commission welcomes the Government's commitment to amend the Bill to provide for a reserve power to break-up a bank that seeks to flout the ring-fence. (Paragraph 17)

4. We consider it important that the regulator's powers to break-up a bank should be exercisable only after consideration of the regulator's relationship with the bank by an independent reviewer. It is also important that the reviewer should be independent of Government. We welcome the Financial Secretary to the Treasury's commitment to give careful consideration to our specific proposals on the conditions on the exercise of this power. Amendments J and K in the Appendix are intended to provide an early opportunity for the House of Commons to consider further this reserve power and the appropriate limits upon its exercise. We would also envisage a specific timetable relating to the exercise of the powers, to be determined at the outset. (Paragraph 18)

5. We recommend that the Government make explicit provision in the Bill to enable the regulator to require a bank to divest itself of a specified division or set of activities which would fall short of the full divestment required under the first reserve power. We envisage that this power would be subject to limits on its exercise similar to those of the first reserve power. (Paragraph 19)

The independent review mechanism

6. The Government's proposal for the periodic review to be conducted by the regulator is wholly inadequate. Such a review conducted by the regulator would be little different in character from the regulator's annual report and could amount to no more than a case of the regulator marking its own examination paper. The creation of a periodic independent review arrangement is crucial to the balance that we

sought to strike between giving regulators the tools they need to do their job effectively and giving Parliament, the public and the banks affected confidence that there will be independent constraints upon the exercise of those regulatory powers. One of the strengths of the banking industry (as well as one of its weaknesses) is its capacity for innovation. The new framework must be subject to regular periodic, independent review to ensure that that framework keeps pace with innovation in the banking sector as well as the experience of the operation of the ring-fence. We welcome the Chancellor of the Exchequer's indication that he is happy to consider the case for an independent review. We urge the two Houses of Parliament to support our proposal for an independent review; Amendment N in the Appendix enables the two Houses to debate and reach a decision in principle on this proposition. (Paragraph 24)

The second reserve power

7. The Government has been at pains to make the case against the provision for full separation being implemented on the say so of the regulator. The Government has erected a straw man which it has then successfully demolished, because we made no such recommendation in our First Report. Instead, we envisaged that the legislative provisions would be brought into force only in the light of the recommendations of the independent review. (Paragraph 27)

8. The Commission continues to believe that statutory provision for full separation should be included in the Bill now before Parliament. Amendments L and M in the Appendix facilitate debate and decision in principle on this proposition. The power would not be available to be implemented until after the case for full separation across the sector had been considered by an independent periodic review of the effectiveness of the ring-fencing framework which had come to a recommendation to that effect. The view of the regulator would be of great importance in such consideration, but we would expect the decision to implement full separation across the sector to be a matter for Government and Parliament. We have therefore made provision for the amendments which give effect to full separation across the sector as a whole to come into force only after an affirmative resolution in both Houses. (Paragraph 28)

Objectives in primary legislation

9. The Commission welcomes the Government's clarification of the relationship between the continuity objective and the PRA's general objective, and the steps it has taken with regard to the formulation of the continuity objective. We invite the two Houses of Parliament to examine the Government's changes alongside Amendments A to D in the Appendix, which we consider adhere more fully to the ICB's objectives for ring-fencing. (Paragraph 30)

Consideration of initial proposed secondary legislation in draft

10. The Commission notes with disappointment that even the 'principal' secondary legislation was not available at the time of publication of the Bill as we had

recommended, but welcomes the commitment to publish it before Second Reading. (Paragraph 32)

Conditions on the exercise of certain delegated powers

11. The Commission welcomes in the Government's commitment in principle to consider toughening the tests for the exercise of delegated powers for exemptions from the ring-fence. We believe that the specific tougher tests we proposed in our First Report are the right ones. We commend Amendments E and F to assist in parliamentary consideration of that recommendation. (Paragraph 33)

Parliamentary scrutiny

12. The Commission remains firmly of the view that the considerable scope for moving the location of the ring-fence through the exercise of delegated powers necessitates enhanced parliamentary scrutiny. We invite the two Houses of Parliament to consider Amendment I in the Appendix which seeks to give effect to our proposals and which additionally provides that the Chair of the Treasury Committee should be the chair of the ad hoc joint committee. (Paragraph 35)

Ring-fenced banks acting as principal in the sale of derivatives

13. The Commission will consider the draft secondary legislation relating to the definition of simple derivatives when it is published. We will wish to satisfy ourselves as to whether the Government has come forward with proposals for a concise and enduring definition of simple derivatives which respond adequately to our other recommendations for safeguards, including a gross cap, before deciding whether to support the sale of derivatives within the ring-fence in our final Report. (Paragraph 41)

14. We commend to both Houses the provisions of Amendment O in the Appendix, which would facilitate more transparent regulatory oversight of any sale of derivatives within the ring-fence. (Paragraph 42)

The de minimis requirement

15. We welcome the Government's commitment to refer specifically to competition as a factor in determining the level of the de minimis threshold. We commend Amendment P in the Appendix which gives effect to this in a way which refers specifically to new entrants and Amendment Q which provides for annual reporting by the regulator on the developments affecting the appropriateness of the level of the threshold. (Paragraph 44)

Independence and governance of the ring-fenced bank

16. The Commission welcomes the steps the Government has taken to enable a clearer parliamentary mandate for the height of the ring-fence to be provided for the regulator in setting rules. To facilitate early parliamentary consideration of the principle of parameters for the rules being set by parliamentary means, Amendments

G and H in the Appendix make provision for the additional delegated power to which the Government has agreed in principle. (Paragraph 46)

17. We strongly support the Government's decision to place on the face of the Bill some of the key parameters for ensuring the operational and economic independence of ring-fenced banks. (Paragraph 48)

18. The Commission welcomes the explicit provision in the Bill to enable the regulator to assign legal responsibilities on directors of ring-fenced banks in relation to its independence. We will consider further steps that might be appropriate in this area in our final Report. (Paragraph 50)

Relationship between the ring-fenced bank and the holding company

19. The Commission finds it disappointing that the Government should seek to fall back on the original position of the ICB on a possible 'parent-child' relationship between an investment bank and a ring-fenced bank when the Chairman of the ICB has moved on from that position. Sir John Vickers has emphasised the problems of culture and standards which have come to the fore since the ICB reported as reasons for now supporting a prohibition on such a relationship, as have we. The Chancellor of the Exchequer, too, has stressed the need for independence of ring-fenced banks from investment banks, yet seems curiously reluctant to implement a straightforward structural reform to buttress it. We invite the two Houses of Parliament to consider Amendment R, intended to give the regulator a duty to require a ring-fenced bank to be owned by a holding company. (Paragraph 53)

Liabilities

20. Given the evidence that we have received about the capacity of the banking sector for creative accounting alongside restructuring in the past, we believe that even a small risk should, where it has been identified, be addressed through legislation. We invite the two Houses to consider further whether adequate safeguards are in place to prevent artificial redistribution of liabilities when a ring-fenced entity is created; Amendment S in the Appendix provides an opportunity for debate on this matter. (Paragraph 54)

21. We consider it vital that the allocation of fines for conduct issues prior to the establishment of the ring-fence is addressed by the Treasury and the regulator prior to the implementation of the ring-fence. We consider that there may be a case for the regulator being given a duty to approve any such allocation. We therefore recommend that the Government, in its response to this Report, set out its views on this matter. (Paragraph 55)

Bail-in

22. An effective bail-in regime is widely-acknowledged as having a crucial role in insulating the taxpayer from losses in future banking crises and ensuring that bondholders bear their share of the downside risk when banks get into trouble in the future, and therefore pay greater heed to the conduct and performance of banks. The

Commission is disappointed by the Government's reliance on reporting by international institutions and by its reluctance to consider the benefits of regular reporting at national level on progress (or the lack of it) in this area. We are similarly disappointed by the Government's apparent rejection of the case for a domestic legislative initiative as a safety net in the event that progress at European level proves inadequate. This is a particularly concerning signal in the light of the number of other important reforms which currently depend on action at a European level, a matter to which we will return in our final Report. The Commission invites the two Houses to consider Amendments T, U and V in the Appendix, which facilitate debate on these crucial **matters.** (Paragraph 64)

Primary Loss Absorbing Capital (PLAC)

23. The Commission welcomes the Government's decision, in line with our recommendations, to revise and limit the Treasury's proposed powers over the regulator in relation to loss-absorbency requirements. (Paragraph 66)

24. We agree with HSBC that the judgements with respect to the burden of proof would need to be examined by the regulators at the highest level. We welcome the broad measure of support for the proposition that the burden of proof for any exemption from PLAC requirements should rest with the bank in question, subject to a requirement for the exercise of a high-level judgement by the regulator based on reasonably foreseeable risks. We invite the two Houses to consider Amendment W which seeks to give effect to this. In addition to our original recommendations, Amendment W also makes provision for any PLAC exemption to be reported to Parliament. (Paragraph 69)

The leverage ratio and risk-weightings

25. The changes to capital ratios, proposed as a result of the international capital rules under Basel III and the revised Capital Requirements Directive that will flow from it, will not adequately address the problems of risk-weightings. The framework for risk-weighting under Basel II was profoundly flawed, permitting certain banks to rely on their own subjective and variable risk-weighting methodologies as a basis for weakening their capital buffers, when they should have been strengthening them. There are already signs that many of these flaws will be carried through into the Basel III framework. We are therefore particularly disappointed that the Government has rejected the Commission's proposal for an annual assessment by the Bank of England of progress of work to improve risk-weighting. We invite both Houses to consider the proposition set out in Amendments X and Y in the Appendix which would require there to be such an assessment. (Paragraph 76)

26. The historic and prospective ineffectiveness of risk-weighting makes leverage ratios at the appropriate level all the more important as a backstop. The case for leaving the leverage requirement unchanged at 33 times when the capital requirement on banks is to be increased in line with the ICB's recommendation is therefore extremely weak. The Commission remains wholly unconvinced by the case made by the Government against a higher leverage ratio for UK banks by reference to international

requirements. We propose to consider this further in our final Report. (Paragraph 77)

Wider reforms and our final Report

27. The Commission considers it essential that the timetable for the progress of the current Bill through both Houses of Parliament allows adequate time not only for the full scrutiny of the current content, but also for the addition of provisions to give effect to the recommendations in our final Report. We welcome the Chancellor of the Exchequer's implied acknowledgement that Royal Assent in 2013 is no longer appropriate. We recommend that the report and third reading stages in the House of Commons do not take place before the Summer. (Paragraph 81)

28. The Commission is encouraged by the positive tone of the Government's response and by the steps it has already taken or agreed to take to give effect to the recommendations of our First Report. This augurs well for the Government's actions in response to our final Report. There is, however, still a long way to go if the legislation now before the House of Commons is to provide legislative impetus for a transformation of the UK banking system. The Bill as presented to the House of Commons represents not the beginning of the end for the necessary reform process, but the end of the beginning. (Paragraph 82)

Formal Minutes

Tuesday 26 February 2013

Members present:

Mr Andrew Tyrie MP, in the Chair

The Lord Archbishop of Canterbury
Mark Garnier MP
Baroness Kramer
Rt Hon Lord Lawson of Blaby
Andrew Love MP
Rt Hon Pat McFadden MP
Lord Turnbull KCB CVO

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Declarations of interest, by members of the Commission, relating to the Commission's work were made on 24 July 2012 and 8 November 2012.

Draft Report (*Banking reform: towards the right structure*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 82 read and agreed to.

Annex agreed to.

A Paper was appended to the Report as an Appendix.

Resolved, That the Report be the Second Report of the Commission to each House.

Ordered, That the Chair make the Report to the House of Commons and that Lord Lawson of Blaby make the Report to the House of Lords.

Ordered, That embargoed copies of the Report be made available (Standing Order No. 134 of the House of Commons).

[Adjourned till Wednesday 27 February at 9.15 am

Appendix: Amendments

RECOMMENDATION 18

A

Clause 1, page 1, line 11, after 'that' insert 'reduces the risk of ring-fenced bodies assuming disproportionate exposure, enhances their capacity to cope with other exposure and otherwise'.

B

Clause 1, page 1, line 18, after 'services,' insert 'in particular by securing the orderly handling of circumstances in which ring-fenced bodies have encountered or may encounter financial difficulties,'.

C

Clause 2, page 2, line 42, after 'that' insert 'reduces the risk of ring-fenced bodies assuming disproportionate exposure, enhances their capacity to cope with other exposure and otherwise'.

D

Clause 2, page 3, line 6, after 'services,' insert 'in particular by securing the orderly handling of circumstances in which ring-fenced bodies have encountered or may encounter financial difficulties,'.

RECOMMENDATION 21

E

Clause 4, page 3, line 33, leave out from 'order' to end of line 35 and insert—

'(a) would significantly enhance the stability of the UK financial system or provide other significant benefit to the economy of the United Kingdom, and

(b) would not pose a risk to the continuity of the provision in the United Kingdom of core services.'.

F

Clause 4, page 5, line 13, leave out from 'circumstances' to end of line 15 and insert—

'(a) would significantly enhance the stability of the UK financial system or provide other significant benefit to the economy of the United Kingdom, and

(b) would not pose a risk to the continuity of the provision in the United Kingdom of core services.'.

RECOMMENDATION 22

G

Clause 4, page 8, line 34 at end insert—

'(7A) The Treasury must make regulations prescribing requirements with which ring-fencing rules made for the group ring-fencing purposes must comply.'.

H

Clause 4, page 12, line 31, at end insert—

'( ) section 142H(7A);'.

RECOMMENDATIONS 25 and 26

I

Clause 4, page 13, line 7, at end insert—

'142NA Enhanced scrutiny procedure for certain affirmative procedure orders

(1) This section applies if—

(a) an order under section 142B(5), other than the first, makes provision for a regulated activity to be or cease to be a core activity or varies the circumstances in which a regulated activity is a core activity,

(b) an order under section 142D(2) varies the circumstances in which the regulated activity of dealing in investments as principal is an excluded activity,

(c) an order under section 142D(4), other than the first, provides for an activity to be or cease to be an excluded activity or varies the circumstances in which an activity is an excluded activity, or

(d) an order under section 142E varies the scope of what ring-fenced bodies are prohibited from doing by virtue of that section (including by varying exemptions or conditions),

and the order is not made in reliance on section 142N(4).

(2) The Treasury must, before laying a draft of the order before either House of Parliament for approval, consult such persons as the Treasury consider appropriate in relation to the proposed draft.

(3) If, after the consultation required by subsection (2), the Treasury consider that it is appropriate to proceed with the making of an order, the Treasury must lay before each House of Parliament a draft of the order together with an explanatory document—

(a) explaining the provisions in the draft order, and

(b) giving details of the consultation under subsection (2), any representations received as a result of the consultation and any changes made to the proposed draft as a result of the representations.

(4) If a joint committee of both Houses of Parliament is charged with reporting on the draft order—
  (a) the chairman of the Treasury Committee of the House of Commons is to be the chairman of the joint committee, and
  (b) the Treasury must have regard to any recommendations of the joint committee made during the 60-day period.

(5) If, after the expiry of the 60-day period, the Treasury wish to make an order including material changes from the draft order, they must lay before Parliament—
  (a) a revised draft order, and
  (b) a statement giving details of the revisions.

(6) After the expiry of the 60-day period (and, if subsection (5) applies, after complying with that subsection) the Treasury may make the order in the terms of the draft, or revised draft, if it is approved by a resolution of each House of Parliament (as required by section 142N(2)(a)).

(7) In this section "the 60-day period" means the period of 60 days beginning with the day on which the draft order is laid before Parliament under subsection (3).

(8) In calculating the 60-day period no account is to be taken of any time during which Parliament is dissolved or prorogued or during which either House is adjourned for more than 4 days.

(9) The references in this section to the Treasury Committee of the House of Commons—
  (a) if the name of that Committee is changed, is to be treated as a reference to that Committee by its new name, and
  (b) if the functions of that Committee (or substantially corresponding functions) become functions of a different Committee of the House of Commons, is to be treated as a reference to the Committee by which the functions are exercisable;

and any question arising under paragraph (a) or (b) is to be determined by the Speaker of the House of Commons.".'.

RECOMMENDATIONS 29 to 31: SEPARATION IN CASE OF PARTICULAR GROUPS

J

Clause 4, page 9, line 21, at end insert—

'Power to order full separation

142JC Power to order separation in case of particular groups

(1) Where—
  (a) the members of a group include one or more ring-fenced bodies and one or more other bodies, and

(b) it appears to the appropriate regulator that the conduct of any one or more of the members of the group is such that there is a significant risk that the appropriate regulator will not be able to advance the objective in section 2B(3)(c) (in the case of the PRA) or the continuity objective (in the case of the FCA) otherwise than by acting under this section,

the appropriate regulator may give a notice to each of the members of the group.

(2) The notice must state that the appropriate regulator proposes to require the taking of relevant steps in relation to the group before the date specified in the notice.

(3) In this section "relevant steps" means steps to secure one of the following results—

(a) that there is no member of the group with a Part 4A permission to carry on a regulated activity of a description specified in the notice;

(b) that no member of the group is a ring-fenced body;

(c) that there is no member of the group with a Part 4A permission to carry on a regulated activity which is not a ring-fenced body.

(4) The notice must—

(a) specify a period, of not less than 3 months, during which any member of the group may make representations to the appropriate regulator in relation to its proposal, and

(b) name an independent reviewer who is to report on the conduct of the members of the group and the appropriateness of the proposal made by the appropriate regulator.

(5) A person may not be named as the independent reviewer without the consent of the chairman of the Treasury Committee of the House of Commons; and the reference in this subsection to the Treasury Committee of the House of Commons—

(a) if the name of that Committee is changed, is to be treated as a reference to that Committee by its new name, and

(b) if the functions of that Committee (or substantially corresponding functions) become functions of a different Committee of the House of Commons, is to be treated as a reference to the Committee by which the functions are exercisable;

and any question arising under this paragraph (a) or (b) is to be determined by the Speaker of the House of Commons.

(6) After receiving any representations made in relation to the proposal by members of the group and the report of the

independent reviewer, the appropriate regulator must decide whether it intends to implement the proposal.

(7) If the appropriate regulator decides that it does intend to implement the proposal, it must publish notice of the proposal, and of its decision to implement it, at least 60 days before it is implemented.

(8) A person who is aggrieved by the decision of the appropriate regulator that it intends to implement the proposal may refer the matter to the Tribunal.

(9) The proposal may not be implemented without the consent of the Treasury; and the Treasury must publish their decision on any application made by the appropriate regulator for consent, together with their reasons for the decision, at least 60 days before it is implemented.

(10) Once the Treasury has consented to the implementation of the proposal and either—

(a) any reference to the Tribunal under subsection (8) has been dismissed, or

(b) the period for making such a reference to the Tribunal has expired without a reference having been made,

the appropriate regulator may implement the proposal by giving notice to the members of the group requiring the taking of the relevant steps specified in the proposal before the date so specified.

(11) If the relevant steps have not been taken by the specified date, the appropriate regulator may—

(a) in a case where the relevant steps are aimed at securing the result in paragraph (a) of subsection (3), take the action specified in subsection (12),

(b) in a case where the relevant steps are aimed at securing the result in paragraph (b) of subsection (3), take the action specified in subsection (13), or

(c) in a case where the relevant steps are aimed at securing the result in paragraph (c) of subsection (3), take the action specified in subsection (14).

(12) The action referred to in paragraph (a) of subsection (11) is—

(a) to cancel the Part 4A permission of any member of the group to carry on the regulated activity specified in the notice, and

(b) to refuse to give a Part 4A permission to any member of the group to carry on that activity.

(13) The action referred to in paragraph (b) of subsection (11) is—

(a) to cancel the Part 4A permission of any member of the group that is a ring-fenced body to the extent that it relates to a core activity, and

(b) to refuse to give any member of the group a Part 4A permission to carry on a core activity.

(14) The action referred to in paragraph (c) of subsection (11) is—

(a) to cancel the Part 4A permission of any member of the group that is not a ring-fenced body, and

(b) to refuse to give a Part 4A permission to any member of the group that is not a ring-fenced body.'.

K

Clause 20, page 21, line 23, at end insert—

'( ) No order may be made appointing a day for the coming into force of section 4 so far as it inserts section 142JC of FSMA 2000 unless the day is later than that on which the report of the first review under section 142J of that Act is published.'.

RECOMMENDATIONS 29, 30, 32 AND 33: REVIEWS AND GENERAL REQUIREMENT OF SEPARATION

L

Clause 4, page 9, line 21, at end insert—

'Full separation

142JD General requirement of separation

(1) Where the members of any group include one or more ring-fenced bodies and one or more other bodies, the members of the group must, before the end of the period of 5 years beginning with the relevant commencement date, take steps to secure that there are no members of the group that are ring-fenced bodies.

(2) If in the case of any group steps to secure that there are no members of the group that are ring-fenced bodies are not taken within the period specified in subsection (1)—

(a) at the end of that period the Part 4A permission of each member of the group that is a ring-fenced body shall be treated as having been cancelled to the extent that it relates to a core activity, and

(b) after the end of that period the appropriate regulator must refuse to give any member of the group a Part 4A permission to carry on a core activity.

(3) At the end of the period specified in subsection (1)—

(a) section 142H(1)(b) and (4) to (7), and

(b) section 142JC,

cease to have effect.

(4) In subsection (1) "the relevant commencement date" means the day appointed for the coming into force of section 4 of the

Financial Services (Banking Reform) Act 2013 so far as it inserts this section.'.

M

Clause 20, page 21, line 23, at end insert—

'( ) No order may be made appointing a day for the coming into force of section 4 so far as it inserts section 142JD of FSMA 2000 unless—

(a) the day is later than that on which there is published the report of a review under section 142J of that Act containing a recommendation that section 4 of that Act should be brought into force to that extent, and

(b) a draft of the order has been laid before, and approved by a resolution of, each House of Parliament.'.

N

Clause 4, page 9, leave out lines 8 to 21 and insert—

'*Reviews*

142J Reviews of ring-fencing

(1) The Treasury must make arrangements for the carrying out of reviews of the effects of the operation of the provision made by or under this Part in relation to ring-fenced bodies, including ring-fencing rules made by the PRA and the FCA.

(2) The first review must be completed before the end of the period of 4 years beginning with the date on which section 4 of the Financial Services (Banking Reform) Act 2013, so far as it inserts this section, comes into force.

(3) Subsequent reviews must be completed before the end of the period of 5 years beginning with the date on which the previous review was completed.

(4) Not less than 9 months, nor more than 12 months, before the date on which a review is due to be completed, the PRA and the FCA must publish a joint assessment of the impact of the operation of their ring-fence rules.

(5) For the purposes of this section a review is completed when the report of it is published.

142JA Persons by whom reviews are to be conducted

(1) The Treasury shall appoint not fewer than 5 persons to conduct a review of whom one is to chair it.

(2) A person may not be appointed to chair a review unless the chairman of the Treasury Committee of the House of Commons has notified the Treasury that, in the chairman's opinion, the person is likely to act independently of the Treasury, the PRA and the FCA in carrying out the review.

(3) The persons appointed to conduct a review must include at least one person with substantial experience in central banking or financial regulation at a senior level.

(4) The reference in subsection (2) to the Treasury Committee of the House of Commons—

(a) if the name of that Committee is changed, is to be treated as a reference to that Committee by its new name, and

(b) if the functions of that Committee (or substantially corresponding functions) become functions of a different Committee of the House of Commons, is to be treated as a reference to the Committee by which the functions are exercisable;

and any question arising under paragraph (a) or (b) is to be determined by the Speaker of the House of Commons.

142JB Reports of review

(1) The persons appointed to conduct a review must give the Treasury a report of the review.

(2) The report must include an assessment of the extent to which the provision made by or under this Part in relation to ring-fenced bodies, including ring-fencing rules made by the PRA and by the FCA, are facilitating the advancement by the PRA of the objective in section 2B(3)(c) and by the FCA of the continuity objective.

(3) If the report is made before section 4 of the Financial Services (Banking Reform) Act 2013, so far as it inserts section 142JD, has come into force it must also include a recommendation as to whether or not section 4 of that Act should be brought into force to that extent.

(4) The report must include—

(a) recommendations to the Treasury as to the provision that should be included in orders and regulations under this Part, and

(b) recommendations to the PRA and the FCA about the provision that should be included in ring-fencing rules.

(5) The Treasury must lay a copy of the report before Parliament and publish it in such manner as it thinks fit.'.

RECOMMENDATION 37

O

Clause 6, page 14, line 7, at end insert—

'( ) the nature and extent of the dealings by ring-fenced bodies in derivative products (including options, futures, contracts for differences and similar products);'.

RECOMMENDATION 39

P

Clause 4, page 3, line 35, at end insert—

'(3A) In making an order under subsection (2)(b) which—
(a) provides an exemption for UK institutions holding deposits below a specified amount, or
(b) varies the amount previously specified for the purposes of such an exemption,
the Treasury must aim to enhance competition among UK institutions which have a Part 4A permission relating to one or more core activities (in particular by having regard to the likely effect on the number of UK institutions applying for or obtaining such a permission for the first time).'.

Q

Clause 6, page 14, line 7, at end insert 'and
( ) developments affecting the appropriateness of the amount for the time being specified for the purposes of any exemption under section 142A(2)(b) for UK institutions holding deposits below that specified amount.'.

RECOMMENDATION 46

R

Clause 4, page 7, line 45, at end insert—
'( ) provision requiring that shares or voting power in a ring-fenced body are held only by another member of the ring-fenced body's group which is not carrying on an excluded activity or by other members of that group none of which is carrying on such an activity;'.

RECOMMENDATION 47

S

Schedule, page 24, line 9, at end insert—
'( ) After subsection (3) insert—
"(4) Without prejudice to the generality of subsection (3), in the case of a ring-fencing transfer scheme the court must not make an order sanctioning the scheme if it considers that it might lead to the dissolution of a company or to the transfer of liabilities owed to any persons in a manner that may prejudice the interests of those persons."'.

RECOMMENDATIONS 49 and 50

T (New Clause)

Bank bail-in regime
To move the following Clause:—

'(1) The Bank of England must, at least once in every year, prepare an assessment of any progress which has been made towards the introduction of a bank bail-in regime in the United Kingdom or, once a bank bail-in regime has been introduced, of its operation.

(2) If a bank bail-in regime is not in force in the United Kingdom by the end of 2015, the Treasury must by regulations make provision for such a regime.

(3) An assessment under subsection (1) must include—

(a) an assessment of how much of the issued debt of banks would be covered by any proposed bank bail-in regime or is covered by the provisions of the bank bail-in regime in force,

(b) (if a bank bail-in regime is in force) an account of the sorts of companies within groups which have creditors who are covered by the bank bail-in regime and of the sorts of persons who are creditors who are so covered,

(c) a review of the descriptions of creditors who would be covered by any proposed bail-in regime or are covered by the provisions of the bank bail-in regime in force, and

(d) an account of progress towards international co-operation in relation to bail-in regimes.

(4) The Bank of England must send the assessment to the Treasury.

(5) The Treasury must lay the assessment before Parliament.

(6) The Bank of England must publish the assessment in such manner as they think fit.

(7) In this section "bank bail-in regime" means provisions under which losses incurred by a bank are to be met by certain descriptions of creditors of the bank should the bank encounter financial difficulties which might otherwise lead to the taking of action which would be likely to have implications for public funds.

(8) For the purposes of subsection (7) "action having implications for public funds" has the same meaning as in section 78(1) of the Banking Act 2009.

(9) In this section "bank" means a UK institution which has permission under Part 4A of FSMA 2000 to carry on the regulated activity of accepting deposits, other than a building society (within the meaning of the Building Societies Act 1986) or any description of institution excluded by virtue of subsection (2)(b) of section 142A of that Act from being a ring-fenced body as defined in subsection (1) of that section.'.

U

Clause 16, page, 20, line 28, after 'ring-fencing)' insert 'or section (*Bank bail-in regime*)(2) (bank bail-in regime)'.

V

Title, line, 4, after 'insolvency;' insert 'to make provision in relation to a bank bail-in regime;'.

RECOMMENDATION 51

W

Clause 4, page 12, line 22, at end insert—

'( ) If an order under this section includes provision for the grant by a regulator of any exemption from the requirements imposed by such an order, the order must—

(a) require a relevant body claiming the exemption to satisfy the regulator that the exemption should be granted,

(b) require the regulator, in deciding whether to grant the exemption, to have regard to all reasonably foreseeable circumstances,

(c) include provision for reviews of, or appeals from, any decision not to grant the exemption,

(d) require the regulator to make to the Treasury a report setting out any decision to grant the exemption and the terms of the exemption granted, and

(e) require the Treasury to lay a copy of such a report before Parliament and to publish it in such manner as they think fit.'.

RECOMMENDATION 57

X (New Clause)

Annual assessment of developments in respect of risk-weighting

To move the following Clause:—

'(1) The Bank of England must, at least once in every year, prepare an assessment of developments in respect of risk-weighting in relation to banks and building societies.

(2) The Bank must send the assessment to the Treasury.

(3) The Treasury must lay the assessment before Parliament.

(4) The Bank of England must publish the assessment in such manner as they think fit.

(5) In this section "risk weighting" means the process by which the assets of a bank or building society are accorded a risk weight.

(6) In this section—

"bank" means a UK institution which has permission under Part 4A of FSMA 2000 to carry on the regulated activity of accepting deposits, other than any description of institution excluded by virtue of subsection (2)(b) of section 142A of that Act from being a ring-fenced body as defined in subsection (1) of that section (or a building society);

"building society" has the same meaning as in the Building Societies Act 1986;

"risk weight" means a percentage that is derived from the risk to the value of an asset.'.

Y

Title, line, 4, after 'insolvency;' insert 'to make provision for reports relating to developments in respect of risk-weighting;'.