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Parliamentary Commission on
Banking Standards

Changing banking for good

First Report of Session 2013–14

*Volume VI: Written evidence to the
Commission*

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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.

Current membership

Mr Andrew Tyrie MP (Conservative, Chichester) (Chairman)
Most Rev and Rt Hon the 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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Rt Hon Lord McFall of Alcluith (Labour/Co-operative)
John Thurso MP (Liberal Democrat, Caithness, Sutherland and Easter Ross)
Lord Turnbull KCB CVO (Crossbench)

Powers

The Commission's powers include the powers to require the submission of written evidence and documents, to examine witnesses, to meet at any time (except when Parliament is prorogued or dissolved), to adjourn from place to place, to appoint specialist advisers, and to make Reports to both Houses.

A full list of the Commission's powers is available in the House of Commons Votes and Proceedings of 16 July 2012 on page 266, and the House of Lords Minutes of Proceedings of 17 July 2012, Item 10.

Publications

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

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

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Volumes of this Report

This Report is the Fifth Report of the Commission (and the First Report of Parliamentary Session 2013–14). It has nine volumes:

Volume I: Summary, and Conclusions and recommendations

Volume II: Chapters 1 to 11 and Annexes, together with formal minutes

Volume III: Oral evidence taken by the Commission

Volume IV: Written evidence to the Commission

Volume V: Written evidence to the Commission

Volume VI: Written evidence to the Commission

Volume VII: Oral and written evidence taken by Sub-Committees A and B

Volume VIII: Oral and written evidence taken by Sub-Committees C, D, E, F and G

Volume IX: Oral and written evidence taken by Sub-Committees H, I, J and K

Lists of witnesses who gave evidence and lists of people or organisations who submitted written evidence are given in the relevant volumes of the Report.

***House of Commons Printing Numbers**

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HC 606-i to –xl, HC 619-i to –ii, HC 705-i to –viii, HC 783-i, HC 706-i to –v, HC 821-i to –iii, HC 710-i to –ii, HC 784-i, HC 881-i to –v, HC 804-i to –ii, HC 860-i to –iv, HC 945-i

List of written evidence to the Commission

Written evidence to the Commission is on pages Ev 736 to 1642, FR Ev 1 to 199, and TR Ev 1 to 27.

Evidence pages Ev 736 to 1184 are contained in Volume IV of the Report.

Evidence pages Ev 1185 to 1642 are contained in Volume V of the Report.

Evidence pages FR Ev 1 to 199 and TR Ev 1 to 27 are contained in Volume VI of the Report.

Written evidence published alongside the Commission's First Report

1	Allen & Overy LLP	FR Ev 10
2	Association of British Insurers	FR Ev 16
3	Association of Corporate Treasurers	FR Ev 171
4	Bank of England	FR Ev 180, FR Ev 197
5	Barclays Bank	FR Ev 26
6	British Bankers' Association	FR Ev 35
7	Building Societies Association	FR Ev 41
8	Rt Hon George Osborne MP, Chancellor of the Exchequer	FR Ev 1, FR Ev 191
9	Charity Finance Group, Charities Aid Foundation, the Association of Chief Executives of Voluntary Organisations and the National Council for Voluntary Organisations	FR Ev 43
10	Davis Polk & Wardwell London LLP	FR Ev 46
11	Delegated Powers and Regulatory Reform Committee, House of Lords	FR Ev 53
12	Federation of Small Businesses	FR Ev 188
13	Financial Reporting Council	FR Ev 55
14	Financial Services Authority	FR Ev 57, FR Ev 188
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17	HSBC Holdings	FR Ev 128
18	ICAEW	FR Ev 67
19	Intellect	FR Ev 141
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21	Legal & General	FR Ev 145
22	Lloyds Banking Group	FR Ev 84
23	Nationwide Building Society	FR Ev 92
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28	RBS Pension Trustee	FR Ev 113
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31	Standard Chartered Bank	FR Ev 149
32	TheCityUK	FR Ev 114
33	United Food and Commercial Workers Union	FR Ev 117
34	Vedanta Hedging	FR Ev 189
35	Virgin Money	FR Ev 152
36	Which?	FR Ev 162

Written evidence published alongside the Commission's Third Report

37	Barclays	TR Ev 1
38	Finance Watch	TR Ev 3
39	Financial Services Authority	TR Ev 8
40	HSBC	TR Ev 12
41	Lloyds Banking Group	TR Ev 17
42	Royal Bank of Scotland Group plc	TR Ev 20
43	Standard Chartered Bank	TR Ev 25

Written evidence

Written evidence from the Rt Hon George Osborne MP, Chancellor of the Exchequer

I am pleased to be publishing the draft Financial Services (Banking Reform) Bill today, and to send the draft Bill to the Parliamentary Commission on Banking Standards for pre-legislative scrutiny. As you know, this is the next important stage in a process of reform to address the failings exposed by the financial crisis in 2007–09, and to implement the recommendations of the Independent Commission on Banking.

I look forward to hearing the views of the Parliamentary Commission on Banking Standards on the draft Bill. As agreed, in order to give the Commission sufficient time to consider the draft Bill and deliver its report by 18 December, I am publishing the draft Bill, and sending it to the Commission for scrutiny, this week, while Parliament is in Recess.

One specific area where I would particularly appreciate the Commission's input is the question of whether ring-fenced banks should be permitted to sell simple risk-management products, including simple derivatives, to their customers. This is not a question that needs to be resolved for the draft Bill itself, but will need to be settled as we develop the secondary legislation under the draft Bill.

As you know, the ICB said that ring-fenced banks could be allowed to offer risk-management products to their customers, provided that they did so in a way that did not expose them to increased market risk, and that the products provided were simple enough that they did not threaten the resolvability of the ring-fenced bank. In the June White Paper, the Government suggested that this could be given effect by allowing ring-fenced banks to sell simple derivative products to their customers, subject to a rigorous framework of safeguards. The White Paper set out what those safeguards might be, including restrictions on the type of product that could be offered, the manner in which risk-management products were provided and the customers to whom they could be sold. The White Paper noted that the Government would continue to explore whether a suitably robust set of safeguards could be developed to ensure that the provision of derivatives by ring-fenced banks did not threaten resolvability.

Recent events have highlighted the conduct risks around the sale of derivatives, including the risk of mis-selling by banks. Regrettably, mis-selling can, of course, occur with any product and under any business structure: hence the need for robust conduct of business regulation, and for the establishment of the Parliamentary Commission on Banking Standards to make recommendations on how the highest standards of behaviour by banks can be maintained. I would welcome the views of the Parliamentary Commission on Banking Standards on this subject, to inform Government thinking as secondary legislation is developed. To allow us to meet our legislative timetable, it is essential that the Commission's recommendations on derivatives, as well as on other legislative matters, are received by 18 December.

I am pleased to see the Commission taking forward its important work on banking standards and ethics, and I look forward to receiving your report on the draft Bill and your wider recommendations. I am copying this letter to the members of the Commission and placing a copy in the House Library.

12 October 2012

Written evidence from HM Treasury

FINANCIAL SERVICES (BANKING REFORM) BILL DELEGATED POWERS MEMORANDUM

INTRODUCTION

1. This memorandum concerns the draft Financial Services (Banking Reform) Bill as published on 12 October 2012.

2. This memorandum has been prepared to assist the Parliamentary Commission for Banking Standards in their consideration of the draft Bill. It identifies the provisions for delegated legislation in the draft Bill. It explains the purpose of the delegated powers taken, describes why the matter is to be left to delegated legislation, and explains the procedure selected for each power and why it has been chosen.

SUMMARY OF PROPOSALS IN THE DRAFT BILL

3. The draft Bill is primarily an enabling Bill. It will change the regulation of banking by:

- (a) providing for additional protection to core services (which will initially be those services related to the accepting of deposits, namely facilities for making payments into an account, for withdrawing money or making payments from the account, or overdraft facilities related to that account) by giving the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) a new continuity objective, and providing for ring-fencing: that is, applying restrictions to ring-fenced bodies (which will carry on core activities), and in particular prohibiting them from carrying on excluded activities.

- (b) amending the Insolvency Act 1986 and related Scottish and Northern Ireland legislation to provide that deposits which are eligible for protection under the financial services compensation scheme are to be preferential debts.
- (c) giving the Treasury power to make regulations governing the way in which the PRA may use its powers under the Financial Services and Markets Act 2000 to impose debt requirements on specified classes of institutions.

4. The draft Bill will also give the Treasury power to require the PRA, the FCA and the Bank of England to impose fees on members of the financial services industry in order to cover relevant expenses incurred by the Treasury in connection with specified international organisations, such as the Financial Stability Board.

THE DELEGATION OF POWERS

5. Decisions on the delegation of powers in this draft Bill is affected by two factors. First the regulation of banking, like regulation of other forms of financial services and markets is very complex, and highly technical. As noted in the delegated powers memorandum for the Financial Services Bill¹, regulation operates against a background of markets for financial products which are continuously developing, sometimes very rapidly.

CLAUSE 4 (RING-FENCING OF CERTAIN ACTIVITIES)

New section 142A (ring-fenced body)

6. *Power: To exempt UK institutions of a class specified by the Treasury by order from the definition of “ring-fenced body”, and to impose conditions on any exemption provided for.*

7. *Body: Treasury*

8. *Parliamentary Scrutiny: draft affirmative resolution procedure when the power is first used; and for any subsequent occasion on which the order restricts or removes an exemption.*

REASONS FOR THE POWER AND PROCEDURE

9. Ring-fenced bodies are defined in the draft Bill as any UK institution which has permission under Part 4A of the Financial Services and Markets Act 2000 (FSMA)² relating to a core activity (that is, accepting deposits) (referred to in this Memorandum as “UK banks”), apart from building societies and institutions which are exempted by the Treasury using this power. The Government does not consider that it is appropriate to apply the restrictions which will be associated with ring-fenced status (such as the prohibition on undertaking excluded activities, additional capital requirements, and restrictions imposed by the regulators in ring-fencing rules) to all UK banks regardless of their size. In the case of smaller banks the imposition of ring-fencing restrictions are likely to make a comparatively small difference to the regulators’ ability to ensure that in the event that the bank fails, it is possible to resolve it so as to maintain the continuity of provision of the core services (by for example the transfer of that part of the business to another institution).

10. At the same time, the costs for smaller UK banks of implementing ring-fencing are likely to increase their costs to a greater degree than larger banks, and may affect their ability to compete effectively. The Government does not wish to set the threshold above which a bank will become a “ring-fenced body” in primary legislation. It is likely that it will need to be adjusted over time to reflect changes in banking practices, and growth in the deposit base for UK banks. It may also be necessary to modify the methodology used to determine whether a bank should be a ring-fence body. Accordingly, section 142A(2)(b) gives the Treasury power to make exemptions from the definition of “ring-fence body”. Under subsection (4), any exemptions provided for may be subject to conditions. The Treasury will not, under section 142A(3), be able to exercise the power in section 142A(2)(b) unless they consider that exempting that class of institution from the definition of “ring-fenced” activity will not have a significant adverse effect on the continuity of provision in the United Kingdom of the core services.

11. The power to exempt institutions from the definition of a ring-fenced bank will determine the scope of the ring-fencing regime. It is similar in nature to the power to provide for exemptions from the general prohibition on carrying on regulated activities without authorisation under section 38 of FSMA. Accordingly, the Treasury consider that it is appropriate for this power to be subject to the same procedure as orders made under section 38 of FSMA: that is, draft affirmative resolution procedure applying to the first occasion on which the power is used, and on any subsequent occasion when an order made under the power contains provisions restricting or removing an exemption for which provision has already been made.

¹ Both the Memorandum prepared by the Treasury in relation to the Financial Services Bill and the Report of the Delegated Powers and Regulatory Reform Committee in relation to that Bill can be found on the website of that Committee—<http://www.parliament.uk/business/committees/committees-a-z/lords-select/delegated-powers-and-regulatory-reform-committee/bills-considered>.

² The Bill proceeds on the basis that the amendments to FSMA to be made by the Financial Services Bill have come into force.

New section 142B(2) Core activities (exceptions)

12. *Power: to specify the circumstances in which accepting deposits is not to be a core activity;*
13. *Body: Treasury;*
14. *Parliamentary scrutiny: negative resolution procedure.*

REASONS FOR THE POWER AND PROCEDURE

15. The Government is taking the power to provide for exceptions where accepting deposits is not a core activity in secondary legislation, because the class of deposit it is considered necessary to protect, and the way in which that class is defined is likely to change over time. Following the recommendations of the Independent Commission on Banking (“ICB”), the Government proposed in its White Paper to provide in secondary legislation that accepting deposits should only be a core activity where the deposits concerned are those of individuals who are not high-net worth individuals, and of small and medium-sized enterprises. Providing for this in secondary legislation will make it easier to adjust the conditions which have to be satisfied before someone can be considered to be a high-net worth individual, or before a company or other association may qualify as a small and medium sized enterprise. And it is possible that it may in future be thought necessary to add to the class of core deposits (for example to protect deposits of larger companies as well as small and medium-sized entities), if it becomes clear that customers in the class in question are not able to arrange alternative banking facilities in the event that their bank fails.

16. In addition, given the very wide definition of “deposit” (see Article 5(2) of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (S.I. 2001/544)), it may be appropriate to exclude some forms of deposit-taking such as the premiums taken by insurers from the core activity of accepting deposits.

17. Under subsections (3) and (4), the Treasury will only be able to exercise the power to provide that accepting deposits is not a core activities in the specified circumstances where the Treasury are satisfied that protection is not necessary in order either to secure that the depositors concerned receive appropriate protection, or to protect the continuity of the provision in the UK of services provided in the course of accepting deposits. The Treasury will therefore have to consider the position of the depositors who will be affected by the proposed order, and the potential impact of providing for such an exception to the core activity on the continuity of the provision of the services associated with the activity in the United Kingdom.

18. The power will be subject to the negative resolution procedure. Given the restrictions on the Treasury’s use of the power, and the fact that the effect of the power will be to narrow the range of cases where a person who accepts deposits must be a ring-fenced bank or an exempt bank, the Treasury consider that the negative resolution procedure is appropriate.

Clause 142B(5) new core activities.

19. *Power: to create new core activities;*
20. *Body: The Treasury*
21. *Parliamentary scrutiny: negative resolution procedure.*

REASONS FOR THE POWER AND PROCEDURE

22. The Government currently consider that only accepting deposits should be a core activity. However, it may in future become apparent that there is another regulated activity other than accepting deposits where an interruption in the provision of the services associated with that activity is likely to harm the stability of a significant part of the financial system in the United Kingdom, and that making alternative provision for the services in question is difficult to do in the short term. It is not possible to tell in advance what activities may need to be protected in this way—making it necessary to take a power to do this in secondary legislation rather than identifying all core activities on the face of the draft Bill.

23. The Treasury will only be able to exercise the power to create new core activities in relation to activities which are regulated activities under FSMA. In addition, under new section 142B(6), they must be satisfied first that an interruption of the provision of the services associated with the regulated activity in question could have an adverse effect on the stability of the UK financial system or any part of that system, and secondly that the continuity of the provision of those services can be more effectively protected if the activity concerned becomes a core activity.

24. Given the conditions attaching to the Treasury’s exercise of the power to create additional activities, and that it is possible that it might in some cases be desirable to take urgent action to protect the activity in question, the Treasury consider that it is appropriate for this power to be subject to the negative resolution procedure.

*New section 142C (Core services)*25. *Power:*

- (a) *to provide that specified services other than those listed in section 142C(2) are core services in relation to the core activity of accepting deposits (section 142C(3));*
- (b) *to specify those services to be considered to be core services in relation to any new core activity created under section 142B(5) (section 142C(4))*

26. *Body: the Treasury;*27. *Parliamentary scrutiny: negative resolution procedure.*

REASONS FOR THE POWER AND PROCEDURE

28. “Core services” are those services which are provided in the course of carrying on a “core activity”. To provide greater certainty as to what services should be treated as “core services” in relation to the core activity of accepting deposits, section 142C(2) lists those categories of services which the Government considers to be associated with the activity of “accepting deposits”. The Treasury are also taking a power to provide that other specified services provided in the course of carrying on a core activity should be considered to be core services. The Treasury have no current proposals to define new core services in relation to the core activity of accepting deposits under new section 142C(3). The power is being taken as a form of “future proofing”. The way in which banking services are provided to customers has changed very significantly in recent decades (as exemplified in the development of internet banking), and it continues to change. It is possible that, as banking develops, there may be other categories of service which become to be considered to be an essential part of the services provided with a bank account, to the extent that it becomes desirable to make them “core services”. It is not possible to tell in advance whether this will be necessary, and therefore not possible to make the necessary provision in primary legislation.

29. In the event that any new core activities are created by the Treasury using the power taken in new section 142B(5), the Treasury will be required to specify the services which they consider are provided in the course of carrying on the proposed core activity and that an interruption in their provision could harm the stability of the UK financial system or a significant part of that system, so that they are also treated as core services.

30. The effect of the definition of new core services is that the services in question are the services to which the regulators’ continuity objective applies, and the services which must be taken account of when—

- (a) the Treasury considers whether creating an exception to the excluded activity of dealing in investments as principal would result in any significant adverse effect on the continuity of provision in the UK of core services (new section 142D(3));
- (b) the Treasury considers whether the creation of new excluded activities under section 142D(4) or the imposition of prohibitions under section 142E(1) is necessary or expedient to protect the continuity of provision in the UK of core services (sections 142D(7); 142E(3)).

31. Both the powers are provided for clarificatory purposes, so that it is clear in all cases what services are considered to be provided in the course of carrying on a core activity, and therefore what, among other things, the regulators’ continuity objective applies to. Given the limited, technical, nature of these powers, the Treasury consider that the negative resolution procedure is appropriate in each case.

New section 142D(2) (Excluded activities: exceptions)

32. *Power: to specify circumstances in which dealing in investments as principal is not to be an excluded activity;*

33. *Body: The Treasury;*

34. *Parliamentary Scrutiny: Negative resolution procedure.*

REASONS FOR THE POWER AND PROCEDURE

35. The Bill provides in new section 142D(2) that the regulated activity of dealing in investments as principal (or dealing on own account) is to be an excluded activity: that is ring-fenced bodies will not be able to carry on this activity. However, there will be circumstances in which UK banks need to undertake this activity in order to raise wholesale funding, to manage liquidity or to manage the risks arising from their core activities of lending and providing payment services. The Treasury is taking this power so that it is possible to permit such dealing in these circumstances while at the same time providing for safeguards to ensure that ring-fenced banks do not expose themselves to unacceptable levels of risk. This is likely to require a level of technical provision which is most easily made in secondary legislation. For example, an exemption might be made conditional on a bank’s residual market exposure being capped at a certain level, and a specified level of collateral being provided for its counterparty credit risk. It is also likely that the circumstances in which such dealing is permitted, or the safeguards applied to it will need to change over time to match developments in financial markets.

36. The Treasury will not be able make an order providing for exceptions to the excluded activity of dealing in investments as principal unless it is satisfied that permitting dealing in the specified circumstances would not be likely to cause significant harm to the continuity of the provision in the United Kingdom of core services.

37. Given the technical nature of the provision to be made in orders made under this power and the limits on the Treasury's power, the Treasury consider that the negative resolution procedure is appropriate.

Clause 142D(4) (new excluded activities)

38. *Power: to provide for activities other than dealing in investments as principal to be treated as excluded activities and to create exceptions to any new excluded activity created.*

39. *Body: the Treasury;*

40. *Parliamentary scrutiny: negative resolution procedure.*

REASONS FOR THE POWER AND PROCEDURE

41. The only excluded activity provided for on the face of the draft Bill is the regulated activity of dealing in investments as principal. The Government considers that it will be necessary to create additional excluded activities. The ICB recommended that ring-fenced banks should be prohibited from providing services which, for example, expose UK banks to risks that are not integral to the provision of payment services to customers or the direct intermediation of funds between savers and borrowers outside the financial sector, or that directly increase the exposure of ring-fenced banks to global financial markets.³ Not all services in this category will be caught by the proposed excluded activity of dealing in investments as principal. For example, structuring, arranging or executing derivative transactions will not always come within the excluded activity, even though such transactions may significantly increase the exposure of the banks which undertake them to global financial markets, as not all derivatives fall within the definition of "investment" under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001⁴.

42. Providing for the appropriate additional excluded activities to catch such activity will require a level of technical provision which may best be provided for in secondary legislation. The precise terms of any particular chosen activity may also need to be changed, and new excluded activities added in response to the rapid evolution of the financial services market, as new financial services and products are developed. This also requires a power for the Treasury to make secondary legislation.

43. Before the Treasury is able to exercise the power in new section 142D(4) to create a new excluded activity, it must, under subsection (6) consider the risks which a ring-fenced body would be subject to if it carried on the activity concerned, and whether permitting a ring-fenced bank to carry on the proposed excluded activity would make it more likely that a subsequent failure of the ring-fenced bank would harm the continuity of provision in the UK of the core services (because, for example it would make it more difficult to wind down the ring-fenced bank in an orderly fashion). The Treasury must also be satisfied that it is necessary or expedient to make the order in order to protect the continuous provision within the UK of the core services.

44. Given the technical nature of the provision to be made here, and the limits on the Treasury's power, the Treasury consider that the negative resolution procedure is appropriate.

New section 142E (power of Treasury to impose prohibitions)

45. *Power: to prohibit ring-fenced banks from entering into specified transactions; establishing branches in specified countries or territories, or from investing in specified companies.*

46. *Body: The Treasury.*

47. *Parliamentary scrutiny: negative regulation procedure.*

REASONS FOR THE POWER AND PROCEDURE

48. This power is being taken to supplement the power set out in new section 142E for the Treasury to create new excluded activities. It permits the Treasury to impose the prohibitions listed in subsection (1). In each case, it is envisaged that action by the ring-fenced body of the type described in paragraphs (a) to (c) of subsection (1) may increase the exposure of the body concerned to global financial markets, and make it more difficult for that body to be wound down in an orderly fashion without disrupting the continuous provision of any core services it may provide. However, such action is arguably not an "activity" carried on by the ring-fenced body, so that the Treasury could not impose such prohibitions by using its powers under new section 142D. Any prohibition imposed under these powers is also likely to be accompanied by a number of exemptions setting out the circumstances in which the ring-fenced body is to be permitted to act in a way otherwise prohibited, and the safeguards which it must observe to do so. For example, the ICB recommended that ring-fenced banks should be prohibited from providing services to other financial institutions (apart from payment services where the regulator considers this to be appropriate), to reduce their exposure to failure elsewhere in

³ Paragraph 3.39 of the Final Report of the Independent Commission on Banking.

⁴ SI 2001/544.

the financial system. A prohibition on all transactions with other financial institutions would achieve this, but may be disproportionate, restricting the business of ring-fenced banks more than is necessary to achieve the objective.

49. The Government therefore proposes to permit transactions with other financial institutions where such transactions are undertaken for particular purposes (such as the management of a ring-fenced bank's liquidity, or for risk-management purposes), subject to specified safeguards. As with excluded activities, both the extent of the permitted exceptions to a prohibition, and the safeguards required, are likely to need to be adjusted over time. It is also likely to be necessary to impose additional prohibitions on ring-fenced banks as financial markets develop further, and new forms of exposure become possible. It is therefore necessary to have powers to make the necessary provisions in secondary legislation, so that amendments can be made over time without the need to bring forward new primary legislation.

50. The conditions which must be satisfied before the Treasury are able to exercise the power are the same, *mutatis mutandis*, as the conditions applying to the power in new section 142D(4) for the Treasury to provide for a new excluded activity. The Treasury must have regard to the risks to which a ring-fenced bank would be exposed if it was permitted to act in the way the Treasury propose to prohibit, and whether permitting a ring-fenced bank to act in such a way would make it more likely that a subsequent failure of the ring-fenced bank would harm the continuity of provision in the UK of the core services. The Treasury must also be satisfied that making the order prohibiting the specified action is necessary or expedient to protect the continued provision of the core services in the United Kingdom.

51. Just as with the power for the Treasury to create new excluded activities under new section 142D(4), it is envisaged that the provision made in orders made under section 142E will primarily be of a technical nature. For this reason the Treasury considers that the negative resolution procedure is appropriate.

New section 142F

52. *Power: supplementary powers to confer powers on the Treasury, or on a regulator; to authorise or require the regulator to make rules for the purposes of any provision in an order made under new sections 142A, 142B, 142D or 142E; or to authorise other instruments to be made for the such purposes.*

53. *Body: the Treasury;*

54. *Parliamentary scrutiny: determined by principal instrument*

REASON FOR POWER AND PROCEDURE

55. These powers are supplementary to the powers contained in new sections 142A, 142B, 142D and 142E, and may only be used on combination with those powers. It is envisaged that it may be appropriate to give the regulator power to make technical provision related to the core activities and excluded activities, in areas which are generally treated as the preserve of the regulator. For example, provision for new excluded activities will also provide for the circumstances in which ring-fenced bodies are to be permitted to undertake such activities. It will be necessary to provide for safeguards, and it may be more appropriate for detailed provision about the safeguards which must be observed to be made in rules by the regulator. Accordingly, it would be necessary for the Treasury to be able to confer powers on the regulator to do this (the Treasury would also have power, if necessary, to require the regulator to make any rules needed). The power to impose conditions on the exercise of any such power, consultation requirements and, where appropriate to require the consent of the Treasury to the regulator's exercise of such a power, will enable the Treasury to provide the framework for the way in which the power is exercised, to assist the regulator, and provide for greater certainty to the market.

56. As these powers are supplementary to the powers in the sections listed, they will be exercised in the same instrument, and will be subject to the parliamentary procedure applicable to the primary powers.

New section 142G(3).

57. *Power: To specify those cases where a person who has suffered loss as a result of a contravention may bring an action for breach of statutory duty in relation to that contravention*

58. *Body: the Treasury*

59. *Parliamentary procedure: negative resolution procedure*

REASON FOR POWER AND PROCEDURE

60. The power is essentially the same as that in sections 20(3) and 202(2) of the Financial Services and Markets Act 2000 (FSMA), which provide that contraventions related to breaches of the general prohibition on carrying on regulated activities without being authorised or exempt from authorisation, or breaches of requirements imposed by the Financial Services Authority under the Act are actionable by those who suffer loss "in prescribed cases" (that is, cases prescribed by the Treasury in regulations). A ring-fenced body which carried on an excluded activity, or acts in a way which has been prohibited by an order under section 142E, will be treated as having contravened a requirement under FSMA, and it is important that that remedies should

be available to those who have suffered loss in consequence of the contravention in the same circumstances as provided for in the equivalent cases under FSMA in the Financial Services and Markets 2000 (Rights of Action) Regulations 2001 (2001/2256).

61. Orders made under this power will be subject to the negative resolution procedure, which is the procedure applicable to regulations made under section 20(2) and 202(2) of FSMA.

New section 142H

62. *Power: a requirement for the regulators to make rules governing specified aspects of the relationship between the ring-fenced body and other companies within the same group.*

63. *Body: the Prudential Regulation Authority (for those ring-fenced bodies which are not authorised by the PRA, the appropriate regulator is the Financial Conduct Authority, but initially, all ring-fenced bodies are expected to be PRA-authorised persons).*

64. *Parliamentary scrutiny: none (see paragraph 67 for the procedure applicable to rules made by the regulator)*

REASONS FOR POWER AND PROCEDURE

65. New section 142H makes provision as to the way in which the appropriate regulator (which, as noted above, is expected to be the PRA) is to exercise its power to make general rules in relation to ring-fenced bodies. The powers to make these rules are set in section 137A (for the FCA), and section 137E (for the PRA). The powers are expressed as being with respect to the carrying on of activities (both regulated and unregulated). Subsection (3) lists the areas in which the regulator is to be required to make rules. In that sense, it is not a new power.

66. The primary purpose of new section 142H is to ensure that the regulator makes rules for ring-fenced bodies in relation to each of the areas which are identified in subsection (3), which cover different aspects of the relationship between a ring-fenced bank and other members of the same corporate group as the ring-fenced bank (such as the terms on which a ring-fenced bank may transfer funds to other members of the group), and what subsidiaries the ring-fenced bank may own. The Government considers that rules in these areas are necessary to ensure that ring-fenced banks which are members of groups are able to operate their businesses independently of the other entities of the group. This should help to ensure that a failure of another member of the group does not pose a significant threat to the continued existence of the ring-fenced bank.

67. Rules made by the PRA to comply with the requirements of this section will be subject to the safeguards applying to all PRA general rules under section 138J of FSMA (unless it is necessary or expedient to make rules quickly): the PRA must consult the FCA about any proposed rules, and thereafter publish draft rules accompanied by a cost benefit analysis and an explanation of the purpose of the rules for consultation. Final rules may only be made after the PRA has considered any representations made.

68. The rules will cover matters of operational detail and the Treasury considers that it appropriate for such rules to be made by the regulators subject to the safeguards described above.

New section 142J (Power in relation to loss absorbency requirements)

69. *Power: to regulate the way in which the regulator imposes debt requirements on relevant bodies (banks, including ring-fenced banks and building societies, and members of the same group as a bank), by requiring the regulator to require a relevant body to issue debt—or to hold debt of a particular class; or by limiting the requirements the regulator may impose;*

70. *Body: the Treasury;*

71. *Parliamentary procedure: negative resolution procedure.*

REASON FOR POWER AND PROCEDURE

72. The Government believes that UK banks should have sufficient capacity to absorb losses to ensure that they are both resilient to shocks and that they can be resolved without recourse to taxpayers' funds. Such loss absorbing capacity may be made up of capital or debt issued by the bank (debt becomes capable of absorbing loss when it may be written down or converted into equity). The rules determining what capital a bank must hold are set out in EU legislation.⁵ This power is intended to permit the Treasury to provide a framework determining how the regulators may use their powers to require a relevant body to have in issue sufficient debt, and debt of an appropriate class, to ensure that it has sufficient loss absorbing capacity. The Treasury will also be able to give itself power to give directions to the regulator, for example requiring the regulator to make rules imposing specified requirements on UK banks.

⁵ The Capital Requirements Regulation and Capital Requirements Directive IV, which will replace EU directives 2006/28/EC and 2006/49/EC (the banking consolidation directive) are currently under negotiation.

73. It will be necessary to strike a balance between ensuring that those UK banks which are considered to be of systemic importance (in that their failure may have implications for the stability of the UK or, in some cases, the global financial system) are required to have sufficient loss absorbing capacity but that they are not subjected to disproportionate requirements which may harm their capacity to contribute to economic growth in the UK. It will also be necessary for the provisions made in relation to loss absorbing capacity to change over time in response to conditions in the global markets. They are therefore more suited to secondary legislation rather than primary legislation.

74. Given the technical nature of the provisions which are likely to be made under this power, the Treasury consider that the negative resolution procedure is appropriate.

Clause 142K

75. *Power: to amend any legislation which might impose liability on one company in a group as a result of something done—or not done—by another company in the group, if this is considered necessary or expedient to ensure that the carrying on of core activities by a ring-fenced body is not harmed by actions or omissions of another company in its group;*

76. *Body: the Treasury;*

77. *Parliamentary procedure: Draft affirmative resolution procedure.*

REASON FOR POWER AND PROCEDURE

78. The ICB report identified circumstances in which a ring-fenced bank might be required to bear costs incurred elsewhere in the group. One of the examples given was the VAT liability which may arise where a ring-fenced body is a member of a VAT group. The ring-fenced body would become jointly and severally liable to pay the VAT. In extreme cases, such liability could threaten the survival of the bank. This may not be the only case in which such liabilities may be imposed on a ring-fenced body in consequence of the acts or omissions of other members of its group, and the Treasury consider that it would be helpful to have the power to make any amendments necessary.

79. Due to the width of the power taken and in particular the fact it enables the Treasury to amend primary legislation, the Treasury consider that it is appropriate for it to be subject to the affirmative resolution procedure.

Clause 6—Building Societies (power to make provision about ring-fencing)

80. *Power—to make provision for ring-fencing legislation to apply to building societies and to apply the continuity objective to the exercise of any powers by the FCA or the PRA in relation to functions conferred to it through applying ring-fencing legislation to building societies;*

81. *Body—Treasury;*

82. *Parliamentary Scrutiny- draft affirmative.*

REASON FOR POWER AND PROCEDURE

83. Under Clause 6 the Treasury may, by statutory instrument, apply any provision of Part 9B (except s142) and any provision made under this part to building societies. In applying these provisions, the Treasury may amend the Building Societies Act 1986, authorise the making of rules or other instruments by the FCA and the PRA as appropriate, confer functions on the FCA and the PRA and make any other consequential amendment, including amendments of other primary legislation as required.

84. As set out in the white paper, HM Treasury's intention is that building societies will be subject to the same restrictions as the ring fence imposes on institutions that fall within its scope. This power is intended to assist the Treasury in applying the ring fence to building societies. It is intended to supplement existing provisions and powers in the Building Societies Act 1986 to circumscribe the activities of building societies. The Building Societies Act 1986 contains a number of restrictions on the activities of building societies, in particular in sections 6 through 9B of that Act. A number of these sections also include power to amend the section through secondary legislation.

85. It is anticipated by the Treasury that many of the existing restrictions in the Building Societies Act 1986 will mirror restrictions that are imposed through the ring fence or will be capable of being amended through the existing powers in that Act to mirror the ring fence. To include building societies within Clauses 1–5 of this draft Bill would therefore risk double legislation of building societies and the upsetting of an established and familiar legislative structure.

86. As set out above, the exact scope of the ring fence will be determined in secondary legislation. It is consequently not yet clear that all matters to be covered in the ring fence will be within the scope of the existing powers in the Building Societies Act 1986. Clause 6 of the draft Bill therefore provides a general power to amend the Building Societies Act 1986 to enable the Treasury to apply the ring fence where the Building Societies Act 1986 would not permit it to do so.

87. The power includes a power both to apply the continuity function to the building societies ring fence and to confer the ability to make rules on the FCA or PRA. The FCA or PRA will be responsible for the supervision of the ring fence as applicable to building societies and thus will need to be able to make rules and issue guidance to fulfil this function. This accords with the power in Clause 4, inserting section 142F into FSMA. A separate power is required for building societies for these matters because as outlined above, it is anticipated that a number of the changes required to apply the ring fence to building societies will be carried out through existing legislation and thus different rules and guidance will be required for building societies as opposed to other ring-fenced entities.

88. Clause 6 also includes power to make consequential amendments to other legislation where necessary. In applying the ring fence to building societies, the Treasury anticipates that there may be conflicting provisions in other pieces of primary legislation applicable to building societies which will require amendment to ensure compatibility with the ring fence. This power will enable the Treasury to make these amendments.

89. The Treasury consider that it is appropriate that a statutory instrument made under Clause 6 should generally be subject to the draft affirmative procedure. This is appropriate given that the statutory instrument is likely to be amending primary legislation.

Clause 9, New section 410A (fees to meet certain expenses of the Treasury)

90. *Power:*

- (a) *to make regulations giving the Treasury power to require the FCA, the PRA or the Bank of England to require certain persons to pay fees to meet relevant expenses incurred by the Treasury in its work in relation to international organisations which relate to the organisation's work on financial stability or financial services;*
- (b) *to list the international organisations concerned.*

91. *Body: The Treasury;*

92. *Parliamentary Procedure:*

- (a) *for regulations which only prescribe the international organisations which are relevant for this purpose, the negative resolution procedure;*
- (b) *for all other regulations, draft affirmative resolution procedure.*

REASONS FOR PROCEDURE AND POWER

93. This power is being taken to enable the Treasury to recover from the financial services industry the costs the Treasury incur in relation to work with international organisations in connection with financial stability or financial services. The power would, for example, enable the Treasury to recover the costs associated with membership of international organisations like the Financial Stability Board (the FSB). International organisations are growing in importance as a means of setting international standards which affect the operation of the financial services industry in London. It is also becoming increasingly clear that in many cases action to address risks to financial stability can only be taken effectively at the international level.

94. The Treasury consider that it is appropriate that the financial services industry (in particular, authorised persons, recognised clearing houses and recognised investment exchanges) should bear these costs. Such firms benefit significantly from these activities by the Treasury. Participation by the regulator (the PRA, the FCA or the Bank of England) in such forums can be recovered from the financial services industry under existing legislation⁶.

95. The Treasury consider it appropriate that both the regulators and the financial services industry have clarity as to what expenses are to be recovered in this way, what international organisations are at issue and the considerations the Treasury will take into account when recovering their costs in this way. The Treasury therefore consider that legislation should set out these matters. However, as these matters may change over time, it is not possible to set them out in primary legislation.

96. For example, the nature of the expenses that the Treasury incur in connection with UK membership of such international organisations or in representing the UK in such forums have generally included the obligation to pay membership fees. However other forms of expense such as the provision of non-financial resources (such as staff) have also been increasingly envisaged. Consideration has also been given to funding the Financial Stability Board via an endowment rather than a membership fee for example. Depending on the nature of the expense, the Treasury may not consider that it is appropriate to be able to recover it from the industry. It is therefore not possible to set out comprehensively what expenses are to be recoverable from the financial services industry.

97. The Treasury also consider that it is not possible to set out a comprehensive list of the international organisations at issue in the draft Bill itself. New institutions may be established at any time. The names of existing organisations may also change over time. For example, the Financial Stability Board itself has only

⁶ See paragraph 20 of Schedule 1ZA to FSMA for the FCA; paragraph 28 of Schedule 1ZB to FSMA for the PRA; and paragraph 32 of Schedule 17A to FSMA for the Bank of England.

existed since 2009 as the successor organisation to the Financial Stability Forum. Thus the Treasury consider it appropriate to take a power to set out the international organisations which are relevant for this purpose in secondary legislation.

98. As the key details of the Treasury power to direct the regulators to impose a fee are to be set out in secondary legislation, it is considered more appropriate for the power to give a direction also to be set out in secondary legislation. This will mean that the legislation in this area is set out in a comprehensive manner in one piece of legislation.

99. Any directions given under regulations made under section 410A must comply with the procedural safeguards set out in section 410B including the obligation on the Treasury to lay a copy of any direction before Parliament.

100. As section 410A confers a power to direct the regulators to impose a fee and so is of the nature of a power to impose a tax, the draft affirmative procedure is considered appropriate to the power to require the payment of fees. However, changes to the list of international organisations in relation to which expenses may be claimed are more technical in nature, and may (as in the case of the Financial Stability Board) be required simply to reflect a change in an organisation's name. Accordingly, the Treasury consider that where regulations made under section 410A only prescribe the international organisations which are relevant for this purpose, the regulations should be subject to negative resolution procedure.

Clause 12 (transitional provisions and savings)

101. *Power: to make transitional, transitory or saving provision by order*

102. *Body: Treasury*

103. *Parliamentary scrutiny: negative procedure*

REASONS FOR POWER AND PROCEDURE

104. This clause enables the Treasury by order to make such provision as they consider necessary or expedient for transitory, transitional or saving purposes in connection with the commencement of any provision made by or under the draft Bill. The power is needed to facilitate the transition between the current arrangements and the new regulatory regime introduced by the draft Bill. Any modifications or exclusions made in relation to any enactment will be of a temporary nature.

105. The Treasury does not consider it necessary that transitional and savings provision should require the approval of each House in draft; it is appropriate that orders under this provision should be subject to the negative procedure.

12 October 2012

Written evidence from Allen & Overy LLP

1. INTRODUCTION

We are grateful for the opportunity to provide written evidence to the Parliamentary Commission on Banking Standards (the **Commission**) in relation to its pre-legislative scrutiny of the UK Government's draft Financial Services (Banking Reform) Bill (the **Draft Bill**).

As a law firm, our principal concerns with the Draft Bill are issues raised by the proposals which go to legal and regulatory certainty. Accordingly, this response primarily focuses on legal and regulatory issues raised by the Draft Bill. Other market participants are better placed to address the policy and economic consequences of the proposals.

We would be delighted to provide the Commission with further details on any aspects of this response.

About Allen & Overy LLP

Allen & Overy is one of the world's leading law firms, with around 5,000 staff and 500 partners worldwide. Since opening its first office in London in 1930, the firm has grown into a global organisation with 42 offices in 29 countries across Europe, Asia, the US, South America, the Middle East and Africa. Allen & Overy LLP acts for many, if not all, of the systemic financial institutions in Europe.

2. KEY COMMENTS

Generally we are supportive of the proposals set out in the Draft Bill. Our key comments are as follows.

- (a) The implementation of the ring-fencing proposals represents by far the most substantial change to the structure of the UK banking sector in living memory. Others are better placed to comment on the economic ramifications of ring-fencing: we would emphasise that the transition to ring-fencing

will be complex, commercially sensitive and resource intensive, and that a poorly designed ring-fence could deliver some outcomes whose costs exceed their benefits. It is hard to overstate the importance of getting the legislation and regulation, and transition and implementation processes, right.

Transition: moving to a clear and workable regime

- (b) It is in the interests of banks, their stakeholders and regulators that the legislative and regulatory process enables transition to ring-fencing in as orderly a manner as possible. In order to create an environment for an orderly transition, there is a need to recognise that financial institutions have a legitimate need for certainty as early as possible in order to facilitate planning and execution of the transition and implementation processes.
- (c) The ICB report raised a large number of highly material policy issues. Over a year since the report was produced, there has been little progress on clarifying these. This is not in itself a criticism of the efforts made by the Government to date in seeking to move the ICB process forwards, as the issues are complex. But our perception is that the very large number of outstanding questions on application of the ring-fencing proposals, and on the scope of mandated and prohibited services and ancillary activities in particular, have left market participants unable to prepare for transition. There is simply insufficient detail on even the major elements of the regime's architecture to enable meaningful planning. Some of the more fundamental examples of that uncertainty are:
 - (i) whether fund management, investment management or custody are permitted within the ring-fence;
 - (ii) whether loan servicing and administration are permitted within the ring-fence;
 - (iii) to what extent a ring-fenced bank may provide credit enhancement or derivatives to a securitisation it originates;
 - (iv) whether macro hedging will be permitted as an ancillary activity;
 - (v) whether retail structured products may be issued by ring-fenced banks;
 - (vi) whether trade finance will be allowable within the ring-fence.

We would be happy to share further examples of important unresolved issues.

- (d) Equally, in some of the areas where there has been a lot of consultative focus (such as the question of what amounts to a financial institution) some significant questions arise around how the proposals can be "operationalised" within banks. There seems to have been insufficient focus on the workability of the detail of the new regime to date.
- (e) Lastly, there is a host of implementation issues—including tax and pensions impacts—which are still to be worked through.
- (f) Whilst the uncertainties associated with the ring-fencing proposals are well known to the larger UK financial institutions, they are less well understood by other stakeholders. The Government has consulted reasonably extensively on some of the issues, but on others (such as the scope of allowable ancillary activities within the ring-fence) there has been very little consultation or dialogue. We are also unclear as to how far the FSA has been involved in the process to date.
- (g) These issues need to be resolved in order to enable transition and implementation. They are complex, often interrelated, and in some cases highly technical.
- (h) Given the complexity and sensitivity of ring-fencing, we believe that more could be done to bring transparency and clarity to the process:
 - (i) it is crucial that a timetable is adopted (whether or not in the draft Bill) to provide certainty on the major open questions in good time to enable banks to plan and prepare for transition;
 - (ii) a forum is needed to provide an open and transparent dialogue between the private and public sector on the unresolved issues within the proposals. We would recommend the creation of a panel under the Bill, similar to the Banking Liaison Panel under the Banking Act 2009, to provide a forum for stakeholders, the Government and the regulatory authorities to ensure that the detail contained in secondary legislation and/or regulation is properly understood and workable. Such a panel would also be a useful mechanism for providing feedback on the effects of ring-fencing post-implementation.
- (i) We believe that the lead time that was proposed by the ICB to implement ring-fencing was a reasonable estimate at the likely timeframe needed given the complexity of the issues raised by the proposals. Given the relative lack of progress on the issues above, we would query whether that timing remains realistic. This also ties in with the question of the legal means by which ring-fencing is achieved—as to which see our comments below on Part VII.

Statutory instrument v regulation

- (g) We do not support the proposed approach of providing for the location of the ring-fence in secondary legislation and height of the ring-fence in regulation. The proposed split is arbitrary.

- (h) In very simplistic terms, we see two possible avenues for implementation of the regime: low certainty high discretion, or high certainty low discretion. A low certainty high discretion regime is one in which the relevant legislation or regulation provides general rules, which require considerable exercise of judgement on the part of the regulatory authorities to enforce it. A high certainty low discretion regime is one in which there are very detailed rules requiring little by way of supervisory discretion. There are policy advantages and disadvantages to each.
- (i) We believe that a low certainty high discretion regime could be provided for by statutory instrument, but not a high certainty low discretion regime. This is because the rules needed to establish the precise location of the ring-fence will be highly technical and run to a matter of hundreds, rather than tens, of pages of requirements (the draft US Volcker Rule is a reasonable precedent here, albeit that it is a far less wide-ranging rulemaking). As is often the case with complex, highly technical regulation, the rules are also likely to need amendment—possibly reasonably frequently—from inception.
- (j) If the intention is to provide for a high level of legal certainty, we believe that the detail needs to be made through regulation rather than statutory instrument (albeit guided by principles to be set in statute or statutory instrument), and that the legislation needs to provide for an enhanced process for scrutiny of the ring-fence rules and accountability of the PRA for them.

Implementation

- (g) It is not clear whether the proposed variation of FSMA Part VII is in practice likely to be the most appropriate tool for the transfer of assets and liabilities whilst establishing the ring-fence. One area of weakness is the current scope of the provisions—these do not extend to businesses or assets held by any subsidiary of a UK authorised person who has permission to carry on one or more core activities. This would, for example, preclude the separation and transfer of funding programmes within a subsidiary. Whilst this issue could be resolved by ensuring that the amendments to section 106 FSMA increase the scope of the provisions so that businesses or assets that sit within subsidiaries of ring-fenced banks could also be moved, it is just one example of the weaknesses inherent in the tool when considered in the context of establishing a ring-fence. Further work is needed on how Part VII can be amended to ensure appropriate coverage and provide a transparent, predictable and timely restructuring process.

The following sections consider the detailed questions posed by the Commission.

3. THE COMMISSION'S QUESTIONS

Objectives and general approach

1. Does the draft Bill successfully give effect to the objectives set out in paragraph 1.3 of Sound banking: delivering reform and is it the most efficient and effective means of delivering those objectives?

We consider that the Draft Bill does give effect to the objectives set out in paragraph 1.3, subject to our comments elsewhere.

2. Do any of the recommendations of the Independent Commission on Banking (ICB), which the draft Bill seeks to implement, need revision as a consequence of developments since the ICB's report?

We believe that it is important to monitor developments within Europe and to ensure that any UK legislation is in line, so far as possible, with any European reform.

3. Do the powers in the draft Bill and the Government's stated intentions for their use give effect to the ICB's recommendations? Are any deviations justified?

Whilst the Draft Bill is clearly intended to give effect to the ICB's recommendations, it will only be possible to confirm whether this is in fact the case once the secondary legislation has been published.

4. What should be the timetable for implementation of these measures, and should it be set out more clearly?

Rather than determining the timetable for implementation, we strongly believe it is crucial to focus on the timetable for drafting and finalising the legislation and regulatory rules to give full effect to the ICB's recommendations. Given how complex (and important) these measures are likely to be, the process needs to be transparent and allow for appropriate dialogue between stakeholders in the private and public sectors.

We believe that an expert panel (similar to the panel that HM Treasury is required to have under section 10 of the Banking Act 2009) would be a suitable forum within which the Treasury, the PRA, affected banks and other stakeholders could understand the evolving policy, its implications and the details. They could prioritise and work through the grey areas and ensure that the draft measures can actually be operated in practice.

By imposing a structured timetable for drafting the measures, it would not only ensure that adequate time is built in to allow for meaningful dialogue, it would also reassure the industry that complex topics are being given the appropriate level of focus and thought.

5. The draft Bill proposes continuity objectives on the PRA and FCA. Are these appropriate and compatible with their other objectives?

The continuity objectives imposed on the FCA and PRA in relation to core services appears to be contrary to Article 8 (*Provisions on democratic principles*) of the Treaty of Lisbon which requires EU citizens to receive equal attention from its institutions, bodies, offices and agencies. The requirement to “prefer” the continuity of services in the UK (ie favouring those clients in the UK over those in the EU) will need to be revisited.

There is also a wider question as to the costs of continuity of core services, and the need to balance continuity with failure. Continuity is not an end of itself, and should not be used as a pretext for a no-failure approach to the regulation of ring-fenced banks.

BANKING STANDARDS AND COMPETITION

As discussed in the introduction, other market participants are better placed to address these questions.

DELEGATED POWERS AND ACCOUNTABILITY

9. The draft Bill grants a large number of delegated powers to the Government. Are the principles under which delegated powers are to be exercised sufficiently clear?

Whilst such principles as are expressed in the Draft Bill are clear, the rather narrow focus of the Bill on continuity of services presents concerns on the interaction of continuity with other objectives. It also misses some of the nuances of the ICB final report, which sets out three, not one, objectives for the ring-fence. We assume that more detail will be provided in secondary legislation. This will need to be analysed before it is possible to fully understand the powers and how they will be exercised.

10. Does the scope of the delegated powers in the draft Bill represent an appropriate balance between flexibility for the Government to respond to changing conditions and accountability to Parliament and the public?

As discussed in the introduction, other market participants are better placed to address the policy and economic consequences of the Draft Bill.

11. Is there sufficient clarity about the Government’s intended use of delegated powers, both to enable public understanding and to enable affected banks to prepare for the proposed changes?

Broadly, we do not consider that there is presently sufficient clarity about the Government’s intended use of delegated powers. As noted in section 2 of this response, there remain a large number of “grey areas” in respect of the necessary detail as to the scope of the ring fence and how it will work in practice. It is critical that such detail be fleshed out as a matter of priority. Banks will be unable to adequately prepare for the proposed changes until such time as this detail has been clarified.

12. The draft Bill provides for review of the ring-fencing rules by the PRA every five years. Does the proposed review mechanism provide sufficient accountability?

We note the review mechanism contained in new section 142I FSMA—what remains unclear from the Draft Bill is what action the Treasury will take as a result of the PRA’s report. Whilst we appreciate the benefits of a review mechanism, it also generates uncertainty if institutions are unclear as to whether they may have to restructure their group five years after the ring-fencing rules come into force (and every five years thereafter).

THE RING-FENCE

Introduction

As we have stated above, the implementation of the ring-fencing proposals will be a fundamental change to the structure of the UK banking sector and as a result will generate a swathe of complex and commercially sensitive issues that will be time and labour intensive to work through. In order to ensure that the process enables an orderly transition, financial institutions need to be provided with a clear and certain structure as early as possible to enable appropriate planning and execution of the transition and implementation processes.

The Draft Bill does little to resolve the large number of outstanding questions on the application of the ring-fencing proposals. By providing that the location and height of the ring fence will be determined by secondary legislation and regulation respectively, the Draft Bill fails to provide financial institutions with sufficient detail relating to the key structural elements of the proposed ring-fencing regime that would allow for substantive planning.

In addition, the Draft Bill arguably creates a degree of confusion by choosing to change the nomenclature used in the ICB report. The industry has had over a year to digest and work through the mandated, prohibited and permitted services terminology but the Draft Bill refers to these services as “core” and “excluded” activities. This makes the process of mapping the ICB recommendations with the new Draft Bill more challenging.

13. *Is the power to be able to exempt certain categories of deposit-taking firms from having to establish a ring-fenced bank appropriate, and on what basis should the conditions for exemption be set?*

Please refer to our response in the introductory paragraph above.

14. *Is the range of core and excluded activities defined in the draft Bill appropriate and sufficiently broad? Are the Government's stated intentions for using powers to define further core and excluded activities appropriate?*

Please refer to our response in the introductory paragraph above.

15. *Which categories, if any, of customer should be permitted to deposit with a non ring-fenced bank?*

As discussed in the introduction, other market participants are better placed to address the policy and economic consequences of the Draft Bill.

16. *The Government is considering whether to allow ring-fenced banks to offer simple derivatives to their customers. Should they be allowed to? If so, what safeguards would be necessary?*

As discussed in the introduction, other market participants are better placed to address the policy and economic consequences of the Draft Bill.

17. *Are the proposed corporate governance arrangements between the ring-fenced bank and the wider group sufficient to ensure the independence of the ring-fenced bank? Are these arrangements compatible with directors' duties and principles of accountability?*

There are some potential inconsistencies with the provisions of the Companies Act 2006 which will need to be resolved in order to ensure that there is certainty for the individuals taking up directorships as well as for the shareholders and creditors. We would be happy to talk through these potential inconsistencies if this would be helpful.

18. *How appropriate are the proposed restrictions on exposures and operational dependencies between the ring-fenced bank and the rest of the group? Will these result in a sufficient degree of independence and resilience?*

As currently set out, the proposals in the Draft Bill simply provide high level principles in relation to the "height" of the ring fence. It will not be possible to comment on the effectiveness or otherwise of such proposals until we have been able to scrutinise the regulatory rules to be drafted by the PRA.

19. *Will it be possible to effectively monitor and police the ring-fence, given the degree of regulatory discretion the draft Bill proposes?*

Please refer to our response in paragraph 6.6 above.

20. *How effective will the provisions on corporate governance for ring-fenced banks be in promoting a wider improvement of standards? Should other measures also be considered?*

Please refer to our response in paragraph 6.6 above.

DEPOSITOR PREFERENCE

21. *Is the proposal to prefer insured deposits in the event of a bank insolvency justified? Is there a case for broadening the scope of deposits which benefit from this protection?*

As discussed in the introduction, other market participants are better placed to address the policy and economic consequences of the Draft Bill.

CAPITAL LEVELS

We believe that other market participants are better placed to address these questions; however, we are concerned that giving the Treasury the right to intervene (pursuant to the new clause 142J FSMA) may cause potential conflicts of interest that would not necessarily arise if this power were controlled by the regulators.

RESOLVABILITY

26. *Will the UK authorities have the necessary tools and powers (as a result of this legislation and other initiatives) to be able to resolve a large failing ring-fenced or non-ring-fenced bank, while maintaining financial stability and minimising the risk to public funds?*

Given the scope and detail of the proposals that have been included, it is too early to respond meaningfully to this question given the limited scope of the Draft Bill.

27. *What is your assessment of the Government's preferred design of "bail-in" powers needed to improve bank resolution? How likely is it that the Recovery and Resolution Directive will deliver effective bail-in powers?*

We note the Government's preferred design of "bail-in" powers and would make the following general comments in relation to the bail-in framework currently being considered as part of the Recovery and Resolution Directive. Bail-in is fraught with legal complexity. Whilst it is conceptually relatively straightforward to haircut creditors by writing down debt and, if desired, converting interests into equity, the legal implications of so doing in the context of a solvent entity are very substantial. This complexity multiplies in respect of bail-in of multi-entity groups and cross border groups raise still further issues.

In order to deliver an effective bail-in tool, there are a number of issues that need to be considered and resolved. We would divide these issues into two types: first order issues to be addressed to make a bail-in framework legally workable, and second order issues dealing with consequential legal and regulatory issues that need to be addressed to ensure that the regime does not unduly disincentivise investment in (and thus damage the market for) bail-inable debt.

First order issues to consider are likely to include conflicts of law issues, cross-border recognition issues, inter-relationship with insolvency law, applicable listing and exchange requirements, and numerous company law issues. Second order legal and regulatory issues include whether bail-inable debt merits changes to the legal, accounting and regulatory framework for investors in and issuers of such debt. Plenty of analysis has been undertaken on first order issues; insufficient thought has been given to second order issues. These are equally important as they will determine the pricing and availability of bail-inable debt following implementation.

IMPACT ASSESSMENT

As discussed in the introduction, other market participants are better placed to address these questions.

INTERNATIONAL ISSUES

30. *What will be the impact of the proposals on the international competitiveness of UK banks?*

As discussed in the introduction, other market participants are better placed to address questions relating to the policy and economic consequences of the Draft Bill.

31. *Are the proposals consistent with existing and forthcoming international and EU regulatory initiatives, for example the recent Liikanen Report? To what extent are they likely to be superseded or generate conflicts?*

We believe that the Draft Bill is consistent with the recent Liikanen Report; however, that report was only published on 2 October 2012 and it is now being considered by the European Commission. It will be necessary to monitor future developments (including any legislative proposals) to identify and mitigate potential conflicts.

OTHER

32. *What other matters should the Commission take into account?*

(a) *Subsidiarisation*

Footnote 4 of the Treasury's white paper entitled *Sound banking: delivering reform* (accompanying the Draft Bill) states that a branch of a non-EEA bank that has significant deposit taking business will be required by regulators to become a subsidiary. This policy position may have a very significant impact on non-EEA banks operating through UK branches. More detail is required in order to provide clarity on what is meant by "significant" as well as when and how this will be mandated.

(b) *Part VII of FSMA 2000*

We are considering whether the proposed variation of FSMA Part VII is in practice likely to be the most appropriate tool for the transfer of assets and liabilities with ring-fencing in mind. Our primary concern is the level of uncertainty introduced for all stakeholders by a procedure that provides a forum for counterparties to object and ultimately gives discretion to the court. We have considered some of the areas of potential weakness in more detail below and where appropriate suggested possible solutions or areas that could be improved:

- (i) Scope: the current scope of part VII does not extend to businesses or assets held by any subsidiaries of a UK authorised person who has permission to carry on one or more core activities. For example, this could preclude the separation and transfer of funding programmes within a subsidiary. In order to overcome this hurdle, the amendments to section 106 FSMA could ensure that the scope of the provisions is extended to allow the movement of businesses and assets that sit within subsidiaries of ring-fenced banks;
- (ii) Part VII requires the court to balance the interests of the different classes of persons affected by the transfer prior to sanctioning the scheme—this approach relies on case law and introduces an element

of discretion and therefore uncertainty. An example of this is in relation to the court's ancillary powers. There is no guarantee as to how the court will use these powers to deal with issues such as overriding change of control consents or termination clauses. Part VII could be modified by introducing statutory objectives that the court needs to consider when deciding whether or not to approve the transfer—this would remove the inherent uncertainty that would be detrimental to the ring-fencing procedure;

- (iii) as alluded to above, another area of uncertainty relates to the ability of counterparties to object to the scheme on the day of the second court hearing to sanction the transfer. To reduce this uncertainty, Part VII could be amended to ensure that any objections are submitted in writing prior to the second court hearing. Whilst it may not be possible to predict all objections, this would go some way to ensuring that objections raised on the day are only heard in exceptional circumstances; and
- (iv) Part VII is unlikely to be recognised in foreign jurisdictions—as a result, non-EEA deposits within the branches of UK banks are likely to require another mechanism.

We will taking part in a working group organised by the BBA to review the proposed business transfer provisions in light of their expected use and consider whether there is a need for further amendment to FSMA Part VII or bespoke enabling legislation or equivalent (for example, additional transfer powers and creditor safeguards that provide greater certainty for all stakeholders). We will be happy to share our thoughts in this regard.

31 October 2012

Written evidence from the Association of British Insurers

THE UK INSURANCE INDUSTRY

The UK insurance industry is the third largest in the world and the largest in Europe. It is a vital part of the UK economy, managing investments amounting to 26% of the UK's total net worth and contributing £10.4 billion in taxes to the Government. Employing over 290,000 people in the UK alone, the insurance industry is also one of this country's major exporters, with 28% of its net premium income coming from overseas business.

Insurance helps individuals and businesses protect themselves against the everyday risks they face, enabling people to own homes, travel overseas, provide for a financially secure future and run businesses. Insurance underpins a healthy and prosperous society, enabling businesses and individuals to thrive, safe in the knowledge that problems can be handled and risks carefully managed. Every day, our members pay out £147 million in benefits to pensioners and long-term savers as well as £60 million in general insurance claims.

THE ABI

The ABI is the voice of insurance, representing the general insurance, protection, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has over 300 members, accounting for some 90% of premiums in the UK.

The ABI's role is to:

- Be the voice of the UK insurance industry, leading debate and speaking up for insurers.
- Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation.
- Advocate high standards of customer service within the industry and provide useful information to the public about insurance.
- Promote the benefits of insurance to the government, regulators, policy makers and the public.

MAIN COMMENTS

1. The reform of the banking model is an important process that needs to be completed and we are grateful for the opportunity to comment on the Bill. We fully support the intention of the Government that the banking sector should not be subsidised by taxpayers and that banks must be resilient and resolvable. Structural reform has an important part to play in achieving this and in making UK banking sector efficient, competitive and stable. It is important that banks should be able to return to operating efficiently in their central role of providing finance to business and retail customers to support growth through the channelling of savings and the productive use of their capital resources. It is essential that the legislative proposals are specified in a manner that ensures the greatest chance of achieving these economic objectives.

2. Making banks an investable proposition is an inescapable part of this process. It is also necessary in order to provide an exit route for the Government, on behalf of the UK taxpayer, to achieve a sale of its banking sector shareholdings. It is of particular significance to our members as major investors historically and prospectively in UK banks. We are preparing a report on the investability of UK banks for completion by the end of November and we outline the progress to date on this in the document which follows. Our preliminary conclusions and observations on these financial aspects of investability are:

-
- Asset value uncertainty, Eurozone risks and mis-selling investigation are all weighing on investor confidence, reflected in very low share price: tangible net asset values. However, regulatory “opacity” also remains a significant investment risk for investors.
 - A robust banking ROE is beneficial for the wider economy and not just equity shareholders. A robust ROE boosts internal capital generation, which in turn supports additional loan capacity, augments core tier 1 capital, i.e. loss absorbing capacity, and creates dividend distribution capacity. Banks are inherently more highly geared, with greater earnings cyclicality, compared with corporate non-financial companies. It therefore follows that investors should be compensated for the increased risk in the investment and a bank’s Cost of Equity will reflect this.
 - By contrast, failure to achieve at least cost of capital across the cycle is likely to lead to banks’ businesses being unsustainable in the longer term and will inevitably constrain asset growth and lending to the wider economy.
 - Dividends remain a key signal of management confidence and will be interpreted as an indicator of regulatory rehabilitation. Banks’ management across the entire sector need to articulate a dividend policy to investors with the confidence and backing of regulators.
 - The Basel 2-IRB approach to risk-weighting has become too complex and susceptible to individual bank interpretation, which distorts any inter-bank comparison by investors. A return to a simpler risk based measurement system, or improved disclosure of the “bridge” from gross assets to RWA, should be considered.
 - Universal banking is not viewed by most investors as an inherently broken model. Whilst accepting that it will happen, investors so far are unconvinced about the real benefits of ring-fencing and/or separation and are sceptical about the benefits relative to the operational costs and disruption.
 - Isolation of higher risk trading books may be better achieved via a Liikanen/Volcker approach rather than an ICB approach. Higher risk trading books are already being unwound in response to Basel-3 and ahead of any ring-fencing legislation.
 - Ease of resolution may be better achieved by marginally higher core tier 1 ratios determined by portfolio mix.
 - The risk-return of additional loss absorbency or bail-in capital is confusing the market and requires clarification.
 - For debt investors:
 - there has been a significant move towards secured funding rather than unsecured;
 - the longer-term implications of this for the costs of unsecured debt funding and the effectiveness of bail-in remain unclear.
 - There are some concerns that a requirement to maintain a certain level of bail-inable debt (effectively “Tier 3 capital”) could cause difficulties if the average tenor is, say, five years and so an amount needs to be “rolled over” each year. A failure to roll over, or roll over on unattractive terms, could itself undermine confidence in the bank.
 - In the absence of significant incremental demand for bank equity, instruments such as Cocos, which offer “near-equity” returns on a fixed income basis, are attractive to a number of investors. However, differentiation in terms of cost—and so maintaining a viable capital structure, mean that tax deductibility is viewed as essential. In addition, Cocos do not account as Core Tier 1 and “gear” the equity further and so may have longer-term negative effect on the ability of a bank to achieve a sustainable ROE and so, in turn, on equity demand.

OBSERVATIONS ON OTHER ASPECTS OF THE PROPOSALS

Delegated powers and accountability and the ring-fence

3. The key theme to whole reform package, as initially developed by the Independent Commission on Banking under Sir John Vickers, is ring-fencing. Of particular significance are the parties that ring-fenced banks can have commercial relationships with and the governance structures that are necessary to safeguard independence while allowing overall group structures and accountabilities to operate effectively. It is essential that the design parameters be got right. However, given that many details are still to be properly nailed down and international environment continues to evolve, this imposes significant challenges as regards legislation at this early stage.

4. We are not comfortable with the “enabling” nature of the legislation, nor with the extent of the response by Government to the consultation on the White Paper where conclusions have not been reached on key matters of importance. We think a clear commitment to further consultation on the elements of any eventual secondary legislation is required.

5. Considerable reliance is still proposed to be made on the nature of counterparties with which a ring-fenced bank may contract as opposed to the nature of the activities it may engage in. The White Paper proposed substantial restrictions on insurance companies and on investment firms, funds and fund management companies and non ring-fenced banks. HM Treasury’s “Sound Banking” paper outlined the objections of many

respondents to this view, including that transactions with insurance companies should not be prohibited since they are unlikely to transmit financial shocks to the ring-fenced bank. It is disappointing that the Government has as yet been unable to reach a view on this but is proceeding with legislation that would enable them to enforce such a prohibition.

6. We consider that the ability of banks to sell insurance—or indeed to take out insurance themselves—is fundamentally necessary for the banks to conduct their business. It is the nature of the transaction that is relevant. If it does not create prudential [balance sheet/market] risk, or indeed is a transaction designed to hedge business risks, then it should be entirely reasonable to permit, indeed facilitate, such exposures. It is necessary for this principle then to be defined in a manner suitable for its application within the regulatory framework. This, together with financial conduct aspects of the sale of investment products, should be matters for regulatory supervision of the bank concerned. Restrictions here would actually reduce the resilience of the banking system by preventing them from passing on risks that insurers are better placed to carry.

7. We believe that these are all matters which should be resolved during the passage of the Bill and the principles by which future restrictions may be imposed carefully defined.

Governance of ring-fenced entities

8. The broad design of governance arrangements as proposed in the White Paper we think is workable. However, a key unresolved question is the extent to which the board of ring-fenced entities may be composed of independent non-executive directors at group level who are treated as holding an analogous status at the level of the ring-fenced subsidiary. If they may be so treated it is right that a majority of the board should be independent though we consider that the board might still need to include at least some individuals who are wholly independent by virtue of having no relationship to the group and who should provide an independent safeguard of the interests of those with whom the ring-fenced bank has a business relationship.

9. We think that model would be operational, and balanced and reasonable, for a relatively broad specification of the ring-fence. Accordingly, we support the suggestion in the White Paper that firms whose business is predominantly conducted from within the ring-fenced entity should have exemptions from the more rigorous specification of independent governance. It is important that directors of each board within the group, whether at holding company or subsidiary level, are able to take unfettered decisions on what is in the best interest of the company concerned, bearing in mind its regulated status. It is also important that the holding company, as owner of its subsidiary companies is able to exercise its rights as shareholder, including to elect the directors. Good governance and public policy objectives may well justify some constraints around how such powers are exercisable, for example to provide for a nominations committee but this should not extend to appointing a majority of non-Group directors to the board concerned. It must be understood that the UK Corporate Governance Code does not provide that a majority of a listed company board should be independent of shareholders but of management.

10. We would expect these listed company standards regarding board structure to be replicated in a subsidiary that is the primary or “ring-fenced” entity, if this is different from the holding company. The arrangements within any non ring-fenced entity undertaking investment, wholesale or higher-risk activities should depend on its circumstances, including the extent to which employees and others are responsible for providing the subsidiary’s capital backing.

11. We are less convinced that the rigorously specified model allied to a tightly drawn ring-fence, will result in constructive relationships between the different group entities that remain under common ownership if such subsidiaries are required to have a majority of directors who are not members of the group board or executives within the group. We do not think this is obviously incompatible with directors’ duties but it does not accord with what we consider the proper lines of accountability i.e. ultimately to shareholders, nor does it sit well with the effective management of the business. It is not clear how such directors would be appointed nor how they would be accountable. We consider that such accountability needs to be to shareholders which, given the importance of safeguarding their independence, might most appropriately be defined as the shareholders of the parent entity which for the most significant groups will be a “UK-listed” company. This could be achieved by making such directors subject to election by those shareholders.

12. We emphasise that design of the ring-fence, and the implications for good governance of the entities that issue debt and equity securities in which our Members invest will have an important bearing on the overall investability of the banking sector which we address in the document which follows.

INVESTABILITY OF UK BANKS—PRELIMINARY REPORT TO THE PARLIAMENTARY COMMISSION ON BANKING STANDARDS

Background and summary

The Association of British Insurers (ABI) is preparing a report on the investability of UK banks for completion by the end of November. The purpose of the report is to incorporate UK investors’ views in the continuing debate on UK banks’ capital structure, funding, liquidity and balance sheet risk weighting. We will aim to submit an interim draft of our report to the Parliamentary Commission on Banking Standards (PCBS)

by mid-November. Discussions so far, whilst at an early stage, have included major UK and international long only funds, UK banks at the CFO and Chairman level and UKFI.

So far, the public debate on banks' capitalisation has reflected the views of regulators, politicians and policy makers, e.g. The Independent Commission on Banking (ICB), but not the providers of the capital—the investors. If more capital is indeed required in the UK banking system, as recently suggested by the Financial Policy Committee (FPC committee meeting 14 September 2012), then investors need to understand first, why this is the case and, secondly, what is the likely return on the capital invested and associated risks. We hope the ABI final report will go some way to representing investors' questions and concerns and welcome the opportunity to contribute to the PCBS's review of the banking bill. This report is based on meetings so far and has been prepared at an early stage in the process: our conclusions and views are therefore necessarily preliminary.

In this document, we set out the areas for attention and discussion with investors and banks and we have linked the points, where appropriate, with the questions raised in the PCBS's call for written evidence. It is not our intention to represent banks' management; however, management input is vital to understand the issues associated with the implementation of current regulatory proposals. Banks' management teams are naturally fully engaged with regulators and, within reason, will create a banking model that regulators require. The question is whether equity and debt investors are willing to invest in the new model.

Our preliminary conclusions and observations so far are:

- Asset value uncertainty, Eurozone risks and mis-selling investigation are all weighing on investor confidence, reflected in very low share price: tangible net asset values. However, regulatory "opacity" also remains a significant investment risk for investors.
- A robust banking ROE is beneficial for the wider economy and not just equity shareholders. A robust ROE boosts internal capital generation, which in turn supports additional loan capacity, augments core tier 1 capital, i.e. loss absorbing capacity, and creates dividend distribution capacity. Banks are inherently more highly geared, with greater earnings cyclicity, compared with corporate non-financial companies. It therefore follows that investors should be compensated for the increased risk in the investment and a bank's Cost of Equity will reflect this.
- By contrast, failure to achieve at least cost of capital across the cycle is likely to lead to banks' businesses being unsustainable in the longer term and will inevitably constrain asset growth and lending to the wider economy.
- Dividends remain a key signal of management confidence and will be interpreted as an indicator of regulatory rehabilitation. Banks' management across the entire sector need to articulate a dividend policy to investors with the confidence and backing of regulators.
- The Basel 2-IRB approach to risk-weighting has become too complex and susceptible to individual bank interpretation, which distorts any inter-bank comparison by investors. A return to a simpler risk based measurement system, or improved disclosure of the "bridge" from gross assets to RWA, should be considered.
- Universal banking is not viewed by most investors as an inherently broken model. Whilst accepting that it will happen, investors so far are unconvinced about the real benefits of ring-fencing and/or separation and are sceptical about the benefits relative to the operational costs and disruption.
- Isolation of higher risk trading books may be better achieved via a Liikanen/Volcker approach rather than an ICB approach. Higher risk trading books are already being unwound in response to Basel-3 and ahead of any ring-fencing legislation.
- Ease of resolution may be better achieved by marginally higher core tier 1 ratios determined by portfolio mix.
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- In the absence of significant incremental demand for bank equity, instruments such as Cocos, which offer "near-equity" returns on a fixed income basis, are attractive to a number of investors. However, differentiation in terms of cost—and so maintaining a viable capital structure, mean that tax deductibility is viewed as essential. In addition, Cocos do not account as Core Tier 1 and "gear" the equity further and so may have longer-term negative effect on the ability of a bank to achieve a sustainable ROE and so, in turn, on equity demand.

We welcome the opportunity to submit these early comments to the PCBS. The ABI will submit an interim document to the PCBS mid-November, aiming for completion of the final report by the end of November.

WHAT EQUITY INVESTORS REQUIRE TO GAIN CONFIDENCE IN UK BANKS

We set out below, based on early discussions, the recurring themes raised by investors so far and the areas to be explored in more detail during the coming weeks.

There is no doubt that equity investors want a secure and properly capitalised banking system and are supportive of regulatory reform. However, investors also require, above all:

- Confidence in both the future operating and regulatory environment. A subdued macro-economic outlook and anxieties regarding the Eurozone have undoubtedly impacted investor confidence. However, it is clear, that at present investor confidence continues to be affected not only by a number of operational matters and legacy issues, but also by apparent indecision around capital levels, capital structure and structural change, e.g. ring-fencing; and, in turn,
- Confidence in the future ability of the sector to achieve sustainable returns above the cost of equity and to re-establish dividend payments across the whole sector.
- Investors require certainty in the regulatory outlook, but also consistency in regulation with other jurisdictions, (*Relates to Q.30 & 31 in the PCBS document*). They are concerned by, for example, the contrasting treatment of life company capital under CRD IV by the FSA compared with some EU member states regulators. The evolving global nature of capital markets heightens the need for a level international regulatory playing field. Approximately 40% of the UK stock market is owned by overseas institutions. Since 2009, the value of ABI members' overseas equity investments has exceeded the value of domestic investments.

THE ABILITY TO FORECAST SUSTAINABLE POST TAX RETURN ON EQUITY (ROE)

(*Relates to Q.32 in the PCBS document*)

Importance of ROE

Investors need a framework in which they can assess the potential post-tax ROE of the banks at both any given point in time and through the cycle. Basic financial economics dictates that, if ROE remains structurally below cost of equity, the equity of banks will remain essentially uninvestable. We acknowledge that ROE, in isolation, without considering risk adjusted returns and leverage can be mis-leading. However, equity investors ultimately value a bank by reference to the sustainable earnings power of its tangible net assets and that must start with ROE.

It is the responsibility of the banks' boards and management, on behalf of investors, to invest only in business where ROE exceeds cost of equity, ensuring cost of equity for the whole group is exceeded. If a bank continues to generate a low ROE, future asset growth will be naturally constrained, unless the bank can gear up on its core tier 1 by issuing additional tier 1 debt. This, of itself, is unlikely to be sustainable in the longer term.

A robust, sustainable post-tax ROE means a bank will internally generate sufficient capital to support future asset growth, whilst bolstering capital ratios, i.e. loss absorbing capacity, and enabling it to distribute a dividend. The apparent regulatory conflict between resilience and recovery is then effectively removed, as a robust ROE enables both of these objectives to be achieved, under the control of a bank's management team. In this respect, a robust sector ROE will have a significant beneficial effect on the broader economy, through enhanced direct lending and income distribution to pension funds and other investors, whilst improving capital ratios and loss absorbing capacity, counter-cyclically. If a bank can consistently deliver an ROE above cost of equity, equity investors will be more prepared to invest and recapitalise the bank if and when required. A strong ROE across the sector is also required to attract new entrants to the UK banking sector.

Whilst underlining the importance of ROE, we recognise the difficulties and risks in calculating it, and of the behavioural risks of capital allocation decisions in a bank run solely or primarily on the basis of ROE:

- The ROE numerator will contain some profit or loss from trading activities, part of which will be struck on a "mark-to-model" basis. The financial crisis highlighted the limitations of many of these models. Investors are mindful of this, and would need to assess the extent to which profitability is being driven by trading revenues and the basis on which those revenues are being accounted for.
- Accounting convention dictates that potential future losses on larger ticket loans cannot be recognised as a provision in current reporting. Therefore assets may, to some extent, be overstated at the point of "fair valuation" in any period's accounts. Investors need to consider "through-the-cycle" provisions when analysing a bank's profitability. Under UK GAAP, general provisions went some way to addressing this issue, enabling a management team to strike provisions based on their own assumptions around economic cycles, interest rates and unemployment.

- ROE is the product of return on assets (ROA) and leverage. The consequences of driving up profitability, by driving up leverage, remains all too fresh in investors' minds from the financial crisis, particularly leverage based on high levels of securitisation. Investors recognise the need to focus on the fundamental drivers of a bank's ROA, i.e. net interest margins (asset yields and blended funding costs), efficiency ratios, the credit cycle and capital structure, whilst also looking at assets on a risk adjusted basis.
- An attempt to "maximise" ROE, particularly in the short-term, can create excessive risk taking, under-investment, or short term uncompetitive pricing. If a bank appears to be generating an ROE that appears out of "synch" with the banking cycle or with its peer group, investors will need to understand why.

We believe these risks are recognised by both banks' management and investors, with management teams attempting to focus on medium term sustainable ROE targets, although lack of clarity on capital levels makes this particularly challenging.

We recognise that public perception of the banking industry is such that the very notion of a bank making a profit may, for many, be quite abhorrent. We would therefore stress that:

- a profitable banking system can self-fund loan growth, increase resilience through internally generating loss-absorbing capacity and pay dividends to shareholders. A healthy banking system, with sustainable profitability, is beneficial to the broader economy;
- arguably, shareholder value (one measure of which is the profitability generated above cost of equity) can only be based on successfully creating customer value, i.e. the combination of attractive products, competitively priced, backed up with superior service. Under-investing or over-pricing is unlikely to deliver *sustainable* growth and profitability.

Assessment of sustainable ROE

ROE is, as stated above, the product of (i) return on assets and (ii) leverage. Certainty around acceptable regulatory leverage levels, whether a simple assets : equity ratio or risk weighted, will determine appropriate capital levels and is therefore a vital first step in determining a sustainable ROE.

Ring-fencing or separation, once complete, should enable investors to assess risk and return both within and outside the ring-fence. For banks' investability to improve, a number of questions need to be addressed:

Retail Banking

Profitability is a function of (i) product mix, including the secured nature of mortgage lending versus the unsecured nature of credit card lending (ii) efficiency ratios, and (iii) charges and provisions relating to prior year practices, e.g. PPI claims, interest rate swap mis-selling.

At the 2012 half year stage, Barclays, for example, reported a UK Retail & Business Bank ROE (which excludes credit cards) of 16.6%, before PPI mis-selling claims, or 9.9% after accounting for the claim. Similarly, we estimate Lloyds Banking Group's H1 2012 annualised core Retail Banking ROE was 23% (including credit cards), or 14% after adjusting for the H1 £1,075 million PPI mis-selling charge (not annualised).

Whilst it is appropriate for prior mis-selling processes to be addressed, investors are mindful of (i) the profound impact mis-selling charges may have on the prospective profitability (and capital levels) of Retail Banking businesses, with, for example, interest only mortgages and bundled current account charges now likely to come under investigation (ii) the longer-term risk that strong headline ROE's may be capped through further regulatory scrutiny in the form of, for example, price controls.

Strong profitability is not, in our view, a function of low competition. At the time of writing, MoneySupermarket.com listed more than 25 current account offerings (excluding multiple accounts from one provider). We would support the ICB's recommendations to ensure that current account switching mechanisms are made as simple and streamlined as possible. However, banks stress that detailed knowledge of customer transactions and financial behaviour, built up over a long period of time, makes for a more effective banking relationship. (*Relates to Q.8 in the PCBS document*)

<http://www.moneysupermarket.com/currentaccounts/CurrentAccountsResults.asp>

Investment Banking

Profitability will vary significantly according to business mix and the broader macro-economic cycle. As Basel-3/CRD-IV is implemented, we would expect ROEs to come under further pressure with management seeking to exit higher capital intensity businesses and develop lower capital intensity (fee based) businesses. UBS's announcement (30 October 2012) on reshaping its investment banking business, may provide a useful template of how restructuring could happen. Investors will want assurance that ring-fencing will not require "fast-forwarding" of Basel-3, with businesses outside the ring-fence immediately funded and capitalised on a standalone basis.

Cost of Equity

Cost of equity will in turn be influenced by (i) capital levels (ii) earnings volatility (ii) business mix. Levels of core tier 1 capital and degree of separation or ring-fencing are therefore pivotal in assessing cost of equity. Discussions so far would suggest that cost of equity for a Retail Banking business is in the range of 8–10%, with Investment Banking around 15%. Thus a blended Universal Banking cost of equity might initially be in the 11–12% range.

Deleveraging of Investment Banking and restructuring into less capital intensive activities, should, in theory, reduce the blended cost of equity for a universal bank, as should an increase in core tier 1 capital. However, a bank's leverage and inherent earnings volatility will continue to be reflected in a relatively high beta creating a structural limitation to any reduction in cost of equity.

We will therefore be examining, in more detail, in the interim and final reports, the likely ranges of cost of equity for UK banks.

CONFIDENCE IN THE REGULATORY ENVIRONMENT AND THAT BANKS HOLD SUFFICIENT CORE TIER I CAPITAL

(Relates to Q.22-Q.25 of the PCBS document)

Economic environment and legacy issues

Andrew Bailey (Managing Director, Prudential Business Unit, FSA and Executive Director, Bank of England) suggested in a recent speech (BBA Annual Banking Conference) that UK banks' low price: tangible net asset values were indicative of investor concerns regarding banks' capital ratios, with capital levels likely to be impacted by (i) further asset write-downs, exacerbated by the current accounting regulations which do not allow recognition of future loans losses (ii) tail risks, e.g. a disorderly Eurozone break-up, (iii) higher funding costs with limited asset re-pricing potential (iv) structural uncertainty and costs e.g. ring-fencing.

It is clear that UK banks' valuations are also weighed down by a range of legacy issues, including: PPI mis-selling provisions, Ireland real estate exposure, UK commercial real estate exposure, potential LIBOR litigation, interest swap mis-selling and, now, the prospect of investigations into interest-only mortgages and "bundled" current account charges. Whilst these factors, by their very nature, are difficult to forecast, the equity market tends to stress-test net tangible asset values by deducting a likely "worst case" net provision, i.e. treating it as a "one-timer" and so applying a P/E of 1x.

UK banks' share prices have enjoyed a recent rerating, effectively following the tightening of five-year credit default swap (CDS) spreads, in turn reflecting improved confidence in Eurozone resolution. Relaxation in liquidity requirements has also recently helped UK banks' share prices. Five year CDS spreads have tightened by around 20% over three months for the domestic banks (Barclays, Lloyds Banking Group and RBS Group), with their respective share prices increasing by some 30–40%. HSBC and Standard Chartered CDS spreads have tightened by around 9% during the same period, with more muted share price movements.

Notwithstanding the recent domestic bank share price rally, Barclays, Lloyds Banking Group and RBS Group are still only trading on price to forecast 2012 tangible net asset values of around 0.6x, with HSBC and Standard Chartered trading on 1.36x and 1.70x respectively. Following this rally, we note a more cautious tone to recent sell-side broker reports, with some trimming of recommendations, reflecting essentially continued regulatory uncertainty, as discussed further below.

Regulatory uncertainty

Based on our investor meetings so far, regulatory uncertainty and inconsistency are a significant investor concern. Lack of clarity regarding capital levels, and the apparent conflict between resilience and recovery, are muddying the investment case for UK banks, limiting a further rerating of share prices relative to earnings and tangible net asset values. Particular concerns arise in a number of areas:

- Investors so far are broadly of the view that resilience and competition are to some extent mutually exclusive, as increased regulation will inevitably raise barriers to entry for potential smaller entrants.
- One investor has also suggested that regulation, or regulatory intervention, may well be a deterrent for potential hires into senior positions at UK banks.
- Investors need to understand if the change of emphasis from core tier 1 ratio to absolute levels of capital is permanent or part of a more temporary mechanism to facilitate asset growth.
- Investors are seeking a deeper understanding of the ICB's 10% core tier 1 guidance. In fact, some investors believe the stock market, rather than regulators' prudential risk analysis, may have led the debate to the conclusion that 10% was the "right" core tier 1 ratio, taking into account a counter-cyclical buffer or G-SIFI/SIFI layer above the Basel-3 minimum 7%.

- Banks must be correctly capitalised but not over-capitalised. Downward pressure on ROE (through expansion of the denominator) can even—paradoxically—increase risk as management teams may be tempted into investing in higher return (and therefore higher risk) activities in order to meet cost of equity. Excess capital and low ROEs are also likely to result in upward asset re-pricing, with the customer picking up part of the cost for increased regulation. This trend is already apparent in mortgage pricing where spreads above the five-year GBP swap rate have widened by around 200 basis points since the end of 2010.
- It is accepted by investors that the price of increased capital and regulation will reduce ROEs. However, investors need to be equipped with the information to assess the likely scale of ROE contraction. Only then can investors assess what can be done to mitigate the ROE impact through cost reduction and/or asset re-pricing. Conversations with banks' management so far indicate that successful operating costs' reduction will be key and perhaps the primary differentiator among banks in the near-term, where the revenue outlook remains subdued.
- Investors are also seeking a better understanding of Pillar II capital and its allocation across banks' business sectors. Pillar II is where supervisory judgement is applied to overlay the capital applied to risk assets under Pillar I. As Andrew Bailey highlighted in his BBA speech, Pillar II capital has increased from just under £20 billion to £150 billion, of which £100 billion is held across the sector in "Capital Planning Buffers".
- Clarification is also needed on whether ratios will be viewed by regulators under transitional rules or on a "fully-loaded" basis.

CONFIDENCE IN MEASURING AND COMPARING ASSET RISK

At the recent Prudential Regulation Authority (PRA) launch conference (22 October), David Rule (Director, International Banks Division, Prudential Business Unit, FSA) emphasised, during Q&A, that the PRA's prime objective was to ensure banks are adequately capitalised and will use a combination of Basel-standardised, Basel-IRB, simple leverage and banks' internal models to assess risk and capital requirements. From a regulatory perspective, this is a pragmatic approach. However, it is likely to increase rather than reduce opacity for investors in understanding and comparing capital requirements across the sector.

Investors require consistency across the sector in calibrating risk weightings on banks' asset portfolios and therefore in estimating capital requirements. It is already apparent from investor meetings that confidence in Basel-2 Internal Ratings Basis (IRB) as a basis for making these comparisons is low. Cross-sector risk comparisons are therefore distorted and international comparisons become extremely challenging.

Investors seek greater clarity in the linkage between gross (un-risked assets) and risk weighted assets, which would highlight the extent to which banks are basing risk-weights on alternative assumptions.

A CLEAR UNDERSTANDING OF LOSS ABSORBING CAPACITY IN ADDITION TO EQUITY

(Relates to Q.22 to Q.25 in the PCBS document)

Investors need to understand the risk/return (yield/coupon) for each layer of the capital structure and have a clear understanding of what constitutes Primary Loss Absorbing Capacity (PLAC) as covered in the ICB submission. Equity investors need full visibility on the cost of each type of debt instrument, as this will have a significant impact ultimately on ROE. Debt investors have less immediate interest in CoE/RoE, but ultimately need the comfort of knowing the bank is capable of achieving an ROE greater than its cost of equity: if a bank is generating insufficient equity internally, it will only be able to fulfil growth plans through the fixed income/convertibles market via issuance of non-equity tier 1 capital.

Early conversations on the subject of PLAC, bail-in capital and contingent convertibles are raising more questions than answers.

Unsecured debt/bail-in

Discussions so far suggest that introducing a separate bail-in layer may serve only to confuse, particularly as it is widely believed that, at the point of resolution, all unsecured funding will be effectively be "bail-inable."

Clarification is required in the areas of:

- bail-in by contract or statute;
- grandfathering of existing and soon to be issued debt instruments;
- destination of new funding, i.e. within or outside the ring-fence, and in particular would banks need to be raising debt capital under two separate names in the market, with separate contracts, separate pricing structures and separate credit ratings. It remains to be determined what the supply of bail-in bonds outside the ring-fence really would be, and whether there would be a market for parallel bail-in bonds under two different issuing names;
- definition of point of non-viability (PONV).

Investors are keen to understand regulators' views on secured (securitisation, covered bonds) versus unsecured funding and in particular how much asset encumbrance regulators will tolerate. The European debt market is moving further towards covered bonds. At the end of September, covered bonds accounted for around half the Euro-denominated investment grade financial supply, broadly in line with 2011, but above the trend rate seen in earlier years. As the secured layers of funding increase within the debt capital structure, then the unsecured, potentially bail-inable, debt layers would be subject to greater loss absorption at the point of resolution. This will have implications both for the cost of unsecured debt and, potentially, the effectiveness of bail-in.

The notion that an unsecured bond purchased by a pension fund is bail-inable is a highly sensitive issue as indeed is the notion of bailing-in guaranteed deposits. Arguably, the effect would be that banks' losses would be effectively "pre-funded" by pension schemes and the FSCS.

One potential unforeseen consequence of bail-in capital stems from its shorter tenor and the requirement for frequent roll-over and refinancing. A deterioration in market conditions could impact a bank's ability to refinance effectively, which would potentially reduce the availability of bail-in capital during refinancing periods and reduce a bank's loss-absorbing layers. This in turn could undermine confidence in the bank.

Cocos

Whilst contingent convertible bonds ("Cocos") may offer (in a market where ordinary equity is difficult/impossible to raise) attractive yields (currently c.9%, and historically, significantly higher) to investors and, assuming tax deductibility, represent reasonable terms to issuers, our meetings so far have highlighted a number of concerns:

- The "death-spiral" arguments around Cocos are now well rehearsed—as core tier 1 approaches the trigger ratio, equity holders fearing dilution through conversion will sell, share prices will fall, in turn creating concern among depositors and money market funds who will withdraw funds i.e. potentially a "run" on the bank. The key is therefore to set the coupon at a level which compensates bond investors for the risk at a core tier 1 trigger level which is unlikely to be breached in the normal course of events, but at a rate which is not seen as punitive for equity investors.
- A potential risk for Cocos is the extent to which a core tier 1 trigger level could be breached through regulatory action, e.g. further mis-selling charges or provisions.
- Logically, if a "Coco" coupon is, for example, 9%, cost of equity cannot be less than 9% and it may be materially higher.
- Coco's are ineligible for core tier 1 (until converted) and therefore do not increase loss absorption until point of conversion.

At present, therefore, Cocos are attractive to a number of investors as they offer near equity returns on a fixed income basis at a time when the equity of banks is difficult/impossible to value in a period when interest rates are likely to stay lower for longer. However, to maintain a longer-term viable capital structure:

- it is important that the required yield on Cocos is materially less than the cost of equity. Investors see tax deductibility of the coupon as a critical factor here;
- care should be taken in the extent of use of Cocos as they do not count as core tier 1 and, of themselves, further gear the equity. Regulatory persistence on the issue of increased loss absorbing capacity, in conjunction with difficulties/an inability to raise pure equity, may result in the forced issuance of Cocos—and so in turn make the market for bank equity more difficult for longer.

Depositor preference (relates to Q.21 in the PCBS document)

Investors are seeking clarity on the depositor preference mechanism and, in particular, whether this would really create additional "market discipline" (as suggested in the ICB final submission) on investors subordinated to depositors.

Index eligibility

Investors have raised questions on the issues of bond-index eligibility and rating agency treatment of loss absorbing debt layers. We sense some resistance to inclusion of an instrument that is difficult to price.

Summary

In summary, investors need visibility on the risk-return characteristics of each layer of the capital structure. The degree to which capital instruments are "bail-inable" is clouding that judgement and may well drive debt investors further to secured funding.

To the best of our knowledge, investor demand for bail-in debt has not been assessed and we are concerned that the risk-return characteristics of bail-in versus the secured debt market may not be sufficiently compelling to provide substantial amounts of bail-in debt. A possible unforeseen consequence of bail-in may be that only the larger (SIFI and G-SIFI status) banks will be seen as sufficiently robust to issue investible bail-in debt.

CLARITY ON LEGISLATION FOR RING-FENCING AND/OR FULL SEPARATION*(relates to Q.13 to Q.20 in the PCBS document)*

Most investors so far are broadly of the view that the universal banking model was not the root cause of the financial crisis. Moreover, many banks that failed during the crisis were “narrow” banks and indeed would be inside the ring-fence rather than outside. This would be true in the UK of all of Northern Rock, Bradford & Bingley and Alliance & Leicester and, arguably, most of HBOS. Within the UK, banking cycles have been closely correlated to real estate valuations and “bubbles” rather than to investment banking cycles or structural limitations or weaknesses within universal banks.

Investors nonetheless recognise the potential pitfalls of universal banking, in particular, the risk of “cultural clash” between the investment bank and the retail/commercial bank and the potential for investment banking activities to be funded with retail/commercial deposits. However, the management of risk, which encompasses maturity transformation, managing liquidity, interest rate risk and credit risk is at the heart of a universal banking model. The role of a bank’s Asset & Liability Management Team is to fund a bank’s lending and investment activities, using a variety of funding, recognising the risk/return on each of those activities. *(relates to Q.7 in the PCBS document)*

We will be addressing the question of what is the underlying purpose of ring-fencing or separation. Is it to facilitate resolvability in the event of a repeat crisis or to protect the provision of Retail/SME banking services? If it is to protect the provision of Retail/SME services, from what is it being protected? A volatile, capital-hungry non-client facing business, consistently earning sub-cost of equity returns has no place in a bank, whether inside or outside the ring-fence.

Some investors have suggested, for example, that:

- Resolvability might be better addressed through increased capital requirements, rather than the cost and customer disruption associated with ring-fencing.
- Protection of vital Retail/SME services may be better achieved through isolation (Liikanen) or suppression (Volcker) of proprietary trading. *(Relates to Q.26 and 31 in the PCBS document)*

In assessing this, other factors need to be addressed, including:

- the distinction between proprietary trading and market-making or client facilitation;
- the location of derivatives to facilitate customer hedging contracts in or outside the ring-fence;
- the location of Treasury and Balance Sheet Management teams to manage the deployment of liquidity and retail deposits;
- the distinction between prudent bank balance sheet management and proprietary trading, i.e. would creating a short position in Eurozone sovereign debt, in order to reduce a bank’s net long position in its primary liquidity pool, in the face of a Eurozone crisis, be regarded as proprietary trading or prudent management?

Most investors so far have been sceptical on the cost-benefits of ring-fencing and have shown little appetite for full separation. Whilst both investors and the banks appear to accept that some degree of ring-fencing is inevitable, the costs and operational complexity plus disruption to clients and employees should not be underestimated. In this respect, if isolation of trading activity is the heart of the issue, the cost benefits of a Liikanen/Volcker approach may be more appealing, possibly augmented by additional core tier 1 capital to reflect portfolio mix.

The Bank for International Settlements (BIS—“An assessment of the long-term economic impact of stronger capital and liquidity requirements”, August 2010) illustrated that an increase in tangible common equity (TCE) to risk weighted assets (RWA) from 6% to 10% would reduce the probability of a systemic banking crisis from 4.8% to 1.2%, assuming banks could meet their net stable funding ratio requirements. An increase from 10% to 11% in the TCE/RWA ratio would still reduce the probability of a systemic banking crisis from 1.2% to 0.9%.

CONFIDENCE REGARDING FUTURE DIVIDEND PAYMENTS

There is broad agreement, so far, that the UKFI’s successful placing of its stakes in Lloyds Banking Group and RBS Group is likely to be contingent on re-establishing dividend payments.

Dividends remain a key signal of management confidence and will be interpreted as an indicator of regulatory rehabilitation. Banks’ management across the entire sector need to articulate a dividend policy to investors with the confidence and backing of regulators.

Banks once accounted for over 20% of the FTSE 100’s dividend income—a valuable income source to UK investors. Whilst lower pay-out ratios will prevail for the foreseeable future, the positive message that a restored dividend policy will convey, together with increased investment funds, should not be underestimated.

Written evidence from Barclays Bank

SUMMARY

1. The reforms recommended by the Independent Commission on Banking (the ICB), alongside broader banking reform activity in the UK and in Europe, will help ensure that the UK banking system is safe, stable and effective.

2. Barclays is determined to introduce the full range of reforms to a high standard and as soon as possible. The current draft of the Bill offers little certainty about the final shape of these reforms for banks to begin implementation, without having to make material judgements about the future direction of the legislation. Without such judgement, or a material increase in the depth of the primary legislation, and following the current timetable, it is unlikely that implementation could begin substantively until 2015 at the earliest.

3. We recognise that decisions on technical implementation details are most appropriately left to regulators. However, we believe that issues such as the thresholds for customer inclusion and the structural requirements for ring-fenced banks are directional policy matters which should be dealt with by the primary legislative process. At the very least, this will ensure that the objectives of the legislation are carried through in implementation and prevent slippage over time.

4. We commend the Government for their focus on incorporating the relevant aspects of the European policy response and working effectively towards harmonisation, most notably on the shape of the rules regarding “bail-in” debt. We encourage the Government to continue to work closely with the EU process to ensure that the UK and EU reforms are directly and fully compatible. This is particularly important in the context of the recently released recommendations of the High Level Group chaired by Erki Liikanen (the Liikanen Group). Based on the understandable lack of specificity in the latter recommendation, we anticipate material areas where work to ensure appropriate alignment will be required.

5. On many topics covered by this consultation response, we have been unable to give full answers due to the lack of any real specificity in the draft Bill. However, we have identified areas where we believe the Commission could offer advice and scrutiny to enhance and strengthen the drafting and potentially accelerate the implementation process. We would strongly welcome specific detail in the next draft of the Bill on the following areas in particular:

1. **Flexibility**—The ICB was careful to note the importance of ensuring the new rules allow for flexibility so long as the stated objectives of the ring fence were met. The ICB explicitly recognised that if the rules become too rigid, they risk failing to reflect the differing starting structures and risk profiles of each bank. It is vitally important that the ring fence, as well as wider structural requirements, achieve their stated objectives, but—subject to that—accommodate the specific circumstances of each institution.
2. **Funding**—we support the prohibition on the ring-fenced bank funding the non-ring-fenced bank. However, we see no public policy benefit to preventing the non-ring-fenced bank from funding the ring-fenced bank, especially in circumstances where the ring-fenced bank has entered a recovery or resolution situation, so long as that support does not in any way cause the non-ring-fenced bank to violate its direct prudential requirements. This activity would serve as a potential rescue mechanism in the event of a crisis and to prohibit such an activity appears contrary to the goals of the ICB and financial stability more generally.
3. **Trading as principal**—it is important that ring-fenced banks do not engage in trading as principal. However, the definition in the draft Bill may, unless clarified, exempt client intermediation, share dealing on behalf of retail customers and other activities which are not “proprietary” in a real sense. We ask the Government to confirm that trading on behalf of clients will be exempt from the prohibition.
4. **Thresholds**—Barclays believes that thresholds for inclusion in the ring fence at £250,000 assets for personal customers and £6.5 million turnover for small business are consistent with the intentions originally stated by the ICB for the ring fence, namely: to ensure that “critical functions” could more easily be protected in the event that either the ring-fenced or the non-ring-fenced parts of the bank fail. Thresholds at this level will meet this intention, covering the vast majority (96%+) of UK businesses and 99% of UK individual customers, without diluting the ring fence by the introduction of large customers and complex needs that a higher threshold would necessitate.

OBJECTIVES AND GENERAL APPROACH

Question 1. *Does the draft Bill successfully give effect to the objectives set out in paragraph 1.3 of Sound banking: delivering reform and is it the most efficient and effective means of delivering those objectives?*

6. The objectives set out in paragraph 1.3 are an accurate description of the objectives of the wider public policy challenge of banking reform, of which the Banking Reform Bill is a fundamentally important aspect.

7. As an example, the challenge of ensuring banks are more stable and better able to absorb losses is being largely addressed through the Basel process, the European Recovery and Resolution Directive, and the Recovery and Resolution Plans UK banks have already submitted to the authorities.

8. This Bill should be seen within this wider context, and care taken that the Bill does not contradict, or become superseded by, other reforms and that no underlap or insufficiencies are created.

9. At this stage the draft Bill does not give sufficient clarity or certainty on any of the major issues to have confidence as to whether it will meet the objectives set out for it. We recognise that the technical details of implementation are most appropriately left to the regulators. However, we believe that issues such as the thresholds for customer inclusion and the structural requirements for ring-fenced banks are directional policy matters which should be dealt with by the primary legislative process and are disappointed that the draft Bill provides no certainty on these matters.

10. We do believe that the Banking Reform Bill and the wider bank reform process have the potential to significantly address the shared objectives for a safe, stable and effective financial system, but the achievement of those objectives risks being delayed by the lack of certainty around the way in which the Government wants banks to change their business and operating models to deliver them.

Question 2. Do any of the recommendations of the Independent Commission on Banking (ICB), which the draft Bill seeks to implement, need revision as a consequence of developments since the ICB's report?

11. The most significant areas of interaction with other policy activity are with the Recovery and Resolution Plan (RRP) process in the UK, and with the Recovery and Resolution Directive, Liikanen and Banking Union processes in Europe.

12. The RRP process requires banks to set out recovery plans for dealing with financial stress, and resolution plans to explain how they could be resolved in the event of a failure, and help the regulators develop a presumptive path to resolution for each firm. This project has been detailed and rigorous, and we are hopeful the plans will be effective. We would advise the Government to avoid inflexible structural requirements which may contradict these plans. In Europe, the proposed RRD should create a common framework for resolution regimes within the EU. In particular, we support the Government's decision to implement the RRD bail-in proposals, as an effective way to preserve the critical operations of a large and complex bank, while minimising the systemic consequences and without reliance on taxpayer funds.

13. The process by which the EU responds to the recent recommendations of the Liikanen Group is of significant concern. In the notes which accompany the draft Bill, the Government state that they expect the Liikanen recommendations to be compatible with the Banking Reform Bill. However, we believe that there are a number of areas where the implementation of those recommendations could deviate materially from the Government's intentions with respect to the ICB's recommendations, even where there do not appear to be direct contradictions. The Liikanen proposals will need themselves to be implemented by EU legislation. Even if the general proposals that have been advanced by Liikanen are not believed to be incompatible with the Bill, great care will be needed to ensure that this remains true when these proposals take final legislated form.

14. In particular, the Liikanen Group's recommendations aim to "separate" trading assets and market making activity, in contrast to the ICB recommendations, which aim to ring fence the assets of smaller customers. The treatment of a number of products, services and customer groups is not specified by either set of recommendations. Depending on how the treatment of these is determined in the UK and the EU, the result could be the requirement for UK banks to create three tier banking groups separated by two differently constructed ring fences. Barclays initial analysis suggests that the most important activities that sit within this indeterminate group include larger clients, interbank lending, loan syndication, wealth management and some hedging services to non-bank customers. It is vital that the treatment of these activities is defined consistently between the UK and EU.

Question 3. Do the powers in the draft Bill and the Government's stated intentions for their use give effect to the ICB's recommendations? Are any deviations justified?

15. The decision to leave the design of the ring fence very significantly to the secondary legislative processes means that it is impossible to be certain whether the ICB's recommendations will be effectively and accurately implemented.

16. The notes and the draft text do however suggest that the final reforms may not be designed with the flexibility which was intended by the ICB, and may therefore not effectively respond to the differing structures and risk profiles of each bank.

17. We highlight three areas of concern in particular:

1. First, the recommendations may require banks to operate the same legal structure, with both the ring-fenced and non-ring-fenced bank sitting under a single holding company. Not all banks operate—or will operate—this structure. This structure has no bearing on the "independence" of the ring fence; is not inherently safer; and does not manifestly improve the resolvability of the overall bank. Barclays believes that the legislation should allow banks to institute a robust ring fence around the appropriate customer groups in a manner appropriate to their specific structure and circumstances and leave decisions on overall bank structure to the relevant resolution authority in the context of creating a credible resolution plan. If the latter requires a change in overall structure, then the resolution

authority will ensure it is put in place. Our work to-date suggests that such a change will not be necessary to create a credible resolution plan.

2. Second, the legislation appears to prohibit the non-ring-fenced bank from funding the ring-fenced bank—even when required from a recovery or resolution perspective. We fully agree that the reverse position, with the ring-fenced bank funding the non-ring-fenced bank is incompatible with the purpose of the ICB proposals and should be prohibited. However, we see no public policy benefit to preventing the non-ring-fenced bank from funding the ring-fenced bank in times when such support would prevent the failure of the ring-fenced bank without in any way jeopardising the health of the non-ring-fenced bank. To prohibit this activity appears to remove a potential rescue mechanism in the event of a crisis and appears contrary to the goals of both the ICB proposals and financial stability more generally.
3. Third, trading as principal. Barclays understanding of Vickers’ intention is that ring-fenced banks should be prohibited from true “proprietary” trading, where banks’ own capital is used to generate trading returns for the institution. However, the definition in the draft Bill may, unless clarified, exempt client intermediation, share dealing on behalf of retail customers and other activities which are not “proprietary” in a real sense. We believe this client intermediation should be permissible.

Question 4. What should be the timetable for implementation of these measures, and should it be set out more clearly?

18. The legislative timetable the Government intends to follow is clear. However, Barclays believes that the importance of these reforms, and their impact on market and customer confidence, demands faster implementation. We ask the Government to provide greater certainty and detail on the shape of the reforms in the primary legislation, and to work with European policymakers to clarify how interactions will be managed.

19. Barclays wishes to begin implementation at the earliest possible stage and seeks the certainty required to do so.

20. Implementation can be pursued without that certainty but at the risk of creating significant additional cost to the economy.

Question 5. The draft Bill proposes continuity objectives on the PRA and FCA. Are these appropriate and compatible with their other objectives?

21. As noted in more detail under question 9, the continuity objective is a narrow one. We would support a broader set of objectives which reflect considerations of the economic impact and any obvious wider cost-benefit analysis of decisions made.

BANKING STANDARDS AND COMPETITION

Question 6. What will be the impact of the proposed changes in the draft Bill on banking standards in the UK more widely?

22. We believe that the ICB reforms, alongside wider public policy activity in the UK, EU and beyond, will be a strong mechanism for creating a safer, more stable and more effective banking system.

23. However, we do not expect the proposals in the draft Bill to address the equally fundamental question of banking standards, as these challenges are behavioural rather than structural in nature, and we do not believe that changes in structure in and of themselves will lead to behavioural changes.

24. Some argue that the “separation” brought about by the ring fence between the retail activities within it and the wholesale activities outside of it will be beneficial. We believe this is an inaccurate interpretation of the source and causes of the banking standards issues that the UK industry needs to address. In particular, well documented and significant failures in industry standards—such as PPI and swaps mis-selling—occurred in the parts of banks that would be allowed within the ring-fenced entity based on the ICB’s recommendations. Furthermore, they occurred in both universal banks, that combine what will be ring-fenced and non-ring-fenced entities, and stand-alone retail banks. This evidence clearly indicates that challenges in bank culture and standards are not a product of cultural contamination between these different entities.

25. It is abundantly clear that public trust in banking standards and behaviours has been fundamentally compromised, and action is clearly required. The reform process, in particular structural reform such as the implementation of the ICB recommendations, will be an important contributor to restoring that trust at the very least because of its impact on perceptions of the industry’s security and stability. As part of this, we believe that banks themselves must play a leadership role in identifying the root cause of the failures of standards, as well as contribute actively to identifying what remediation is required. Barclays has begun an independent review under the leadership of Antony Salz to do just that, the results of which will be made public before our AGM in 2013 and which the Barclays Board have committed to implement in full. We are also undertaking specific changes, for instance redrawing the banks incentivisation schemes, to ensure that customers are at the heart of our thinking at all times.

26. Any such changes from within the industry need to be reinforced by a rigorous, external mechanism. In responding to the Commission's initial call for evidence on banking standards, Barclays proposed a new professional body for bankers and a professional register from which it would be possible to strike off individual bankers who exhibited behaviour inconsistent with industry ethical norms. While there are many complexities to be resolved in instituting such a reform, we believe that this would make a substantive contribution towards addressing the issue of banking standards and invite the Commission to consider it.

Question 7. What will be the impact of the separation of retail and wholesale banking on the culture prevailing within each?

27. As noted above, we do not anticipate that structural reforms, as envisaged by the ICB or the Liikanen Group, would of themselves have direct implications for the culture of either retail or wholesale banking. Examples of exceptional standards, as well as failures, can be found in standalone retail banks, standalone wholesale banks and in banks that combine both. Changing the behaviour and culture of staff in banks will require much more than structural change.

28. Barclays expects exactly the same standards of honesty, integrity, probity and customer focus from colleagues in every single part of Barclays. It would be wrong to have different expectations from colleagues in any particular part of the business given the systemic implications of the activities undertaken in each.

Question 8. What will be the impact of the ring-fence on competition, both in retail and investment banking, and in other areas of financial services?

29. We anticipate a significant impact on the competitive environment within the UK. The ring fence is likely to introduce distortion of pricing for deposits and lending. Ring-fenced banks would have no incentive to offer competitive interest rates for deposits, either business or retail, as they would have assurance of deposits due to the government mandate. In addition, ring-fenced banks would be at a competitive disadvantage to the non-ring-fenced financial institutions, which will be able to offer higher deposit rates and operate un-burdened by the regulatory and funding cost of ring-fencing.

30. Ring-fenced banks would have an incentive to aggressively lend against cheaply acquired deposits, which would likely distort pricing of loans and potentially encourage irresponsible lending behaviour.

31. There may be implications for the competitiveness of UK banks in the international market place if the ring fencing (or any other material aspect of the ICB's recommendations) is imposed without appropriate harmonisation with other markets, especially the EU.

DELEGATED POWERS AND ACCOUNTABILITY

Question 9. The draft Bill grants a large number of delegated powers to the Government. Are the principles under which delegated powers are to be exercised sufficiently clear?

32. In many instances, these delegated powers are exercisable by reference to the "continuity of core services" objective; for example the power to derogate from the restriction on principal trading, or the power to impose prohibitions such as opening branches or dealing with particular types of entity.

33. The flexibility of this approach is understandable but it generates three concerns:

- The "continuity of core services" objective is narrow, and excludes considerations of the economic impact and any obvious wider cost-benefit analysis.
- The objective in question is subjective and hard to measure. If the Government acts unreasonably then, absent judicial review it is open to HMT to define its own sense of what is required in order to best maintain core services and how that should be interpreted.
- There appears little accountability over the exercise of these powers. The PRA reviews referred to at 142(I) require that the PRA publish the report in the manner it sees fit, which provides a framework for review but not a mechanism of challenge as such.

Question 10. Does the scope of the delegated powers in the draft Bill represent an appropriate balance between flexibility for the Government to respond to changing conditions and accountability to Parliament and the public?

34. Where HMT chooses to delegate authority to the regulator, an Order may, but is not required to, impose conditions on how the regulator will exercise its powers. Again, in the absence of detail, the capacity for a challenge mechanism is likely to be limited. If the regulator's actions are guided only by the continuity objective, then the opportunity for challenge and careful application of the powers may be reduced. A broader form of impact assessment and scrutiny would be welcome.

Question 11. *Is there sufficient clarity about the Government's intended use of delegated powers, both to enable public understanding and to enable affected banks to prepare for the proposed changes?*

35. There is insufficient clarity about the intended use of delegated powers, which reflects the general lack of certainty throughout the Bill. Particular examples are the definitions of activities and services which will and will not be permissible within the ring fence. There is less certainty still about questions related to funding.

36. Barclays wishes to begin implementation at the earliest possible point. We require far greater certainty than is provided by the Bill to do so.

Question 12. *The draft Bill provides for review of the ring-fencing rules by the PRA every five years. Does the proposed review mechanism provide sufficient accountability?*

37. This timescale appears appropriate, however we are concerned about the objective against which the rules will be constructed and reviewed, as in our response to question 9.

THE RING-FENCE

Question 13. *Is the power to be able to exempt certain categories of deposit-taking firms from having to establish a ring-fenced bank appropriate, and on what basis should the conditions for exemption be set?*

38. There is an intention in both the Banking Reform Bill and the Liikanen proposals to exempt a significant majority of deposit-taking institutions from introducing a ring-fence. This is a major stability concern.

39. Exempting all institutions with less than £25 billion in deposits would only capture six UK banks⁷, with building societies in addition. Similarly, the Liikanen Group's proposals would capture around c10–20 institutions EU-wide, compared to the approximately 6,000 banks within the proposed Banking Union alone.

40. An important lesson from this and previous financial crises is that smaller, less resilient institutions, without the stability and diversification that comes with scale, can very easily be compromised in large numbers by the impact of a shock. In such instances, they become a mechanism of crisis transfer, and an early and public sign of bank failure further worsening a loss of confidence.

41. Many note that the fact that these banks are small suggests that any particular issue that might arise can be dealt with more easily and directly. However, the experience in Ireland, Spain and Greece, to name but three, during the recent crisis highlights that such banks tend to take very similar risks which leads to a very high correlation in their failure rates. As a consequence, the experience shows that the joint failure of a large number of such smaller institutions creates just as much, if not more, financial instability as the failure of a large institution.

Question 14. *Is the range of core and excluded activities defined in the draft Bill appropriate and sufficiently broad? Are the Government's stated intentions for using powers to define further core and excluded activities appropriate?*

42. The draft Bill and accompanying policy notes do not provide sufficient clarity or certainty about which activities—or services—will be considered core or excluded to allow banks to begin to design their structures for the purpose of implementation. The inclusion of deposits, withdrawals and overdrafts is consistent with the intention of the ring fence. Exclusion of dealing in investments as a principal is expected and appropriate, but requires clarification from the Government that they do not intend to prevent client intermediation, share dealing on behalf of customers and other activities which are not “proprietary” in a real sense. In these instances, in order to facilitate the transaction, the bank will take the transaction onto its own books before an offsetting sale.

43. The inclusion of “related payments” is concerning. It is unclear from the current drafting whether payment services are to be considered core services or not. We believe that the rules should allow payment services to be provided through an operational subsidiary, providing services to both parts of the bank but bankruptcy-remote from each.

44. Additionally, if related payments is intended to refer to retail payments, this drafting would require splitting—and to a large extent duplicating—payment functions within a bank with no incremental benefits to stability.

45. We would therefore advise that related payments be removed from the list of core activities to allow for greater flexibility in the way that banks manage the technicalities of the payments process.

46. We would encourage any further documentation to clarify the language between selling and manufacturing, as such terms are not synonymous nor are the activities to which each term refers.

47. In considering core and excluded activities, the Commission may wish to consider the distinction between selling/offering a product and manufacturing a product. It may be the case that by offering a product, a bank takes on credit risk that the customer will default. In contrast, by manufacturing a product, the bank may take

⁷ HSBC, Barclays, Santander, Lloyds, RBS and The Cooperative Bank.

on additional market risk associated with creating and managing an asset. This would be the case, for example, with derivative products.

There may be examples of where policy makers consider the credit risk associated with offering a product to be appropriate, but would not support the ring fence from manufacturing the same product.

48. Beyond this point, the draft Bill and accompanying notes do not provide sufficient clarity over what will be core, permissible or excluded. We ask the Government to deliver further certainty, and emphasise in particular the importance of ensuring that the final UK position matches the European one.

49. On the question of simple derivatives, Barclays recognises the commercial motivation for inclusion of both manufacturing and distribution within the ring fence from both banks and small business customers. However, we believe that inclusion is counter to the broader intention of the ICB and represents a significant dilution of the objective of the ring fence at implementation.

50. In addition to a general need for greater certainty in the Bill, we would strongly encourage detail in the primary legislation on the following areas:

- *Thresholds for inclusion within the ring fence*—confirmation of the customer thresholds below which businesses and individuals will be mandated within the ring fence.
- *Funding between entities*—confirmation that the non-ring-fenced bank will be allowed to support the ring-fenced bank if required.
- *Bank Structure*—confirmation that banks will not be required to adopt a specific company structure, but will be able to apply to institute a robust ring fence around the appropriate customer groups in a manner appropriate to their specific structure and circumstances.
- *Principal trading*—confirmation that the prohibition on principal trading will not prohibit trading on behalf of clients, such as retail investment in shares.
- *Depositor preference*—confirmation of which deposits will be preferred above other unsecured liabilities in the creditor hierarchy.

Question 15. *Which categories, if any, of customer should be permitted to deposit with a non-ring-fenced bank?*

51. Barclays supports thresholds for inclusion in the ring fence at £250,000 for personal customers and £6.5 million for small business, which would cover the vast majority (96%+) of UK businesses and 99% of UK individual customers, without compromising the ability of banks to meet client needs. We also support the view that customer needs will be best served by allowing some customers to opt out of the ring fence, if they require access to the services offered by the non-ring-fenced bank. The ICB's original intention in recommending ring fencing was to ensure that "critical functions" could more easily be protected in the event that either the ring fence or the non-ring-fence parts of the bank fail. Thresholds at this level will meet this intention, without introducing the dilution of size and complex needs that a higher threshold would necessitate.

Question 16. *The Government is considering whether to allow ring-fenced banks to offer simple derivatives to their customers. Should they be allowed to? If so, what safeguards would be necessary?*

52. On the question of simple derivatives, Barclays recognises the commercial motivation for inclusion within the ring fence from both banks and small business customers. However, we believe that inclusion is counter to the broader intention of Vickers and represents a dilution of the ring fence. If they are to be included as permissible activity, it must not represent the beginning of a piecemeal dilution of the ring fence.

Question 17. *Are the proposed corporate governance arrangements between the ring-fenced bank and the wider group sufficient to ensure the independence of the ring-fenced bank? Are these arrangements compatible with directors' duties and principles of accountability?*

53. The ring-fenced bank must have strong governance, as must the non-ring-fenced bank and the Group overall. All financial institutions (and entities within those institutions) must have a strong risk management and control framework, set appropriate tone from the top and have a culture of doing the right thing for customers, clients and society more generally.

54. The key question is how to achieve strong governance across the group in a way that also recognises the unique position of the ring-fenced bank and serves to promote and protect the integrity of the ring fence.

55. Barclays shares Paul Volcker's concern about independent boards for the ring-fenced bank. Directors act as agents of the company's owners. We would caution against implementing any governance structures that further widen the agency gap between the ultimate, beneficial shareholders and those who manage the business on their behalf. Installing a largely independent board at ring-fenced bank level adds another link in the agency chain, widening the agency gap, particularly where the ring-fenced bank represents a significant part of the business of a group when taken as a whole.

56. The governance arrangements for the ring-fenced bank should therefore focus on promoting the right behaviours and values and concentrate on ensuring that those governance arrangements function effectively

rather than conforming to a set of perceived best practice rules that simply prescribe form and structure. Such an approach will also allow each ring-fenced bank to apply governance arrangements in a way that is appropriate to its own—and its parent company’s—particular circumstances.

57. Furthermore, any question of “independence” needs careful definition to ensure that stipulations are not applied to the construct of the ring fence which are unnecessary in ensuring that it achieves the desired statutory objectives. Barclays believes that the “independence” of the ring-fenced bank should be focused on ensuring that it separately meets its regulatory requirements—both conduct and prudential. The principal obligation of the Board of the ring-fenced bank must be to ensure that those obligations are met and no intervention from the parent company or otherwise should be able to prevent that from happening. Once that objective is satisfied, the Board’s other obligation must be to serve the interests of its beneficial owners in the usual way.

Question 18. How appropriate are the proposed restrictions on exposures and operational dependencies between the ring-fenced bank and the rest of the group? Will these result in a sufficient degree of independence and resilience?

58. This is an area of significant concern. We fully support funding restrictions which prevent the ring-fenced bank being used to fund or recapitalise the non-ring-fenced bank. This restriction is entirely consistent with the letter and intention of the ICB recommendations.

59. However, we see no public policy benefit to preventing the non-ring-fenced bank from funding the ring-fenced bank especially in circumstances where the ring-fenced bank has entered a recovery situation, so long as that support does not in any way cause the non-ring-fenced bank to violate its direct prudential requirements. This activity would serve as a potential rescue mechanism in the event of a crisis and to prohibit such an activity appears contrary to the goals of the ICB.

60. Experience from the crisis shows that the ring-fenced bank is as likely to experience difficulties as the non-ring-fenced bank, and both are measurably less stable than universal banking models. We would propose asymmetric funding restrictions to allow for large universal banks to support their retail arms where required.

61. Within this context, “independence” should be understood as ensuring that both sections of the bank are in complete fulfilment of their regulatory requirements under the reforms, without acting beyond this point to restrain the prudential and economic benefits of the universal banking model.

Question 19. Will it be possible to effectively monitor and police the ring-fence, given the degree of regulatory discretion the draft Bill proposes?

62. Barclays has confidence in the current and incoming regulatory bodies and will work with them to achieve the deepest possible regulatory oversight.

63. If the Commission believes that there are deficiencies in the regulatory regime, Barclays would propose that those are fixed at source—ie within the regulatory regime—rather than by imposing incremental burdens within the implementation of the ICB recommendations.

Question 20. How effective will the provisions on corporate governance for ring-fenced banks be in promoting a wider improvement of standards? Should other measures also be considered?

64. As noted in answer to questions 6 and 7, banking standards are not problems which can be addressed through structural adjustments to the shape of banks, but require a broader range of changes within banks themselves.

65. Improvements in governance have an important role to play in both defining, implementing and maintaining those changes. But the imposition of separate governance for a ring-fenced bank, against the same governance standards as the non-ring-fenced bank and parent company will need to put in place, will not—in and of itself—bring about that change.

66. We also invite the Committee to consider Barclays recommendation for a Chartered Institute of Bankers and a professional register.

DEPOSITOR PREFERENCE

Question 21. Is the proposal to prefer insured deposits in the event of a bank insolvency justified? Is there a case for broadening the scope of deposits which benefit from this protection?

67. Depositor preference (DP) for insured deposits would mean ranking the Deposit Guarantee Scheme (DGS) above general unsecured creditors in bank resolution. This would force better market discipline by strengthening the incentive for general unsecured creditors, including senior debt-holders, to monitor banks they have exposure to. Additionally, deposits insured through the Financial Services Compensation Scheme are already protected, so the imposition of depositor preference has no bearing on the outcome for individual depositors. Rather, depositor preference provides greater certainty about from where the funds required to protect those depositors will be sourced, which is to be welcomed.

68. These two benefits of DP are to be welcomed. We are pleased by the Government's recognition of the need to ensure international consistency on DP, and would encourage particular focus on how the policy will be affected by the final drafting of the EC RRD and the design of the bail-in, given that DGS bail-in is by definition inconsistent with DP. In addition to achieving harmonisation of approach across Europe, we would encourage European policymakers to consider the added challenge of harmonisation with the United States, which has already introduced depositor preference.

69. It is important to note that DP would substantially reduce the need for a pre-funded DGS; because the DGS would only lose money after all general unsecured creditors had been wiped out (on top of equity and sub-debt holders). Removing the need for a pre-funded DGS would help mitigate the expected increase in funding costs to the banking sector.

70. However, the expansion of depositor preference beyond insured depositors would confer a new protection to otherwise uninsured depositors. This seems to us to be a wholly inappropriate outcome. First, it is not equivalent to the insurance protection provided to other depositors, as it will not guarantee payment. Second, it creates a material communication issue with depositors as to the nature of any protection to which they are exposed. Third, in the context of communications, understanding how depositor preference without insurance will work will require significant sophistication on the part of customers. We believe that any expansion of depositor protection should be dealt with best through changes to the relevant insurance schemes and carefully coordinated across at least Europe.

CAPITAL LEVELS

Question 22. Does the draft Bill adequately implement the ICB's recommendations on loss absorbency requirements?

71. The draft Bill leaves the implementation of absorbency requirement to the European Commission's Recovery and Resolution Directive (EC RRD) process, which we welcome as a measure to ensure international coordination.

72. However, we note that, in the impact assessment accompanying the draft Bill, the Government set out 17% PLAC requirements and an additional 2% "management buffer". We believe this buffer to be contrary to earlier Government policy, most notably the White Paper which preceded this draft Bill and seek to have it removed.

Question 23. The draft Bill gives the Government power to direct the way in which the regulators can implement loss-absorbency requirements. How appropriate and well-designed is this power?

73. We understand these powers to allow the regulators to implement the EC RRD proposals, and we welcome them on this basis.

Question 24. Is the Government's stated intention for the design of loss-absorbency requirements workable? Will it provide a sufficiently well-capitalised banking system? In particular, how justified is the intention to allow an exemption for assets held in overseas operations?

74. In general, the design of the loss absorbency requirements is workable, with the focus on European harmonisation entirely appropriate. However it will be important that the Government provides clarity over the definition of PLAC, and how this will work alongside the EC RRD proposals.

75. Any exemption of asset held in overseas operations must be subject to very stringent tests which require the "host" regulator to state unequivocally that the UK is in no way liable if the entity of the relevant bank needs to be independently resolved and that, in such circumstances, the parent bank cannot take steps to rescue that unit that would in any way jeopardise the overall banking group.

Question 25. Is the Government justified in its decision not to implement the ICB recommendation for a higher leverage ratio than is required by Basel III?

76. Yes. The Basel III requirement is rigorous, internationally harmonised and consistent with the Government's stability goals.

77. Additionally, unilateral higher ratios will inevitably push activity outside of the jurisdiction, but will not remove the risk of impact on the UK financial system. As the financial crisis demonstrated, banking failure in one jurisdiction will quickly spread to other jurisdictions due to the speed and interconnectedness of modern markets. Losing banking activity to other jurisdictions is therefore both a competitiveness issue, and a stability one.

RESOLVABILITY

Question 26. *Will the UK authorities have the necessary tools and powers (as a result of this legislation and other initiatives) to be able to resolve a large failing ring-fenced or non-ring-fenced bank, while maintaining financial stability and minimising the risk to public funds?*

78. Banking Act 2009 provided authorities with a permanent framework providing tools for dealing with failing UK banks and building societies. The tools outlined in this Bill do not appear to offer incremental benefits beyond those set out in the 2009 Act.

79. The Banking Reform Bill is a part of a far wider policy focus on recovery and resolution. Banks are required to develop recovery and resolution plans and although there is still much to do, we are confident about creating a presumptive path to resolution. Equally, the adoption of a bail-in tool, termination rights and stay considerations, and the expansion of the UK SRR to holding companies through the EC RRD is a positive and necessary step, which will enhance the UK SRR in line with the FSB's Key Attributes for Effective Resolution Regimes.

80. It is important that these reforms are considered in the round, and each new initiative is calibrated to enhance, rather than supersede existing work, which has not as yet had sufficient time to demonstrate success.

81. We do believe that the reforms as a whole will achieve an end to both the reality and perception of too big to fail, so that banks of any sort can collapse without fiscal impact or counterparty contagion, and with retail depositors properly protected.

Question 27. *What is your assessment of the Government's preferred design of "bail-in" powers needed to improve bank resolution? How likely is it that the Recovery and Resolution Directive will deliver effective bail-in powers?*

82. We support the EC RRD's intentions and policy direction. We outlined to the European Commission four key characteristics which we believe bail-in must achieve:

- *Clarity*—The trigger point should be the same (the point of non-viability) for all resolution tools; the field of liabilities in scope should be clear, and the bail-in powers and process that the resolution authorities have to enact must be clearly defined.
- *Practicality*—the distortive impact of a bail-in should be as minimal as possible for business as usual purposes. This is of particular importance when determining the scope of affected liabilities.
- *Flexibility*—a bail-in regime should be able to deal with the different business models and structures of the institutions in scope.
- *Consistency*—the principles of application should be capable of international agreement. This does not require identical paths, but agreement of general principle of application that do not create material distortions.

83. We are confident that the EC RRD will deliver bail-in powers that achieve these characteristics.

IMPACT ASSESSMENT

Question 28. *Is the impact assessment of the costs and benefits credible and balanced?*

84. Without certainty about the final shape of the reforms, it is not possible to comment with certainty about the impact of these reforms.

Question 29. *Might there be any other unintended consequences which have not been considered?*

85. We would identify two areas where we believe that unintended consequences counter to public interest may be created by the Bill.

86. First, the apparent prohibition on the non-ring-fenced bank from funding the ring-fenced bank when required as previously outlined. We fully agree that the reverse position, with the ring-fenced bank funding the non-ring-fenced bank subject to stipulations on timing and circumstances is incompatible with the purpose of the ICB proposals and should be prohibited. However, we see no public policy benefit to preventing the non-ring-fenced bank from funding the ring-fenced bank. To prohibit this activity appears to remove a potential rescue mechanism in the event of a crisis and appears contrary to the goals of the Vickers report. We ask the Government to allow an exemption from the Large Exposures regime for this purpose under specific circumstances.

87. Second, the prohibition on trading as principal. Barclays understanding of Vickers' intention is that ring-fenced banks should be prohibited from true "proprietary" trading, where banks' own capital is used to generate trading returns for the institution. However, the definition in the draft Bill may, unless clarified, exempt client intermediation, share dealing on behalf of retail customers and other activities which are not "proprietary" in a real sense. We ask the Government to clarify their intentions.

INTERNATIONAL ISSUES

Question 30. *What will be the impact of the proposals on the international competitiveness of UK banks?*

88. It is not possible to accurately measure the impact on international competitiveness with the level of detail provided by this draft Bill. However, we would advise against unilateral or super-equivalent policy implementation.

89. It is also unclear how the interplay between the Liikanen Group recommendations and the banking Reform Bill will affect the international competitiveness of UK banks. Any gaps between the two may result in added obligations for UK institutions, which would be to the detriment of their competitive position.

90. Higher compliance costs will inevitably push activity outside of the jurisdiction, but will not remove the risk of impact on the UK financial system. As the financial crisis demonstrated, banking failure in one jurisdiction will quickly spread to other jurisdictions due to the speed and interconnectedness of modern markets. Losing banking activity to other jurisdictions is therefore both a competitiveness issue, and a stability one.

91. We believe the Government shares these concerns, and we are pleased with the focus on achieving harmonisation which is apparent throughout the draft Bill and accompanying documents.

Question 31. *Are the proposals consistent with existing and forthcoming international and EU regulatory initiatives, for example the recent Liikanen Report? To what extent are they likely to be superseded or generate conflicts?*

92. In many instances the draft Bill seeks to implement EU wide policy. This is an important acknowledgement of the need for harmonisation, and is to be welcomed. In particular, Barclays supports the decision to implement the EC RRD.

93. However, we do not share the Government's view that the ICB recommendations are inherently compatible with the Liikanen Group's proposals. We believe that there are several areas where the Liikanen Group's recommendations could deviate materially from the ICB's proposals, even where these differences do not create direct contradictions or incompatibilities. In particular, this relates to the placement of business activities that are not stipulated as mandatorily "in" or "out" by either set of recommendations. This anxiety is compounded by the understandable lack of specificity in the Liikanen Group's recommendations.

94. Barclays initial analysis suggests that larger clients, interbank lending, loan syndication, wealth management and some hedging services to non-bank customers all currently sit outside of the confirmed scope of the two ring fences.

OTHER

Question 32. *What other matters should the Commission take into account?*

95. The Commission's questions are comprehensive.

31 October 2012

Written evidence from the British Bankers' Association

1. The British Bankers' Association (BBA) welcomes the opportunity to provide written evidence in connection with the pre-legislative scrutiny of the draft Financial Services (Banking Reform) Bill being undertaken by the Parliamentary Commission on Banking Standards. The BBA represents over 200 banks from 50 countries on international and domestic banking and financial services issues.

2. As the call for evidence observes, the main objectives for the draft Bill as set out in the "sound banking: delivering reform" policy document are to:

- making banks better able to absorb losses;
- making it easier and less costly to sort out banks that still get into trouble; and
- curbing incentives for excessive risk taking.

3. We believe that when taken together with other financial stability measures currently being put in place that the recommendations of the Independent Commission on Banking now being enacted will result in the stated objectives being met. We are, in particular, strong proponents of the introduction of a statutory "bail-in" tool as a means of ensuring that creditors contribute to the cost of any resolution and see recovery and resolution planning as sitting at the heart of ensuring that no organisation be viewed as "too big to fail". The capital measures and the retail ring-fencing set out within the draft Bill are both intended to strengthen these capabilities while maintaining diversity within the market place. This is in addition to significant changes to the UK regulatory framework involving a designated focus upon both prudential and conduct aspects of banking and financial services and the introduction of a macroprudential element to banking supervision to be overseen by the Financial Policy Committee,

4. We now turn to the detailed questions set out by the Commission and have noted the request that, where these questions relate to proposed secondary legislation that the Government has not yet published, the Commission would welcome views based on the Government's stated intentions as set out in the accompanying policy document and the June White Paper "Banking reform: delivering stability and supporting a sustainable economy". We have attached as *appendix 1* our response to the White Paper as this sets out our position on a broad range of issues relating to the implementation of the ICB's recommendations.⁸

OBJECTIVES AND GENERAL APPROACH

1. Does the draft Bill successfully give effect to the objectives set out in paragraph 1.3 of Sound banking: delivering reform and is it the most efficient and effective means of delivering those objectives?

5. As explained in paragraph 3, we consider the framework proposed within the draft Bill achieves the stated objectives.

2. Do any of the recommendations of the Independent Commission on Banking (ICB), which the draft Bill seeks to implement, need revision as a consequence of developments since the ICB's report?

6. The draft Bill needs to be seen in the context of other initiatives including the advent of the Financial Conduct Authority and a firm signal of intent that misconduct will result in enforcement action and possible criminal sanction. We have also seen the recommendations of the Wheatley Review. We therefore consider that the measures contained in the draft Bill achieve what they set out to do without prejudging the outcome of the Commission's inquiry into banking standards. There will, however, be need for consideration to be given to emerging EU and international initiatives as the Bill proceeds and the secondary legislation and regulation giving effect to the Bill's provisions are prepared and finalised.

3. Do the powers in the draft Bill and the Government's stated intentions for their use give effect to the ICB's recommendations? Are any deviations justified?

7. The draft Bill follows the ICB's recommendations closely with only limited deviations made in response to concerns raised during the consultation. Questions 16, 24 and 25 address these specifically.

4. What should be the timetable for implementation of these measures, and should it be set out more clearly?

8. The Government has we understand committed to the primary and secondary legislation being completed before the end of the current Parliament—scheduled for Spring 2015. The measures set out in the Bill, however, are complex and are also dependent upon PRA/FCA regulation and authorisation before implementation can take place. It would be helpful therefore to have a commitment from the regulatory authorities on the timetable for their completion of the relevant policy decisions and regulatory framework on a basis consistent with meeting the 2019 compliance deadline.

5. The draft Bill proposes continuity objectives on the PRA and FCA. Are these appropriate and compatible with their other objectives?

9. The continuity objectives are aimed at ensuring the continuity of core services from ring-fenced banks to their customer and would seem in keeping to us with both the purpose of ring-fencing and the other objectives of the two authorities.

BANKING STANDARDS AND COMPETITION

6. What will be the impact of the proposed changes in the draft Bill on banking standards in the UK more widely?

10. The reform process is an opportunity for banks to enhance and improve culture and standards, and to ensure that customers of both the ring-fenced and non-ring fenced bank are well served. Reform to incentive schemes, compliance mechanisms and a renewed focus on cultural expectations all have an important part to play alongside the structural benefits of ring fencing.

7. What will be the impact of the separation of retail and wholesale banking on the culture prevailing within each?

11. We believe that the ability of the different parts of a banking group to focus more on the maintenance of businesses focused upon the provision of services to specific and distinct core client groups will improve the ability of Boards to set clear directions for the restructured groups with respect to their expectations of how these businesses should operate.

⁸ Appendix not printed.

8. *What will be the impact of the ring-fence on competition, both in retail and investment banking, and in other areas of financial services?*

12. It is arguable that the effective removal of the “implicit guarantee” will also level the competitive playing field. On the other hand, since the UK appears to be unique in requiring legal separation along the lines proposed UK banks impacted by the measures will face significant disruption and cost in the short term and will be placed on a different footing to many of their overseas peers. Those operating internationally will be impacted by more than one approach since different jurisdictions are each looking at structural issues separately.

DELEGATED POWERS AND ACCOUNTABILITY

9. *The draft Bill grants a large number of delegated powers to the Government. Are the principles under which delegated powers are to be exercised sufficiently clear?*

13. The policy paper explains that the scope or “location” of the ring-fence is to be set in secondary legislation and the rules governing the legal, economic and operational independence or “height” of the ring-fence through existing regulatory powers. This would appear clear within the context of the ICB’s recommendations as set out in its final report though the issues to be addressed within these delegated powers are far from insignificant. The delegated powers also provide the means by which the Government can tie the loss absorbency aspects of the ICB’s recommendations into the implementation of the Recovery and Resolution Directive.

10. *Does the scope of the delegated powers in the draft Bill represent an appropriate balance between flexibility for the Government to respond to changing conditions and accountability to Parliament and the public?*

14. We believe the delegated powers provide the means by which the Government can respond to changing conditions and achieve an appropriate level of consistency with developing EU legislation such as the draft Recovery and Resolution Directive, CRD IV and possibly outputs from the Liikanen review. It is unclear however whether accountability to Parliament and the public for these arrangements are as strong as they need be. It is also important that draft secondary legislation is tabled while the primary legislation is being debated in Parliament—as currently envisaged—to ensure sufficient input into the legislative process from all interested parties. For example, if the threshold for the application of the ring-fence were lowered significantly, it would result in the measures applying to a wider number of firms, some of which may not be engaging fully with the process and possible implications for their business models.

11. *Is there sufficient clarity about the Government’s intended use of delegated powers, both to enable public understanding and to enable affected banks to prepare for the proposed changes?*

15. It would be helpful to have a clearer understanding of the way in which the Government envisages the delegated powers being used and the due process which this would involve.

12. *The draft Bill provides for review of the ring-fencing rules by the PRA every five years. Does the proposed review mechanism provide sufficient accountability?*

16. While a review clause is understandable, it would be preferable for the legislative provision to provide a commitment to consultation as part of the review though this may be implicit.

THE RING-FENCE

13. *Is the power to be able to exempt certain categories of deposit-taking firms from having to establish a ring-fenced bank appropriate, and on what basis should the conditions for exemption be set?*

17. Basing ring-fencing requirements on larger deposit-taking firms would seem entirely in keeping with the ICB’s objectives for ring-fencing: financial stability, the continuous provision of core services and the ability to resolve in an orderly manner without putting taxpayer funds at risk.

14. *Is the range of core and excluded activities defined in the draft Bill appropriate and sufficiently broad? Are the Government’s stated intentions for using powers to define further core and excluded activities appropriate?*

18. The ICB ring-fencing model, set out in figure 3.6 on page 54 of its September 2011 final report, is intended to define the ring-fence through services being “mandated”, “prohibited” and “permitted”. As the ICB itself recognised, this involves a balance between losing synergies, and therefore increasing costs on the one hand, and the benefits of improving financial stability through separation on the other. There are however some complex issues involved. Further judgment is needed to determine the way forward where there appear internal inconsistencies in the ICB model. For instance, the ICB report indicated that trade finance should be a permitted activity whereas all services outside the EEA and services to financial institutions other than deposit-taking and payments are prohibited. As the policy document relates, a final decision has not yet been taken on whether ring-fenced banks should be able to provide direct trade finance services in support of their business customers.

19. Exclusion of dealing in investments as principal is expected and appropriate but requires clarification from the Government that they do not intend to prevent client intermediation, share dealing on behalf of customers and other activities that are not “proprietary” in nature using the bank’s own capital to generate trading returns for the institution.

15. *Which categories, if any, of customer should be permitted to deposit with a non ring-fenced bank?*

20. In addition to corporates and high net worth individuals, in responding to the Government White Paper the BBA explained that defining mandated services to SMEs on the basis of the lower size threshold would allow banks to locate the prime customer relationship from within or outside the ring-fence according to the complexity of their needs; this however would be entirely negated if larger SMEs remaining within the ring-fenced bank on a permitted basis were then denied direct access to services made available to smaller, mandated SME customers.

21. We further added that:

- We would see a *prima facie* case for a subsidiary of a non-SME corporate group being able to opt out of the requirement that it can only deposit money with the ring-fenced part of a banking group if this meant that its banking services could not be integral to those provided to the rest of the corporate group. This would be consistent with the approach taken by the European Union which requires financial thresholds (and staffing levels) for “linked enterprises” to be taken into account when determining whether a particular firm is an SME. This however may be something that would in practice only arise infrequently since a corporate group would seem more likely to have a banking relationship spanning the ring-fenced divide—possibly through a corporate banking division that would encompass both the ring-fenced and non-ring-fenced part of the group (but be clear on behalf of which part of the group a legally contracted service was being provided from).
- More difficult perhaps may be the question of a small but highly specialised company that may have a need for relatively complex financial product which the ring-fenced bank is prohibited from providing. We possibly see a case for an opt out since it is unclear to us that it has been established as a matter of fact that services can be provided on an agency basis from across the ring-fence divide on a competitive basis in the customer’s interest. Examples would include manufacturers with exposures to changes in commodity prices, haulage and distribution company exposures to changes in fuel prices and certain real estate partnerships or company linked ownership.

16. *The Government is considering whether to allow ring-fenced banks to offer simple derivatives to their customers. Should they be allowed to? If so, what safeguards would be necessary?*

22. Recognising that mis-selling constitutes a failure of financial conduct, we must also make sure that ring-fenced banks are in a position to provide the products and services which their customers need in the pursuit of their legitimate business. This includes the provision of hedging services and also trade finance. By definition, the processes supporting the provision of these products and services should be suitably robust.

17. *Are the proposed corporate governance arrangements between the ring-fenced bank and the wider group sufficient to ensure the independence of the ring-fenced bank? Are these arrangements compatible with directors’ duties and principles of accountability?*

23. The principles requiring the ring-fenced bank to be independent of the wider group and the directors of the ring-fenced bank to act principally according to their shared responsibility as a member of the independent Board of the ring-fenced bank are clear. However, further clarity needs to be provided as to the impacts of this independence on directors’ duties. It needs to be made expressly clear what duties are owed by the directors of a ring-fenced bank and to whom. This clarity is needed for there to be full and transparent accountability. The Government consultation on “Sanctions for the directors of failed banks” is also of relevance and our response is attached as *Appendix 2*.⁹

18. *How appropriate are the proposed restrictions on exposures and operational dependencies between the ring-fenced bank and the rest of the group? Will these result in a sufficient degree of independence and resilience?*

24. We have no difficulty with the principle that the relationship between a ring-fenced bank and other parts of a banking group should be on an arm’s length basis consistent with the independence of the ring-fence. We would be concerned however if the detailed rules resulted in the relationship between the ring-fenced bank and other parts of the banking group being subject to stricter demands than apply in the case of external third parties.

⁹ Appendix not printed.

19. *Will it be possible to effectively monitor and police the ring-fence, given the degree of regulatory discretion the draft Bill proposes?*

25. We see no reason why regulatory discretion should impede the ability of the authorities to maintain a keen eye on the operation of a bank's ring-fence and therefore see the balance between statutory provision and regulation more as a matter of exercising the more appropriate legal tool.

20. *How effective will the provisions on corporate governance for ring-fenced banks be in promoting a wider improvement of standards? Should other measures also be considered?*

26. As explained above, the reform process is an opportunity for banks to enhance and improve culture and standards, and to ensure that customers of both the ring-fenced and non-ring fenced bank are well served.

27. It is also being introduced within a regulatory framework in which a more intrusive approach is envisaged on both the prudential and conduct side and firmer efforts are made by banks themselves to improve the governance processes around risk and compliance. There is we believe a further case for initiatives in support of raising professional standards.

DEPOSITOR PREFERENCE

21. *Is the proposal to prefer insured deposits in the event of a bank insolvency justified? Is there a case for broadening the scope of deposits which benefit from this protection?*

28. The financial crisis showed the importance of deposit guarantee schemes and for the protection they afford to be set at a suitably high level. In the UK this currently stands at £85,000 and the banking industry stands behind this. Depositor preference, however, gives customers no added protection and instead increases substantially the losses of other creditors—particularly those holding bail-in instruments—in the event of a bank going into resolution. Depositor preference has the potential to put the new capital regime out of balance particularly if the UK proceeds and the EU does not. It is therefore unclear whether the Government has given sufficient consideration to the consequences for bank funding (and the ability of others to invest in UK bank bail-in debt instruments) if the UK adopts a course of action which differs from the final Recovery and Resolution Directive. The prospect of the EU moving towards the partial pre-funding of deposit guarantee schemes also needs to be considered in the context of UK/EU coordination. We would suggest, therefore, that depositor protection backed by an obligation upon the part of industry towards a deposit guarantee scheme strikes the right balance between the need to protect depositors and the need for a consistent regulatory regime.

CAPITAL LEVELS

22. *Does the draft Bill adequately implement the ICB's recommendations on loss absorbency requirements?*

29. While the draft Bill is in keeping with the ICB's recommendations, it needs also to be borne in mind that the ICB recognised the need for the UK capital regime to be based upon the same building blocks as those being developed by the EU institutions. Accepting the higher requirements of the ICB, notably for UK ring-fenced banks and UK-headquartered globally systemic important banks to be required to hold PLAC equivalent to 17% of RWAs, we believe that the UK regime should be based on the same fundamental definitions as those to be put in place by the Recovery and Resolution Directive.

23. *The draft Bill gives the Government power to direct the way in which the regulators can implement loss-absorbency requirements. How appropriate and well-designed is this power?*

30. We are strongly of the view that the UK regime needs to be defined within the terms of the Recovery and Resolution Directive. Delegating implementation of the loss-absorbing requirements to the regulatory authorities provides the means by which the Government can stick to its timetable for putting the legislative framework in place and reflect the fact that the Recovery and Resolution Directive is not yet finalised.

24. *Is the Government's stated intention for the design of loss-absorbency requirements workable? Will it provide a sufficiently well-capitalised banking system? In particular, how justified is the intention to allow an exemption for assets held in overseas operations?*

31. As matters stand, the intended design for PLAC is not consistent with the proposed bail-in tool proposed under the Recovery and Resolution Directive in that the Government considers that PLAC should be based on regulatory capital and subordinated debt with a senior unsecured debt with a twelve month term remaining whereas the RRD is premised upon a one month cut-off. . There is also a difference between the Government proposing an RWA-based threshold for PLAC and the RRD proposing a gross liabilities based threshold for bail-inable liabilities, although the RRD rapporteur has proposed an amendment in favour of an RWA-based measure. While there is an open debate as to which definition which is the most appropriate the imperative is for the UK to align to the commonly agreed EU definition.

32. Turning to overseas operations, the policy document explains that the Government does not believe it is appropriate to set PLAC requirements against RWAs held in non-EEA operations of UK-headquartered banks providing they pose no threat to UK or EU financial stability. This strikes us as the right approach since placing

major additional capital requirements upon global institutions purely by virtue of their domicile would have been disproportionate and additionally have unduly disadvantaged their competitiveness. Requiring additional capital against non-EEA operations would also not appear necessary when viewed against the objectives of the ring-fence including the need to insulate the taxpayer from the cost of ensuring the continuity of core services which do not include non-EEA operations.

25. Is the Government justified in its decision not to implement the ICB recommendation for a higher leverage ratio than is required by Basel III?

33. The concern with increasing the leverage ratio to a level higher than that required by Basel III is that for low risk asset portfolios it results in the leverage ratio being a determining factor in the amount of business written as opposed to being the backstop as Basel envisaged. This, for instance, has the potential effect of requiring banks (and building societies) with low-risk mortgage books to adopt a less prudent approach. We do not believe this to have been the intention of the ICB.

RESOLVABILITY

26. Will the UK authorities have the necessary tools and powers (as a result of this legislation and other initiatives) to be able to resolve a large failing ring-fenced or non-ring-fenced bank, while maintaining financial stability and minimising the risk to public funds?

34. When taken together with the special resolution regime already in place and the extension in scope to be introduced under the current Financial Services Bill, the UK authorities we believe will be well placed to bring about an orderly resolution. For large banking groups, however, this may depend upon cross-border cooperation, which explains our preference for proceeding through international agreement upon a commonly defined approach.

27. What is your assessment of the Government's preferred design of "bail-in" powers needed to improve bank resolution? How likely is it that the Recovery and Resolution Directive will deliver effective bail-in powers?

35. We believe that there is a growing appreciation across the European Union of the role to be played by recovery and resolution planning and the part to be played by "bail-in" capital. We are therefore confident of agreement on the directive being reached and view it as imperative that the UK bail-in regime sits squarely within the EU model.

IMPACT ASSESSMENT

28. Is the impact assessment of the costs and benefits credible and balanced?

36. We are less confident than the Government that the aggregate private cost to the UK banks of depositor preference would be in the range of only £0.3–£0.7 billion per year in the event that this involved the UK diverging from the framework adopted across the EU upon the finalisation of the Recovery and Resolution Directive.

29. Might there be any other unintended consequences which have not been considered?

37. Our comments on bail-in debt and depositor preference apply.

INTERNATIONAL ISSUES

30. What will be the impact of the proposals on the international competitiveness of UK banks?

38. Our biggest concern would be if the Government proceeded with depositor preference and others declined. This would have the potential to substantially disadvantage the ability of UK banks to issue bail-in capital and would as far as we are concerned work against the broader financial stability objectives of the measures in the draft Bill.

31. Are the proposals consistent with existing and forthcoming international and EU regulatory initiatives, for example the recent Liikanen Report? To what extent are they likely to be superseded or generate conflicts?

39. The Liikanen Report drew a substantially different conclusion to the ICB in that the recommendation is for a limited form of separation—which may or may not end up being adopted—and further structural separation in the event of banking supervisors not being content with the robustness of an individual banking group's recovery and resolution planning. In proceeding with domestic legislation on the timetable envisaged there is a need for the UK authorities to be confident that their approach will be sufficiently consistent with any subsequent European regime. As much of a concern would be if the UK approach differed significantly in terms of the capital measures including for the issuance of bail-in debt.

OTHER**32. What other matters should the Commission take into account?**

40. As ring fencing will inevitably involve the transfer of customers between entities, we welcome the Government's intent, in Clause 5 of the draft Bill, to amend Part VII FSMA, which is the main legislative method currently available in the UK for transfers of banking business without the need for customer consent. However we have some concerns about whether Clause 5 would effectively address the shortcomings of Part VII:

- (a) It is not entirely clear from the current draft of the amendment to section 106 FSMA as to whether the new category of Part VII transfer would still require there to be an element of deposit-taking. We assume this is not the case but would welcome early clarification.
- (b) Part VII does not extend to businesses or assets held by any subsidiaries of a UK authorised person who has permission to carry on one or more core activities. For example, this could preclude separation and transfer of funding programmes within a subsidiary. The amendments to s106 FSMA in the draft Bill do not contemplate the business of subsidiaries of a ring-fenced bank.
- (c) The Part VII process seeks to balance the interests of the transferor and stakeholders through a court process. This process is inherently uncertain. More analysis should be undertaken as to whether the court process is the right one in light of the ring-fencing policy, or should be modified to avoid that inherent uncertainty. As an example, there is no certainty under Part VII as to how the court will use its ancillary powers to make provision for issues which will be necessary for successful transfer (such as overriding change of control consents, termination rights under contracts, ratings downgrade provisions) but which potentially affect the rights of third parties.

41. We note also that the amendment to Part VII FSMA does not (and clearly could not) solve the issue of separation of businesses held in overseas subsidiaries and branches where individual customer and counterparty consents may be required. To this end we would hope that the UK regulator would reach out to its overseas counterparty regulators to ask for their cooperation when banks approach them to discuss the impacts in the relevant jurisdiction and offer assistance where required.

31 October 2012

Written evidence from the Building Societies Association

EXECUTIVE SUMMARY

- The BSA supports the exemption from ring-fencing for building societies (and instead amending the Building Societies Act where necessary to bring it into line) including the intention not to legislate for structural restrictions on building societies.
- The *de minimis* threshold for ring-fencing should be lower so that banks compete on equal basis with building societies.
- Building societies should continue to be allowed to provide derivatives and structured retail deposits, subject to the same safeguards as ring-fenced banks.
- Requirements for loss absorbing capacity should be targeted at the most systemic institutions. The minimum leverage ratio should reflect differences in the riskiness of different business models, and bail-in requirements should be proportionate to the risk an institution poses to the system.
- The BSA would support increasing coverage of depositor preference to all retail deposits as this would aid consumer understanding.
- To enhance competition, a greater diversity of providers should be supported. This would result in more effective competition, and greater financial stability. Mutuals' ownership structure ensures that consumers' needs carry greater weight, meaning they operate to different incentives than shareholder-owned banks.

INTRODUCTION

1. The Building Societies Association (BSA) represents mutual lenders and deposit takers in the UK including all 47 UK building societies. Mutual lenders and deposit takers have total assets of over £375 billion and, together with their subsidiaries, hold residential mortgages of £245 billion, 20% of the total outstanding in the UK. They hold more than £250 billion of retail deposits, accounting for 22% of all such deposits in the UK. Mutual deposit takers account for 31% of cash ISA balances. They employ approximately 50,000 full and part-time staff and operate through approximately 2,000 branches.

2. The BSA has described elsewhere in more detail its position in relation to many of the points made below in response to the Commission's questions. This submission is therefore brief, and more expansive explanations can be found in our previous submission to the Treasury White Paper and our response to this Commission's review on banking standards. These are attached as appendices to this submission. The questions in the Commission's call for evidence to which our points are most relevant are identified in square brackets.

3. The BSA supports structural changes to the banking system. Reforms that expose large, complex banks to greater market discipline shall enable mutuals and other challengers to compete on a more equal basis. Increased competition from a more diverse range of institutions shall provide a more effective challenge to the big banks, giving consumers increased choice, counteracting malformed incentives, and improving financial stability.

EXEMPTION OF BUILDING SOCIETIES FROM RING-FENCING [Q13]

4. The BSA believes that exempting building societies entirely from the definition of a “ring-fenced bank” is sensible. Mutual lenders and deposit takers, such as building societies, did not cause the financial crisis. Building societies have long been subject to legislative restrictions on their activities so are already, in effect, ring-fenced. To enable building societies to continue to focus on lending for house purchase funded by retail deposits, the Government’s intention not to introduce new legislative restrictions on a number of building societies’ supporting activities (such as estate agency and independent financial advice—activities which support societies’ principal purpose and do not increase their exposure to global financial markets) is also sensible.

5. The BSA endorses the Treasury’s high level principles for amending the Building Societies Act to bring it into line with ring-fencing and introduce other reforms so that building societies are free to compete on an equal basis with ring-fenced banks subject to retaining the distinctive nature of building societies. The BSA looks forward to working with the Treasury on the necessary amendments to the Act on this basis.

THE *de minimis* EXEMPTION [Q13]

6. The draft Bill grants the power to amend the Building Societies Act 1986 where necessary to bring it into line with the ring-fencing provisions. This means that all building societies, regardless of size, will be subject to these amendments. However, it is proposed that ring-fencing via the Bill will not apply to banks with less than £25 billion of deposits from individuals and SMEs. If the same *de minimis* exemption applied to building societies, all but the largest two would probably be exempt. There is therefore a potential competitive disparity if large to medium sized banking groups are not subject to ring-fencing legislation, but a building society of equal size is subject to ring-fencing via the amended Building Societies Act. As well as potential distortions to competition, £25 billion may simply be too high a threshold. This would have excluded Bradford & Bingley plc before it failed, even though at the time that bank was undoubtedly of systemic importance. For both these reasons, the BSA proposes that the *de minimis* exemption should be set at £10 billion of assets or £5 billion of deposits from individuals or SMEs, whichever is lower.

PRODUCT RESTRICTIONS [Q16, Q18]

7. If any building societies are to diversify into small business banking, they would need to be able to offer derivatives commonly provided to SME customers, consistent with those ring-fenced banks are permitted to offer.

8. Building societies currently sell a range of retail investment products, such as protected equity bonds, collective investment products and life assurance-based investments. These complement building societies’ core purpose, and the potential for higher returns are particularly valued by consumers in the current low interest environment.

9. Provision of these products does not necessarily add to the risks to an individual firm or the financial system as a whole. It is important that outright bans in these areas preventing the provision of valued services to individuals and SMEs do not take the place of effective conduct regulation which should be sufficient to prevent mis-selling.

10. Deposit-taking and lending subsidiaries in the Crown Dependencies should not be prohibited for ring-fenced banks or building societies as the close links with these islands and the absence of currency risk make such operations a much lower risk undertaking than operations in other non-EEA states.

LOSS ABSORBENCY AND DEPOSITOR PREFERENCE [Q25, Q27, Q21]

11. The BSA supports the Government’s decision, proposed in the White Paper, not to go beyond the Basel III requirements for the minimum non-risk weighted leverage ratio. A leverage ratio is a blunt measure that discriminates against low-risk businesses, like building societies and other mutuals, in particular. The BSA would endorse the further differentiation of minimum leverage ratios according to the riskiness of business models, as proposed in the European Parliament during the passage of the CRD4 package.

12. The BSA has argued that the requirement to hold of a stock of liabilities that are capable of being bailed-in should be targeted at the most systemic banks. Imposing substantial bail-in requirements on smaller and simpler institutions would raise their cost of funds with little benefit to financial stability. To this end, we draw attention to the criteria set out in Article 39 of the draft RRD for determining the minimum amount of liabilities eligible for bail-in, which clearly (and correctly in our view) emphasise the size, business model, risk profile, and interconnectedness of the institution.

13. The BSA would also support depositor preference [Q21] being widened to include all retail deposits held with a ring-fenced bank or building society, not just those covered by the FSCS. This would be much simpler for savers to understand. Any changes to creditor hierarchies should be carefully managed and communicated.

COMPETITION AND MARKET STRUCTURE [Q2, Q8]

14. As described in our previous submission to the Parliamentary Commission, mutuals' ownership structure has been seen to deliver a long-term, low risk approach. As a result, they were less affected by the credit crunch than were many other financial services providers. Mutuals' organisational culture stems from the primacy of member savers and borrowers, rather than external shareholders, with a mutuals' staff knowing that when they serve a member they are serving an owner of the business. Mutuals go to great effort to get their members engaged in how the organisation is run.

15. Building societies and other mutuals provide a competitive challenge to the large incumbent banks. Structural reforms that break the power of banks which are too big and complex to fail are likely to enhance this challenge. Rather than the market being dominated by institutions with very similar organisational structures or business models, a diverse range of providers can increase competition by competing across a range of factors and widening the choice available to consumers. A greater diversity of providers can also make the financial system more stable, if firms operate to different incentives and are affected by external shocks in different ways. Firms competing in different ways can also help to prevent incentives that are detrimental to society from becoming widespread¹⁰. Diversity of financial services provision should therefore be supported, as the Government committed to in its Coalition Agreement. And the implementation of ring-fencing arrangements in complex banking groups should ensure that the internal separations are strong, particularly regarding treasury functions, and that governance structures support the development of cultures and incentives that fit the needs of society.

30 October 2012

Written evidence from the Charity Finance Group, the Charities Aid Foundation, the Association of Chief Executives of Voluntary Organisations and the National Council for Voluntary Organisations

EXECUTIVE SUMMARY

As organisations which represent the interests of the charity and voluntary sector, we welcome efforts to reform the UK banking system to enhance stability and integrity and encourage competition. The charity sector holds around £18 billion in cash deposits; protecting this money is of the utmost importance.

The purpose of this submission is to reiterate our concerns, the unique features of charity banking and the lessons learned from the collapse of the Icelandic banks, and ask that the Commission take these into consideration in their scrutiny of the reforms.

We recognise that the impact of the banking reforms on the charity sector is just one element of what is a vastly extensive undertaking. However, in scrutinising the impact and effectiveness of the reforms it is important that charities are recognised as a distinct category of customer with unique needs. We are concerned that failing to do so could result in unintended negative impacts on the charitable sector further down the line.

Many charities held money in the Icelandic banks and were affected by their collapse in 2008. In the aftermath of the Icelandic banking crisis, we have had a number of concerns with the banking system and protections in place for charities:

- Charities have a unique set of requirements when it comes to banking. Their funding structure, public benefit function and activities all mean that they bank differently from other classes of customer (for example, individuals and businesses), however the protections in place for charities (i.e. FSCS coverage) does not recognise the distinctive nature of charity banking.
- In the period following the crisis it became apparent that there was a clear gulf between charities' exposure to risk and capacity to manage it, and their level of protection. This was also acknowledged by the Treasury Select Committee during their inquiry into the banking crisis.
- The depositor preference principle laid out in the draft Bill fails to recognise the unique position of charities and in fact increases risk by pushing them further down the creditor hierarchy. Our proposed solution was to grant charities preferred creditor status, so that charity deposits ranked alongside those of the FSCS in the event of bank failure.

These concerns were outlined in our response to the Banking Reform white paper, however HM Treasury did not adopt our recommended solution as it was felt extending depositor preference would dilute key aims

¹⁰ For instance, the Bank and FSA recently drew attention to the inherent incentives to excessive risk-taking at shareholder-owned plc banks, stating in The PRA's approach to banking supervision: "When a firm is owned by private shareholders whose stake is leveraged through borrowing from depositors and other creditors, the owners will tend to have an incentive to take on more risk than is in the interests of the firm's creditors. That is because shareholders, although the first bearers of loss, typically have limited liability in the event of failure but enjoy the unlimited upside associated with successful risk-taking."

of the policy and reduce the alignment between risk and reward in investment decisions. The need for fairer protection for charities therefore remains and we believe that it is essential that these concerns are considered during the process of pre-legislative scrutiny and the current focus on banking reform.

1. WHY WE ARE SUBMITTING EVIDENCE

1.1. This is a joint submission on behalf of Charity Finance Group (CFG), the Association of Chief Executives of Voluntary Organisations (ACEVO), Charities Aid Foundation (CAF) and the National Council for Voluntary Organisations (NCVO). Our organisations represent charity finance professionals, donors, and the wider voluntary sector.

1.2. We welcome efforts to reform the UK banking system to enhance stability and integrity and encourage competition. However, we have raised a number of concerns with the reforms, principally the impact of depositor preference on charities. Section 4 of this submission outlines our activity in this area.

1.3. We recognise that the impact of the banking reforms on the charity sector is just one element of what is an extensive undertaking. However, the charity sector is a major contributor to the UK economy and supports millions of beneficiaries across many areas of society. This submission sets out some of the features of charity banking, and asks that the Commission consider these in their scrutiny of the reforms. These unique features are the reason why charities were particularly affected by the collapse of the Icelandic banks (as detailed in section 3) and why depositor preference could prove particularly detrimental.

2. THE UNIQUE POSITION OF CHARITIES

Charity funding and the impact of bank failure

2.1. The unique way charities hold and manage funds mean that the impact of losses—for example as a result of bank failure—can be particularly severe.

2.2. Charities typically hold large amounts on deposit (approximately £18 billion across the sector) as they require quick and easy access to cash to ensure service delivery commitments are met or to fund specific long-term projects. Charities therefore stand to lose a lot more, relative to their size, than other creditors who generally have a smaller proportion of their income in the bank, and a much more fluid cash flow.

2.3. To give an example, one large London-based charity holds around £50–60 million on deposit, which is around 100% of turnover. Another holds £25 million on deposit, approximately 40% of turnover. Most charities (particularly the large ones like these) split deposits between carefully-selected banks to manage the risk; however this can still mean millions in one bank in some cases.

2.4. Charities' funding arrangements are also unique in that they hold a mix of unrestricted funds, which a charity can choose to spend as they wish, and restricted funds, which are given and can be used only for a specific purpose, e.g. DfID funding for a project in Malawi. This separation means the impact of any losses is often amplified. For example, loss of restricted funds means the shortfall has to be sourced from somewhere else (and if the project is not delivered the funds often have to be paid back) and loss of unrestricted funds will impact on a charity's ability to cover general overhead costs and therefore operate. This strict division of funds therefore means an organisation may be cash rich, yet disruption to just one pot of funding can have serious consequences.

Public benefit function and accountability to the public

2.5. The nature of charitable activities means in many cases the effects of losses are wide-reaching and long-term. Charities must demonstrate that their activities are for the public benefit and ultimately beneficiaries—often the most vulnerable in society—are the ones who lose out. In contrast to the commercial sector, it is extremely difficult for other charities to step in to take on and deliver the services of another if it has closed.

2.6. Unlike businesses or individuals' funds, charity funds are for public, not private, benefit. Charity deposits do not “belong” to the charity—instead the charity is simply the vehicle channelling money from the donor/funder to the beneficiary, and so any losses will impact on both these groups.

2.7. Charities rely on the trust and confidence of the giving public to support them—financially and otherwise. Charities therefore must carefully consider the reputational implications when managing their money and banking arrangements. There are a number of elements to this, including:

- Individuals choose to give to charity on the grounds that the money will be spent as intended. Losing money as a result of bank failure, or a perceived increase in the likelihood of this happening, could impact on an individual's inclination to donate.
- While charities have to spend a proportion on overheads to ensure the efficient running of the charity—and should not shy away from making the public aware of this—charities still have a duty to be extremely careful when it comes to these types of costs (see paragraph 2.9).

Capacity to manage risk

2.8. We would be extremely concerned with any measure that increases banking risks for charity (hence our concerns with depositor preference). In the notes accompanying the draft Bill, HM Treasury reject the extension of depositor preference on the grounds that “[charities and other creditors] are likely to be at least as well positioned to monitor and manage risk as many other groups of senior unsecured creditors”. However, the reality is many charities are not as well positioned as commercial organisations to do so.

2.9. The vast majority of charities manage their finances and risk extremely well, yet most simply do not have the same level of technical banking knowledge and expertise as other creditors of comparable size. Managing increased banking risk is extremely resource-heavy and investing in up-to-the-minute treasury management diverts funds away from frontline services. It is therefore difficult to justify using substantial charitable funds for this purpose, particularly given the challenging funding environment.

2.10. Another aspect of managing risk for charities is the trade-off between risk and return. While this is the key consideration when making all types of investment, for charities the tension between these is particularly pronounced. This is because charity trustees are required to protect charity funds and ensure they are used as intended (making them risk averse) but also have a legal duty of care to achieve the best risk adjusted returns on charitable deposits under the Trustees Act 2000 (which sets out a Trustee’s duty of care and investment powers).

2.11. We would ask that Government keeps this tension in mind when shaping the rules around ring-fencing and the retail-wholesale split. Creating a clear division and choice between greater security (depositing in the ring-fenced area) and higher returns (depositing in the non-ringfenced area) could exacerbate this tension.

3. Impact of the collapse of the Icelandic banks

3.1. For many charities, the banking reforms will be considered in the context of how successfully they address the failures in the system that became apparent following the collapse of the Icelandic banks and financial crisis. In the Treasury Select Committee’s inquiry report the unique position of charities and consequences of this were acknowledged, and it is important that the lessons learned are taken into consideration when shaping the reforms.

3.2. Following a request from CAF and CFG, 48 charities indicated that they had held funds in Icelandic banks that they had not immediately been able to recover. The combined total amount was £86.6 million.

3.3. This data was a conservative indication of the level of impact on the charity sector. Many charities did not want to be named or were reluctant to speak up as they feared it would negatively impact their reputation. Many charities held deposits with Kaupthing, Singer & Friedlander in particular—it was a respected City firm that had long provided bespoke charity banking services.

3.4. In the aftermath of the collapse, there was confusion and frustration around FSCS coverage. Many charities were unaware of whether they were entitled to protection or not, or had assumed they were but were found to be ineligible by virtue of their constitutional/corporate structure. It was extremely difficult to obtain clear advice from the FSCS and the need for greater clarity remains.

3.5. The retail-wholesale split which dictated FSCS eligibility was considered wholly inappropriate and unfair in the charity context. Many charities were deemed “sophisticated” wholesale investors by virtue of their size, and therefore were left without any financial support when others were fully compensated.

3.6. It was widely accepted that charities and others could not have been expected to foresee the crisis, particularly given the Bank of England’s failure to do so and the fact that the credit ratings were only downgraded days before institutions went into administration. For many charities this rendered the fact that they were deemed wholesale depositors and therefore better placed to foresee the crisis even more unjust.

3.7. In the Treasury Select Committee’s inquiry into the impact of the failure of the Icelandic banks, a number of points were raised with regard to the charity situation. We believe that these should be noted when considering the new reforms.

“We recommend that the Government consider the case for providing charities with further statutory guidance relating to the management of a charity’s finances and investments. We further recommend that the Government take steps to clarify what protection is available to charities under the Financial Services Compensation Scheme”.

“We are concerned that one of the tests a charity must pass to be protected under the FSCS definition of a retail depositor is inappropriate for those charities using fixed assets in the course of their work... we recommend that the FSCS re-examine the criteria for the classification of charities as retail or wholesale depositors...”¹¹.

¹¹ This point will be addressed if FSCS protection is extended to all non-financial customers, as it expected when the relevant Directive is enacted. However, we believe the important point to note is that the unique position of charities was acknowledged during the inquiry.

4. OUR POSITION AND ACTIVITY

4.1. Our work on the banking reforms has so far focused on our concerns around the impact of depositor preference on charities, and the effects pushing charities further down the creditor hierarchy in the event of bank failure will have.

4.2. We anticipate that there will be two main impacts as a result of depositor preference: Firstly, charities will stand to recover a smaller percentage of their deposits should a bank fail. The other, more immediate impact and area of concern was that charities would then need to invest substantial resources into mitigating this additional risk.

4.3. More broadly, we were concerned that the proposals failed to recognise the unique nature of charity funding and banking, and undermined one of the reforms' underlying aims that the cost of bank failure should be borne by those best able to understand the risks and who can absorb loss best. Charities are not as well placed as other creditors of a similar size to manage the risks and absorb losses, and many of the perceived benefits of depositor preference (e.g. that it incentivises other creditors to exert discipline on banks' behaviour) would not apply to charities.

4.4. Our proposed solution was to grant charities preferred creditor status, so that charity deposits ranked alongside those of the FSCS in the event of bank failure. We raised this, along with our concerns, in a letter to the minister and in our response to the Banking Reform white paper.

4.5. In the notes accompanying the draft Bill, HM Treasury said that it did not feel there was a compelling enough case for extending depositor preference to charities and that therefore only FSCS -protected deposits would be preferred. While we appreciate the reasons for doing so, and understand that an improved banking system will inherently mean greater protection and fewer risks for all bank users, anything that puts charities in a materially worse situation is extremely concerning. It is important that fairer protections for charities are put in place (see below) and we believe failing to do so would be a missed opportunity.

5. MAKING THE REFORMS WORK FOR CHARITIES

5.1. In addition to granting charities preferred creditor status, we have also made a number of recommendations for making the reforms work better for charities to HM Treasury. In light of their decision not to extend depositor preference it is particularly important that these measures, outlined below, are included.

- Government support for the development of additional training or guidance for the sector on managing banking risk. The standards of financial management in charities are generally high, however managing this type of risk is a niche skill and charities could benefit from clear information and support on how to manage exposure and make the most of the current protections in place.
- Ensuring the FSCS provide greater clarity on which charities are protected and to what extent. While the quality of the information provided has improved since the collapse of the Icelandic banks, progress is still needed in this area.
- There needs to be greater transparency around the ownership of banks and how this impacts on levels of FSCS protection. Depositors may think that they are splitting their deposits to effectively manage risk and ensure full FSCS protection, however if the financial institutions fall under the same savings compensation licence the depositor will only be eligible for £85,000 across both. Financial institutions must be forced to be much more explicit about whether their protections fall within the same compensation licence as another "parent" bank.
- The banking reforms will result in significant changes to the way banks are run and what will happen in the event of bank failure. Government must clearly communicate what these changes are and exactly what they will mean in practical terms. The impact of depositor preference and ring-fencing, for example, will change levels of risk for charities; however few are aware of what effects the changes may have on their organisations. The information needs to be clearly communicated, and must come directly from Government.

31 October 2012

Written evidence from Davis Polk & Wardwell LLP

1. INTRODUCTION

1.1 Davis Polk & Wardwell LLP welcomes the opportunity to make this written response to the Parliamentary Commission on Banking Standards' pre-legislative scrutiny of the Government's draft Financial Services (Banking Reform) Bill.

1.2 We are a global law firm headquartered in New York and have long been involved in the policy debates surrounding the appropriate structures for the financial sector and individual institutions as well as the architecture of financial legislation and regulation.

1.3 Our current partners worked on many of the transactions, regulatory interpretations, and court cases involving the Glass-Steagall Act in the 1980s and 1990s and the repeal of certain portions of the Glass-Steagall

Act by the Gramm-Leach-Bliley Act of 1999. Since the financial crisis, as part of our representation of many of the UK and US banks that were in difficulty, we have worked extensively on the Dodd-Frank Act and its implementing regulations, with an emphasis on the Volcker Rule; the enhanced capital, liquidity, risk management and other prudential standards designed to reduce the riskiness of the financial system while encouraging a healthy supply of credit, other financial products and services, job creation, and economic output; and the recovery and resolution planning of many US and foreign financial institutions.

1.4 Past partners who have left us their historical files, which we have recently had occasion to consult, advised the major US banks during the creation of the Federal Reserve in 1913 and the enactment in 1933 of the Glass-Steagall Act, the provisions that formed the core of what later became the Federal Deposit Insurance Act, and Section 23A of the Federal Reserve Act.

1.5 We have also recently advised clients on the final report of the UK Independent Commission on Banking (the Vickers Report) and the Government's white paper response as well as on the final report of the High-level Expert Group on reforming the structure of the EU banking sector (the Liikanen Report).

1.6 In various capacities, we represent or have close contact with virtually all of the largest UK and US banks and bank holding companies and so bring both a historical perspective as well as our recent experience to the issues being considered by the Commission.

1.7 As the Commission will no doubt receive written evidence from many interested parties who are better placed to address many of your questions at a greater level of technical specification for UK law and regulation, we will focus our comments on the relevant lessons from the US experience that should be applicable to your considerations around adopting legislation to implement the Vickers recommendations.

2. EXECUTIVE SUMMARY

2.1 The retail ring-fence concept, if properly implemented, is a more effective, resilient, and workable structural arrangement than the Volcker Rule or the portions of the Glass-Steagall Act that were repealed and is more consistent with the rest of the Dodd-Frank Act and the portions of the Glass-Steagall Act and related provisions, such as Sections 23A and 23B of the Federal Reserve Act, that remain in effect.

2.2 Any ring-fence model should be implemented with regulatory flexibility. In the process of creating an entirely new system, it is not possible to anticipate all potential interactions and outcomes. Thus, building in flexibility for regulators is a prudent approach, as illustrated by the exclusion of commonly controlled insured banks from the numerical limits in Section 23A of the Federal Reserve Act and the effective use during the 2008 financial crisis of temporary waivers of the numerical limits that are otherwise applicable to transactions between insured banks and their nonbank affiliates.

2.3 The post-financial crisis experience in the US shows that implementing structural change, particularly drawing definitional lines, is much more difficult than anticipated and should be approached with a measure of caution and humility.

2.4 The new corporate governance arrangements that have been proposed for the ring-fenced bank and its wider group should be approached with some degree of regulatory flexibility. It may be instructive to consider the use of bank board committees consisting primarily or solely of independent directors to review and monitor group policies affecting the ring-fenced bank and transactions between the ring-fenced bank and other members of the group.

2.5 Regarding the intra-group restrictions proposed for the ring-fenced bank and its corporate group, a certain amount of regulatory flexibility should be built into the system. As a matter of public policy, rigid numerical limits should only apply to transactions between a ring-fenced bank and its nonbank affiliates; a more flexible standard should apply to transactions among commonly controlled retail banks and wholesale banks. In addition, regulatory authorities should have the discretion to provide a temporary waiver of any otherwise applicable numerical limits during a financial panic when ordinary markets are dysfunctional.

3. KEY PRINCIPLES AND RECOMMENDATIONS

3.1 We would like to highlight three overarching principles that we believe are key considerations in relation to the draft Financial Services (Banking Reform) Bill and, indeed, any major piece of legislation that seeks to make radical changes to the structure of the financial sector. Our responses to certain of the specific questions set out by the Commission build upon these principles.

Principle 1: The retail ring-fence concept, if properly implemented, is superior to the Volcker Rule and the portions of the Glass-Steagall Act that were repealed and is more consistent with the rest of the Dodd-Frank Act and the portions of the Glass-Steagall Act and related provisions that remain in effect.

3.2 We believe that, if appropriately implemented, the retail ring-fence concept is a more effective, resilient, and workable structural arrangement than the Volcker Rule or the portions of the Glass-Steagall Act that were repealed and is more consistent with the rest of the Dodd-Frank Act and the portions of the Glass-Steagall Act and related provisions, such as Sections 23A and 23B of the Federal Reserve Act, that remain in effect.

3.3 The Glass-Steagall Act had two main effects:

- (1) it prohibited US insured banks from underwriting, dealing, or market making in corporate debt and equity securities, while preserving their ability to:
 - (A) underwrite, deal, and market make in US government and agency securities and certain other securities, as well as financial instruments not considered to be securities for purposes of the US banking laws such as loans, collateralized debt obligations, and derivatives;
 - (B) buy and sell corporate debt and equity securities for bona fide hedging purposes, subject to certain conditions;
 - (C) act as an agent or riskless principal in securities brokerage transactions; and
 - (D) buy and sell high-grade corporate debt securities, provided that such buying and selling does not amount to dealing or market making in such securities; and
- (2) it prohibited US insured banks from having affiliates that were “engaged principally” in underwriting, dealing, or market making in corporate securities.

The portion of the Glass-Steagall Act that prohibited insured banks (as opposed to securities affiliates) from underwriting, dealing, or market making in corporate debt or equity securities was *not* repealed by the Gramm-Leach-Bliley Act and remains in effect today. The portion of the Glass-Steagall Act that prohibited insured banks from having certain securities affiliates was repealed by the Gramm-Leach-Bliley Act of 1999.

3.4 Section 23A of the Federal Reserve Act complements the portion of the Glass-Steagall Act that remains in effect. It limited, and continues to limit, the ability of insured banks to enter into certain transactions with their affiliates, including their securities affiliates, to the extent that such transactions expose the banks to what is considered to be an excessive amount of the credit or certain other risks of their affiliates.

3.5 Section 23A is not a flat prohibition on all such risk-taking by US insured banks and never was. Instead, it attempts to limit such risk to a manageable level. It imposes both numerical limits and collateral requirements on exposures to *nonbank* affiliates. It also imposes a general “safety and soundness” requirement on exposures to all affiliates, including bank affiliates. The numerical limits include a limit on exposures to any single nonbank affiliate equal to 10% of the insured bank’s total capital and a limit on exposures to all nonbank affiliates in the aggregate equal to 20% of total capital. Credit exposures must be fully secured by high-quality collateral.

3.6 Section 23A permits the numerical limits to be waived in emergency situations, and they were temporarily waived during the 2008 financial crisis, subject to certain conditions, including that all such transactions be on market terms and all credit exposures be fully collateralized.

3.7 Section 23A does not (and never did) impose numerical limits or collateral requirements on transactions among insured banks that are commonly controlled at a level of 80% or more. Instead, exposures among such commonly controlled banks are subject only to the more flexible “safety and soundness” requirement. The safety and soundness requirement provides that all intra-group exposures be “consistent with safe and sound banking practices.”

3.8 Section 23B of the Federal Reserve Act was added in 1987 to supplement Section 23A. Section 23B requires that all covered transactions between an insured bank and its affiliates must be on market terms, rather than on terms that represent a discount to market.

3.9 The justification for the prohibition on certain activities of insured banks in the portion of the Glass-Steagall Act still in effect and the limits on their transactions with nonbank affiliates in Sections 23A and 23B of the Federal Reserve Act is that insured banks enjoy a federal subsidy in the form of deposit insurance and general access to the Federal Reserve’s lender-of-last-resort liquidity facilities. The quid pro quo for this federal subsidy are these and other restrictions on activities, which are designed to reduce insured banks’ risk of failure.

3.10 Setting aside the Volcker Rule for a moment, the Dodd-Frank Act is designed to enhance and be entirely consistent with this statutory framework. Its general theme is that, in addition to the special limitations on the activities of insured banks, all financial institutions, regardless of their charter, should be subject to the same limitations and requirements to the extent that they engage in the same activities, with certain exceptions for activities taking place outside the United States.

3.11 Thus, for example, all financial institutions are subject to the same rules and regulations if they engage in swap dealing activities or such a large volume of swap transactions that they are considered major swap participants. It does not matter whether they are chartered as banks, broker-dealers, insurance companies, hedge funds, commodity pool operators, or any other type of financial institution. If they are engaged in the defined activity or the defined volume of activity, they are subject to the same regulations.

3.12 This general theme of the Dodd-Frank Act is subject to an important exception for financial institutions that are deemed by statute or determined by regulators to be “systemically important.” Systemically important financial institutions (SIFIs) are subject to enhanced capital, liquidity, risk-management, and other enhanced prudential standards. However, the Dodd-Frank Act mandates that all SIFIs be subject to the same rules, regardless of their charter, with some flexibility for SIFIs that are less systemically important than others.

3.13 The Dodd-Frank Act generally contemplates that US financial regulators will calibrate the required capital, liquidity, risk-management, and other prudential standards to the relative riskiness of particular activities, regardless of a financial institution's charter. Thus, riskier activities will require more capital and liquidity and better risk management, regardless of the institution's charter. Conversely, less risky activities will require less capital and liquidity and less stringent risk management. This framework gives regulators the flexibility to balance the costs and benefits of particular financial regulations—for example, the benefits of a safer financial system against the costs of credit contraction, reduced economic output, and higher unemployment.

3.14 The Volcker Rule was grafted onto the Dodd-Frank Act at the last minute, without sufficient discussion or debate. It is both broader and narrower than the Glass-Steagall Act and is inconsistent with the overall theme of the rest of the Dodd-Frank Act.

3.15 The Volcker Rule is narrower than the Glass-Steagall Act because it does not affect the ability of insured banks to continue having affiliates that are engaged in underwriting, dealing, or market making in corporate securities, except to the extent any such activities amount to short-term "proprietary trading" or investing in hedge funds or private equity funds.

3.16 The Volcker Rule is broader than the Glass-Steagall Act because it flatly prohibits both insured banks and all of their affiliates from engaging in short-term proprietary trading or investing in or having certain relationships with hedge funds or private equity funds. At the same time, it expressly permits insured banks and their affiliates to continue engaging in proprietary trading of US government and agency securities and to continue engaging in otherwise permitted market making and hedging.

3.17 The Volcker Rule is also inconsistent with the general theme of the rest of the Dodd-Frank Act that the activities of all financial institutions should be subject to the same regulation, regardless of their type of charter. Instead, the Volcker Rule applies only to insured banks and their affiliates. It does not apply to other financial institutions unless they are affiliated with an insured bank. These other financial institutions are free to engage in the activities prohibited by the Volcker Rule, regardless of how much systemic risk they impose on the financial system as a result of those activities.

3.18 In addition, the Volcker Rule flatly prohibits some activities—for example, trading in certain highly liquid securities, such as UK and certain other sovereign debt securities or exchange-traded corporate equity securities—even if those activities are safer than certain activities that are permissible under the Volcker Rule. For example, the Volcker Rule does not prohibit banks from making any sort of loans, even though certain types of lending can be far riskier than certain types of short-term proprietary trading. Nor does it impose any restrictions on the ability of insured banks or their affiliates to make long-term investments in any type of securities or other financial instruments, including illiquid securities, mortgage-backed securities, collateralized debt obligations, or credit default swaps, even if such long-term investments are riskier than short-term proprietary trading in such instruments, so long as these long-term investments are not made through a hedge fund or private equity fund and the instruments are not traded with sufficient frequency or intent to amount to short-term proprietary trading.

3.19 The Volcker Rule has proven to be extremely difficult to implement in a way that would not destabilize existing markets or adversely affect the ability of banking entities to manage risk effectively. As a result, the US financial regulatory agencies have been unable to agree upon final implementing regulations despite a statutory deadline of October 2011.

3.20 US regulators have had a particularly difficult time writing regulations that provide a coherent line between short-term proprietary trading, which is expressly prohibited, and market making or hedging, which are expressly permitted. Several governments around the world, including the UK Government, have submitted public comments to the effect that, unless the implementing regulations include a safe harbor for proprietary trading or market making in high-grade sovereign debt securities, the Volcker Rule could disrupt the market in their sovereign debt securities, substantially reducing the liquidity in the market for such securities.

3.21 Numerous other commenters have argued that the lack of robust safe harbors for market making and hedging could destabilize the securities markets generally and have a significant adverse effect on the ability of banking entities to manage risk effectively.

3.22 Proponents of the Volcker Rule typically justify its prohibitions on the ground that US insured banks enjoy the implicit subsidy of deposit insurance and regular access to the Federal Reserve's lender-of-last-resort liquidity facilities. As a result, they argue that insured banks should not be permitted to engage in short-term proprietary trading or investing or to have certain relationships with hedge funds or private equity funds.

3.23 The problem with this argument is that it only provides a justification for applying the Volcker Rule to insured banks. It does not provide any support for extending the Volcker Rule to an insured bank's nonbank affiliates. Those affiliates do not enjoy any federal subsidy because they are not permitted to take insured deposits and do not have regular access to the Federal Reserve's lender-of-last-resort liquidity facilities. Moreover, Sections 23A and 23B of the Federal Reserve Act are specifically designed to prevent insured banks from passing on any material federal subsidy to their nonbank affiliates.

3.24 While the ring-fence concept is not without its shortcomings, we believe that it is a more effective, resilient, and workable structural arrangement than the Volcker Rule or the portions of the Glass-Steagall Act that were repealed and that it is more consistent with the rest of the Dodd-Frank Act and the portions of the Glass-Steagall Act and related provisions, such as Sections 23A and 23B of the Federal Reserve Act, that remain in effect.

3.25 Like the portions of the Glass-Steagall Act that remain in effect, the ring-fence proposal would impose certain activities restrictions on UK retail banks, including a prohibition on proprietary trading, which are designed to reduce their risk of failure. Like Section 23A of the Federal Reserve Act, the UK proposal would also impose limits on the ability of retail banks to enter into certain transactions with their affiliates, although we believe it should be more flexible than proposed for the reasons stated below. Like Section 23B of the Federal Reserve Act, the UK proposal would require all such covered transactions to be on market terms, rather than at a discount to market. The UK proposal would also impose special capital and corporate governance requirements that would further insulate UK retail banks from the risks of their affiliates, although we recommend below that more flexibility be built into such requirements. While the distinction in the UK will be between retail banks and other financial institutions (including wholesale banks), rather than between insured banks and nonbank affiliates, the intent and effect will be similar.

3.26 Unlike the Volcker Rule, the UK proposal would not require the sort of line-drawing between short-term proprietary trading, on the one hand, and market making or hedging, on the other, that has created so many problems for the US regulatory authorities. Like the portion of the Glass-Steagall Act that is still in effect, it would prohibit UK retail banks from engaging in both proprietary trading and market making and provide more regulatory flexibility to distinguish between these activities and permissible hedging. It would not prohibit the wholesale affiliates of a UK retail bank from engaging in proprietary trading, market making, or hedging.

3.27 There is a risk, however, that a ring-fence may be implemented in too strict or rigid a manner or in such a way as to make it difficult to attract capital to the wholesale affiliates. We therefore think that any ring-fence should be implemented following the two principles we suggest below: flexibility and a healthy humility about the difficulty of implementing structural change.

Principle 2: Importance of incorporating flexibility into structural change.

3.28 In the process of creating an entirely new system, it is not possible to anticipate all potential interactions and outcomes; thus, contrary to Chairman Volcker's recent testimony, we believe that building in regulatory flexibility is a prudent approach.

3.29 Although promising, the concept of the ring-fenced bank is entirely new in the UK and the EU and is untested in practice. Its implementation also comes at a time when other major elements of financial regulation in the UK, EU, and US are being materially changed and are in flux.

3.30 Moreover, the shift to the ring-fenced bank will occur mid-stream, amid the full and regular functioning of global capital markets. In contrast, major US banks had already stopped securities underwriting when the Glass-Steagall Act was first implemented in the depths of the Great Depression. Similarly, the structural foundation for the partial repeal of the Glass-Steagall Act by the Gramm-Leach-Bliley Act of 1999 was established slowly and well in advance. In the current situation, however, there will be no such luxury of a pause in the marketplace or the benefit of a gradual, ongoing development of such a structural shift.

3.31 We believe the importance of regulatory flexibility is well illustrated by the US experience during the last financial crisis with temporary waivers of the numerical limits in Section 23A of the Federal Reserve Act that would otherwise have applied to transactions between insured banks and their nonbank affiliates. We discuss this example of flexibility in further detail in response to Question 18.

3.32 Although there are rightful concerns about regulatory and cognitive capture, creating a new structural framework without significant regulatory flexibility is equally unwise, especially given all of the possible unintended consequences. We therefore recommend that as much flexibility as possible be given to the Treasury, the Prudential Regulation Authority, and the Financial Conduct Authority, with a recognition that "[t]here are known knowns ... We also know there are known unknowns ... But there are also unknown unknowns" (Rumsfeld). Flexibility is an indispensable tool for dealing with the "unknown unknowns" of the ring-fence model or any other significant change in the structure of financial institutions and their regulation.

Principle 3: Recognition of the difficulty of implementing structural change.

3.33 The post-financial crisis experience in the US shows that implementing structural change, particularly drawing definitional lines, is much more difficult than anticipated and should be approached with a measure of caution and humility.

3.34 By now it is well-known that the implementation of many of the changes mandated by the Dodd-Frank Act is taking far longer than anticipated. Out of a total of 237 Dodd-Frank rulemaking requirement deadlines that had passed as of October 1, 2012, regulators had missed 149 deadlines, or approximately 63%, according to Davis Polk's October 2012 Dodd-Frank Progress Report.

3.35 Ascribing these delays and difficulties only to regulatory advocacy by the banking sector or other stakeholders is not credible. Nor is it appropriate to blame the regulators for taking more time than the legislature initially contemplated once it became clear that implementation was more difficult than envisioned.

3.36 Major structural change in the banking sector is extremely challenging and getting it wrong can disrupt economic recovery.

3.37 It is not a surprise, for example, that the Volcker Rule and its proposed regulations are running far behind schedule. Notwithstanding the simplicity that Chairman Volcker has ascribed to his rule, it has proven very difficult to draw lines around the concepts of short-term proprietary trading and market making in order to distinguish prohibited from permitted transactions as required by the Volcker Rule's transaction-focused approach.

4. Question 14: *Is the range of core and excluded activities defined in the draft Bill appropriate and sufficiently broad? Are the Government's stated intentions for using powers to define further core and excluded activities appropriate?*

4.1 Please see our core principles outlined above, in which we suggest that built-in regulatory flexibility is appropriate, especially in light of the fact that implementing structural change takes far longer than anticipated. We believe it is appropriate to begin with retail deposits as the sole core activity, but regulatory flexibility may be needed over time.

5. Question 17: *Are the proposed corporate governance arrangements between the ring-fenced bank and the wider group sufficient to ensure the independence of the ring-fenced bank? Are these arrangements compatible with directors' duties and principles of accountability?*

5.1 Based on the US experience, we believe it would be wise to approach these new corporate governance arrangements with some degree of regulatory flexibility. We do not believe that establishing separate, independent boards at the holding company, the ring-fenced bank, and the non-ring-fenced bank will be conducive to effective management of what will remain integrated groups from both a financial reporting and a market perspective. It may be better to consider alternatives, such as including some independent board members, rather than a majority, on the ring-fenced bank's board of directors.

5.2 In the post-financial crisis US, supervisors have engaged in informal efforts to strengthen the quality of board members at the largest bank holding companies and banks. At the subsidiary bank level, there are specific regulatory requirements for independent directors to be represented on a bank's audit committee. Depending on the size of the bank, the audit committee may be required to consist solely of independent directors or to have a majority of independent directors. It is not generally the case, however, for the full boards of bank holding companies or banks to have a majority of independent directors. Moreover, it is neither a requirement nor customary business practice for nonbank affiliates, such as broker-dealers, to have independent board members.

5.3 If a ring-fenced bank is part of a larger banking or financial group, we do not think it is realistic for the board of directors of that bank to be fully independent of the parent company of the group. In the US, the regulatory expectations for the board of directors of a bank that is part of a larger banking or financial group include, as part of fulfilling the board's duty of loyalty to the bank, the protection of the bank in its dealings with the rest of the group. To that end, a bank's board must review bank holding company policies that affect the bank to ensure they are appropriate for the bank and must carefully monitor transactions between the bank and its nonbanking affiliates, including the payment of dividends to the parent company, extensions of credit, and purchases of assets. Discharging these obligations may be facilitated by providing for a bank board committee, such as the audit committee or a risk committee, of which independent directors are either the only members or a majority of the members, to be primarily responsible for reviewing and monitoring such transactions and policies.

5.4 An alternative to requiring full independence of a bank subsidiary board is to require directors of an insured bank to take into consideration the interests of stakeholders other than shareholders in discharging their duties. This is, in fact, the approach generally taken with respect to the duties of the directors of insured banks in the United States. For most US companies incorporated under Delaware law, directors' duties focus on the best interests of the corporation and its shareholders. However, it has long been the position of the Office of the Comptroller of the Currency, which is the federal chartering authority and primary federal banking supervisor for national banks (which include the largest US banks), that the directors of an insured bank owe duties not only to the bank and its shareholders, but to a range of other stakeholders, including insured depositors. Similarly, the banking law of New York state, under which many major state-chartered banks are chartered, specifically provides that bank directors may take into account various constituencies and factors, including the bank's customers, its creditors, and its ability to continue to provide services to the communities in which it does business.

6. Question 18: *How appropriate are the proposed restrictions on exposures and operational dependencies between the ring-fenced bank and the rest of the group? Will these result in a sufficient degree of independence and resilience?*

6.1 Once a country moves to a system that separates a protected banking entity—i.e., the insured bank in the US and the ring-fenced bank in the UK—from its affiliates and limits the powers and activities of each on the policy basis that the protected entity needs to be separated and insulated from activities deemed to be riskier and appropriate only for the affiliate, it is a necessary corollary that there must be a system of principles and rules governing the relationships among the affiliates.

6.2 In the US, we view the core purpose of such rules as designed to protect the insured bank from being exposed to an excessive amount of the credit and other risks of its affiliates, especially its nonbank affiliates, and to prevent insured banks from passing on any material federal subsidy to their nonbank affiliates.

6.3 The proposed UK intra-group restrictions are also focused on the goal of protecting the ring-fenced retail bank from being exposed to an excessive amount of the credit and other risks of its wholesale bank and nonbank affiliates.

6.4 Although the UK intra-group numerical limits of 25% of a ring-fenced bank's total capital appear to be somewhat less restrictive than the numerical limits in Section 23A of the Federal Reserve Act, we believe that they could turn out to be unduly restrictive under certain circumstances unless they are limited to transactions between a ring-fenced bank and its *nonbank* affiliates and some flexibility is built in for waivers during financial panics when ordinary markets are dysfunctional.

6.5 As noted above, the numerical limits in Section 23A have never applied to transactions among FDIC-insured banks that are commonly controlled at an 80% or more level, even if one of the insured bank affiliates engages in riskier activities than the others, such as riskier lending activities or underwriting, dealing, or market making in financial instruments not considered to be securities for purposes of the US banking laws, including loans, collateralized debt obligations, or derivatives. Instead, transactions between such commonly controlled insured banks are subject only to a more flexible safety and soundness requirement. This more flexible approach for transactions between commonly controlled insured banks has worked well since 1933, including during the financial crisis of 2008.

6.6 We believe that such a flexible standard is more appropriate for controlling the exposures of ring-fenced retail banks to the credit or other risks of wholesale bank affiliates. Under such a standard, numerical limits would be permitted but not required. Instead, the main tools for limiting the exposures of ring-fenced retail banks to their wholesale bank affiliates would be appropriate collateral requirements as well as requirements that transactions be made on market terms, rather than at a discount to the market.

6.7 We also believe that UK regulatory authorities should have the flexibility to waive any numerical limits when appropriate, including during financial panics when ordinary markets are dysfunctional. During the 2008 financial crisis, for example, when the broker-dealer affiliates of the largest US insured banks suffered a run on their short-term repo financing and otherwise encountered severe liquidity difficulties, the Federal Reserve granted temporary waivers to the numerical limits in Section 23A, allowing insured banks to make fully secured liquidity available to their affiliated broker-dealers on market terms in excess of the normal intra-group numerical limits. These liquidity facilities were repaid without losses.

6.8 Although the Dodd-Frank Act imposed additional conditions on such exemptions (i.e., they can no longer be granted unilaterally by the Federal Reserve, but must be found by multiple regulators to be “in the public interest” and consistent with the purposes of Section 23A and are subject to veto by the FDIC), it nonetheless retained an explicit process for waiving the limits in certain circumstances. The UK proposal, on the other hand, does not explicitly provide for any sort of safety valve mechanism to temporarily lift the intra-group numerical restrictions when the financial system is in distress.

6.9 Our strong recommendation is that a waiver authority, which should involve an appropriate process and safety backstops, is necessary and should be set out in any subsequent legislation.

6.10 We believe that the waiver mechanism also should permit other members of the corporate group outside the ring-fence to provide assistance to the ring-fenced bank in a period of stress. If the ring-fenced entity finds itself in trouble and the parent company or an affiliate has the capacity to provide assistance, as a matter of public policy, the “independence” requirements of the ring-fence model should not preclude those entities outside the ring-fence from offering assistance to the struggling ring-fenced bank.

7. Question 19: *Will it be possible to effectively monitor and police the ring-fence, given the degree of regulatory discretion the draft Bill proposes?*

7.1 Please see our comments on flexibility above.

8. Question 23: *The draft Bill gives the Government power to direct the way in which the regulators can implement loss-absorbency requirements. How appropriate and well-designed is this power?*

8.1 Please see our comments on flexibility above.

9. Question 30: *What will be the impact of the proposals on the international competitiveness of UK banks?*

9.1 To maintain the competitiveness of UK-based banks and the City, the ring-fence model must be structured and implemented with as much flexibility and attention to international coordination and harmonization as possible.

10. Question 31: *Are the proposals consistent with existing and forthcoming international and EU regulatory initiatives, for example the recent Liikanen Report? To what extent are they likely to be superseded or generate conflicts?*

10.1 The UK proposal, the Liikanen proposal, and the Volcker Rule (both in its statutory form and under proposed regulations) all aim to achieve the same general policy goals: changing the culture of banking, separating higher-risk activities from an insured bank, and aiming to avoid taxpayer funding of the banking sector in the next financial crisis.

10.2 Agreement on goals, however, has not led to agreement on the architecture of financial regulation to achieve these goals. We urge the Commission not to be swayed by reports in the media or the diplomatic statements of some policymakers who say that the retail ring-fence proposals are overwhelmingly similar to the Volcker Rule or a return to the Glass-Steagall Act.

10.3 As we have discussed above, there are major differences among the retail ring-fence models and the Volcker Rule that exist at a fundamental level and not merely in the sense that “the devil is in the details.” The outlier, however, is the Volcker Rule, which, as explained above, sits uneasily within the Dodd-Frank Act’s larger framework and will coexist even more uneasily with the retail ring-fence models.

31 October 2012

Written evidence from the Delegated Powers and Regulatory Reform Committee, House of Lords

INTRODUCTION

1. The Commission was requested by the Parliamentary Commission for Banking Standards to consider the provisions in the draft Financial Services (Banking Reform) Bill that delegate legislative power. HM Treasury has provided a memorandum on the powers in the draft Bill. These powers include powers to amend or modify Acts of Parliament at Clauses 4 (new section 142K), 6 and 12. They also include powers at Clauses 4 (new section 142H) for existing regulations to make rules, but, as the memorandum explains, this is largely the nature of a duty on the regulator to exercise its powers to make rules in a particular way.

2. Overall, our consideration picked up two consistent themes: a lack of appropriate Parliamentary control; and a lack of explanation for some significant powers contained in the draft Bill. We had particular concerns about delegated powers in clauses 4 and 9 that the Commission may wish to consider, with the rules relating to clause 4 the most significant.

Clause 4—New Sections 142A and 142B FSMA: Ring-fenced bodies and core activities

3. New section 142G of the Financial Services and Markets Act 2000 (“FSMA”) prevents a “ring-fenced body” from carrying out an “excluded activity”. Under new section 142A(1) a ring-fenced body is a UK institution which has a Part 4A permission relating to a “core activity”. “Core activity” is explained in section 142B.

4. There are three powers relevant to whether or not an institution is caught by the provisions relating to ring-fenced bodies:

- (a) section 142A(2)(b) enables an order by the Treasury to exempt classes of institutions;
- (b) section 142B(2) enables an order by the Treasury to specify circumstances in which accepting deposits is not a core activity; and
- (c) section 142B(5) enables an order by the Treasury to specify activities (in addition to accepting deposits) that are core activities.

5. So the policy discernable from the Bill is that institutions (other than building societies) that accept deposits will, unless the Treasury makes an order to the contrary, be caught; and that institutions (other than building societies) carrying on any other regulated activity will be caught if the Treasury makes an order to that effect. Before making an order, the Treasury must form a particular opinion stated in the Bill (sections 142A(3) and 142B(3),(4) and (6)), though it was unclear to us what opinion had to be formed before making an order reversing the effect of an earlier order. This seems hardly the most robust of frameworks, but may not be surprising in the context of FSMA. For instance, whether an activity is a regulated activity at all under

FSMA is determined largely by orders made by the Treasury (section 22). So the powers do not seem inherently inappropriate. But there are questions about Parliamentary control.

6. Since the exercise of any of these powers is central to the scope of section 142G, the Committee would have expected the affirmative procedure in all three cases—between them the powers operate as a switch by means of which the Treasury may bring institutions within, or exclude them from, the ring-fencing regime. However, only the negative procedure applies, except in the case of section 142A(2)(b), where the first order, and any other subsequent orders which restrict or remove an exemption, are subject to affirmative procedure.

7. In relation to section 142A(2)(b), paragraph 11 of the memorandum explains that the power will determine the scope of the ring-fencing regime and rightly draws the analogy with section 38 of FSMA, which is subject to similar provisions for Parliamentary control. We accept that the choice of procedure for section 142A(2)(b) is founded in precedent in FSMA itself. However, the procedure chosen is based on the assumption that removing control needs a lower level of Parliamentary scrutiny than imposing it and we do not consider that the assumption may be so easily made here where important issues of public policy may be at stake.

8. As for the other two powers, we were not persuaded by paragraphs 12 to 24 of the memorandum that the negative procedure is appropriate. Certainly, the possible need for urgency (paragraph 24 of the memorandum) cannot be accepted as a justification, since FSMA itself deals with urgency in other affirmative cases by means of the 28-day “made affirmative” procedure (ie in force immediately but lapses if not approved within 28 days.)

9. Similar considerations apply to the power at sections 142D(2) and (4) (excluded activities) and 142E(1) (prohibitions). These ought all in our view to be subject to affirmative procedure.

Clause 4—New Section 142F: Supplementary Powers

10. New section 142F expands the powers in each of sections 142A, 142B, 142D and 142E so that they may be used to do things which otherwise would not necessarily be covered. This is explained at paragraphs 52 to 56 of the memorandum.

11. Clause 142F is extremely significant. Among other things, it enables an order:

- to confer powers on the Treasury or on a regulator;
- to require the regulator to make rules;
- to authorise the making (by anybody) of other instruments for purposes connected with any provision of the order;
- if it authorises the regulator to make rules, to enable the Treasury to control the content of the rules (section 142F(2)).

12. So, for example, an order could authorise the Treasury to make regulations or give directions for the purposes of the order, without a need for Parliamentary procedure, thus relegating parts of the material covered by the order to an instrument free of any Parliamentary control. We were not convinced that this is appropriate.

Clause 4, New Section 142J FSMA

13. New section 142J, explained at paragraphs 69 to 74 of the memorandum, enables the Treasury, by order subject to negative procedure, to dictate how a regulator is to use its power in one specific area (debt instruments). This seems appropriate, as one would expect a degree of Parliamentary control over back-seat driving of this sort by the government. But the order may (new section 142J(4)(e)) confer power on the Treasury to give directions, not subject to any Parliamentary control, to the regulators. This is mentioned, but not justified, at paragraph 72 of the memorandum. We normally require a full and convincing justification for power which may be used to circumvent Parliamentary control and we were not convinced on this occasion.

Clause 4, New Section 142K FSMA

14. Paragraphs 75 to 79 of the memorandum explain this Henry VIII power, subject to affirmative procedure, to amend legislation relating to groups of companies, etc. Paragraph 79 acknowledges that this is a wide power, but paragraph 78 does little more than explain that this wide power would be “helpful”. We acknowledge that there may be specific areas of law, such as VAT, which may need to be modified, but we considered it more appropriate for those to be identified more clearly in the Bill itself, leaving it to the delegated legislation to make the detailed modifications needed for the purpose stated in the draft Bill.

Clause 9—Fees

15. Clause 9 inserts two new sections into FSMA, enabling the Treasury by regulations subject to affirmative procedure to give itself power to levy fees via the regulators (but payable by authorised persons, i.e. the industry). The fees are to cover the Treasury’s expenses in connection with their participation in the activities of international organisations (to be prescribed by regulations subject to negative procedure.)

16. The power is explained at paragraphs 90 to 100 of the memorandum. The significant feature is that Parliament will have no control over the amount of the fees or over who from among those specified in new

section 410A(8) will have to pay them. This is done by a combination of directions by the Treasury and the regulators' rules, neither of which are subject to any form of Parliamentary procedure, though the directions must be laid before Parliament. This may be one way of doing things. But we would see no convincing reason why the content of the proposed regulations under sections 410A(1), which would give the Treasury themselves the power to require payment of fees, could not be in the Bill itself. Whilst we would not say it was necessarily inappropriate, the four tier structure—Act; affirmative regulations; directions; rules—did call perhaps for a fuller explanation.

1 November 2012

Written evidence from the Financial Reporting Council

SUMMARY AND INTRODUCTION

1.1 The Financial Reporting Council is an independent regulator responsible for conduct and standards setting in the fields of accounting audit, actuarial practice and corporate governance. As sponsor of both the UK Corporate Governance Code and the Stewardship Code we are charged with promoting high standards of governance across all sectors, including banking. One reason for the introduction of the Stewardship Code was to address the weaknesses in governance that contributed to the banking crisis.

1.2 Our response to the call for evidence makes three- main points:

- While we recognise the need for tighter regulation of banks, it is important that this is not done in a way that puts up barriers to the further provision of capital. Making shareholder control rights less powerful and relevant would act as a disincentive to shareholders' engagement and monitoring and limit their interest in providing additional capital.
- Governance arrangements for ring fenced banks need to allow for accountability via the group to the ultimate shareholders. We believe this is best achieved by explicitly allowing the group to appoint the board of the ring-fence bank within the independence requirements and other parameters set out in the rules.
- There needs to be more recognition of and debate about the risks to the investibility of banks from the provision of bail-in debt. The Commission is well placed to open discussion on the extent to which widespread use of bail-in debt would change the hierarchy of rights among all holders of bank capital, including its possible impact on control rights and the practicalities of using bail-in debt to remunerate bank executives.

SPECIFIC RESPONSE

2.1 Our approach to banking is guided by the belief that regulation imposed in the wake of the banking crisis should not only make banks safer in systemic terms and therefore less at risk of requiring taxpayer support. It should also make them attractive to those with long term capital to invest. Unless they are able to attract new capital, they will not be able to support economic growth through lending to business.

2.2 Since most banks are now trading below book value, there is a problem with investibility. Ring fencing, which is primarily focused on the first objective, should be designed in a way which alleviates this problem, or at least does not aggravate it.

2.3 The Financial Reporting Council has a responsibility to promote good governance and this response is therefore focused on Question 17 of the call for evidence, which asked whether the governance arrangements will secure the independence of the ring fenced bank, and whether they are compatible with directors' duties and accountability. Critical to good governance are the procedures for appointing the directors of the ring fenced bank and the need for a clear chain of accountability to the group shareholders who provide its capital.

2.4 The purpose of the ring fence, as we understand it, is to make it easier for the authorities to intervene effectively in times of trouble, to prevent losses in one part of the business contaminating the other, especially that part of the business which would require state support because of its systemic importance, and to be able a bank to be resolved without affecting depositors and the operation of the payments system.

2.5 It should not be assumed, however, that the ring fenced banks will be intrinsically safer than the remainder of the group. Retail banks are periodically subject to large losses. Indeed property lending, which would be a legitimate activity for a ring fenced bank, was a significant reason for the collapse of Northern Rock, and HBOS.

2.6 In neither of these cases were there large losses from investment banking activities. Were such situation to arise again in a ring fenced bank, it is important that the authorities do have the option to orchestrate a recapitalisation via the market. This will be much harder if investors are being asked to put money into an organisation where they have no effective control rights. A ring fenced bank will also need access to capital in order to support its lending on a continuing basis.

2.7 However, the proposals, as they stand, do not properly recognise this point. The draft bill states that governance arrangements should secure as far as possible the ability of the ring-fenced bank to act

independently of other members of the group. However, in its original proposals government envisaged that the ring-fenced bank should treat, and be treated by, other members of the group as a third party. It is to have a separate legal entity and meet capital and liquidity requirements on a standalone basis. Ring fenced banks should therefore have a separate board with a chairman who is independent on appointment. Half the members of the board must be independent, which means they may have no material relationship with the group. No more than one third of the board may be representatives of the rest of the group. There is a strong case, the government has argued, for ring-fenced banks having their own committees, in particular regarding risk and possibly nomination and remuneration.

2.8 We fear the market may be uncomfortable about the extent to which such procedures could divorce shareholders from the business which they would still own. If the board of the ring fenced bank is separate from the group and separately appointed, it cannot be accountable—directly or indirectly—to the shareholders of the group.

2.9 One of the generally accepted lessons from the banking crisis is the importance of shareholder engagement. This approach would move us a step backwards in terms of stewardship if it excludes any possibility of shareholder challenge and influence over the ring fenced bank.

2.10 The final arrangements therefore need to address important questions about the position of the ring-fenced bank within the group and the balance of regulatory powers with shareholder rights. Regulators already have the ability to veto the appointment of unsuitable individuals to board positions and to demand a certain level of capital. It is right that this should continue to apply within the ring fenced structure, but there does also need to be a clear line of accountability to shareholders who will wish to be satisfied that the ring-fenced bank complies with the overall group strategy and risk appetite.

2.11 We consider that the problem could be addressed by making it explicit that the group remains responsible for appointing the directors of the ring-fenced bank subject to both the FSA approval process and achieving the balance of independence laid down in the proposals. There are a number of examples in the financial services sector where similar arrangements already apply and groups have appointed independent directors to subsidiaries. In such cases the group board can be accountable to group shareholders for its stewardship of the subsidiary while still retaining an effective ring-fence.

2.12 The key to independent governance will be the composition of the board and a requirement on board members to act in the interests of the ring-fenced bank and protect the ring fence. These are reasonable duties, but the Companies Act 2006 also states (Section 172) that directors have a duty to promote the success of the company for the benefit of its members as a whole. This responsibility to shareholders cannot be ignored and must exist at least in tandem with duties of directors to support the ring fence. Otherwise the ring fenced bank would be operating in a vacuum, accountable to nobody, except perhaps the regulators.

2.13 Meanwhile Question 32 invites respondents to suggest other matters that the Commission should take into account. The Liikanen Report has proposed a greater use of bail-in debt to bolster bank capital. It has also suggested that it be used to remunerate bank executives. The Commission may wish to consider some governance issues arising from this.

2.14 First, it is expected that holders of bail-in debt will actively monitor and engage, but because they lack control rights, they have no effective power to influence management. Moreover the debt securities they are holding are likely to be substantially less liquid than equity shares, and debt holders therefore lack an orderly exit opportunity. The question therefore arises as to whether consideration should be given to the extension of some control rights to bail-in debt holders in proportion to the residual risk they are being asked to bear. This would be a highly controversial move and the FRC has no firm views on the issue at present. However, we believe this is one example of where more debate is needed on the consequences of using bail-in debt. The Commission is well placed to open up public debate on issues around the structural impact on bank capital, its effect on the hierarchy of capital and any accounting impact that would follow from the different choices that may eventually be taken.

2.15 Second, we note suggestions that the use of bail-in debt might make sense in remuneration because of the incentive it would place on bank executives to avoid reckless risks for short term gain. However, the high coupons attached to this debt might enable them to extract substantial amounts of cash before any crisis struck. As long as there is no active market for bail-in debt, the grants would be very hard to value. There is a risk that some executives would use this to mask excessive reward.

Written evidence from the Financial Services Authority

1. The Parliamentary Commission on Banking Standards' scrutiny of the draft Banking Reform Bill provides an important opportunity to debate the major reforms proposed in that Bill and ensure that it is as robust as possible in making the necessary reforms to the banking sector. We welcome the opportunity to submit this Memorandum, which addresses several of the issues raised in the Parliamentary Commission's Terms of Reference.

2. We strongly support the Government's objectives as set out in the policy document accompanying the draft Bill (*Sound banking: delivering reform*). Our submission covers the following areas:

- Objectives and general approach.
- Delegated powers and accountability.
- The ring-fence.
- Capital levels.

EXECUTIVE SUMMARY

A. Objectives and general approach

3. The draft Bill and accompanying secondary legislation should establish clear objectives that set out exactly what the draft Bill intends to achieve and create an accessible regime that is easily understood by all relevant stakeholders including regulators and firms.

4. The draft Bill should clearly set out how the Prudential Regulation Authority's (PRA) statutory objectives interact and their hierarchy.

5. It should also provide the necessary powers to ensure the appropriate degree of separation between the Ring-Fenced Bank (RFB) group and the rest of the group.

B. Delegated powers and accountability

6. There should be clarity in the draft Bill and accompanying secondary legislation setting out the division of responsibility between HM Treasury (the Treasury) and the regulators. We agree with the Government that legislation should set out which activities are to be undertaken within RFBs, and which are to be prohibited or excluded. These are fundamentally social and economic issues, and are therefore rightly a matter for Government and Parliament. We also agree with the Government that it is for the PRA to ensure the appropriate degree of separation between the RFB and the non-Ring Fenced Bank (NRFB) based upon the objectives set out in legislation.

7. We do not believe it is desirable for the Financial Conduct Authority (FCA) to be given a continuity objective when the only core activity is the acceptance of deposits (and services related to deposit-taking).

8. It would be difficult for the FCA to fulfil this new objective considering its limited regulatory remit over the core services and the relevant RFBs that carry out such services. Giving the FCA an additional objective that encompasses matters and institutions it will have little direct oversight of (except from a conduct perspective), runs the risk of obscuring the FCA's purpose, remit, and its strategic and operational objectives.

C. The ring-fence

9. The draft Bill and accompanying secondary legislation should give rise to RFBs with a coherent set of assets and liabilities. This should be wide enough to include all of the critical banking services that must be continued in a resolution scenario, and removes incentives for taxpayers to support NRFBs in times of stress. The PRA should be empowered to ensure RFBs meet this public interest test.

D. Capital levels

10. Firms should be required to have sufficient loss-absorbency to enable the authorities to execute their preferred resolution strategy and reduce the risk of public authorities having to provide financial support where a bank is under stress.

11. We agree with the Government that banks should be required to hold sufficient loss-absorbing capacity to ensure that they are more resilient against failure and that, if they do fail, losses can be borne by their shareholders and uninsured unsecured creditors.

12. We consider that loss-absorbing capacity should apply on a whole group basis, with the ability to exempt non-EEA subsidiaries from the loss-absorbency requirement only if certain conditions are met. For example, the group will need to demonstrate to the UK authorities that its UK operations are sufficiently ring-fenced from its overseas entities. They will need to take into account financial, operational and managerial interdependencies, so that the overseas operations can be resolved in a manner that will not pose a risk to financial stability in the EEA.

13. We support the Government in delivering the majority of the Independent Commission on Banking's (ICB) loss-absorbency proposals through the negotiation of relevant European Directives.

A. Objectives and general approach

Timetable

14. We welcome the Government's commitment to ensure that all the required legislation is in place by 2015. We agree with the Government that banks should be compliant with the requirements of the legislation by 2019. A shorter timeline could increase the implementation risks associated with such wide-ranging reform.

Objectives of the draft Bill

15. We strongly support the Government's objectives as set out in the policy document accompanying the draft Bill (*Sound banking: delivering reform*) to:

- make banks better able to absorb losses;
- make it easier and less costly to sort out banks that still get into trouble; and
- curb incentives for excessive risk-taking.

16. However, we are concerned that the enabling nature of the draft Bill makes it difficult to assess whether or not these objectives will be met. That will, in large part, be dependent on how the delegated powers in the draft Bill are exercised by the Treasury and the PRA. **To help ensure that the Government's objectives are met, we believe there is value in specifying them in the draft Bill to provide clarity on how the Treasury and the PRA should exercise their delegated powers.** This would necessarily involve broadening out the matters the Treasury and the PRA would need to consider when using their delegated powers. These are currently narrowly focused on the continuity of the provision of core services in the UK. This by itself does not meet the broader objectives intended by the Government.¹²

17. Spelling out the objectives of the reforms in the draft Bill in this way would provide clarity for the Treasury and the PRA when exercising their delegated powers. It would have the broader benefits of both providing clarity to firms and regulators over what the draft Bill is intended to achieve and also should help avoid the dilution of the reform objectives over time.

18. One option for articulating these objectives in the draft Bill would be to add a provision similar to that in section 4 of the Banking Act 2009, which requires the authorities to have regard to the special resolution objectives when using or considering the use of particular powers.

19. We would welcome the Committee considering whether such an approach to the architecture of the Bill might deliver an assurance that the objectives of the reforms will be achieved.

PRA statutory objectives

20. We agree with the Government that, in the majority of cases that the PRA will confront, the proposed continuity objective will not create problems of inconsistency with the safety and soundness objective.

21. However, it is not inconceivable to imagine situations where this might not be the case, for instance, in times of stress. It is, therefore important that the draft bill builds on the clarity of purpose and remit that the Financial Services Bill has given to the PRA, and sets out in a clear and transparent manner how the PRA statutory objectives (including those we propose above) are to interact and spells out their hierarchy.

Powers in the draft Bill

22. To ensure that the draft Bill provides enough powers to enable the Government's proposals on ring-fencing and loss-absorbency to be properly implemented, we consider that the draft Bill should go further in providing for:

- powers over financial holding companies incorporated in the UK; and
- prohibitions on ownership structures.

¹² The Treasury paper that was published alongside the draft Bill also describes the ring-fencing objectives as follows:

"The purpose of the retail ring-fence is to isolate those banking activities where continuous provision of service is vital to the economy and to a bank's customers in order to ensure, first, that this provision is not threatened as a result of activities which are incidental to it and, second, that such provision can be maintained in the event of the bank's failure without government solvency support. A retail ring-fence should be designed to achieve the following objectives at the lowest possible cost to the economy:

- make it easier to sort out both ring-fenced banks and non-ring-fenced banks which get into trouble, without the provision of taxpayer-funded solvency support;
- insulate vital banking services on which households and SMEs depend from problems elsewhere in the financial system; and
- curtail government guarantees, reducing the risk to the public finances and making it less likely that banks will run excessive risks in the first place."

Powers over financial holding companies incorporated in the UK

23. In our view it is necessary for the PRA to have a power to make rules over UK-incorporated financial holding companies in order to ensure the proposed reforms can achieve their aims, particularly in ensuring the structural separation of the RFB from the NRFB.

24. To date, when it has been necessary to take action on unregulated holding companies (such as when implementing European Directive requirements on consolidated capital and group supervision), we have been obliged to take action through the regulated subsidiary. This involved requiring the regulated subsidiary to “ensure” that its parent took the necessary action, even though the regulated subsidiary had no power over its parent. This limitation leaves the FSA in a very weak position to enforce group-level requirements.

25. The Financial Services Bill, in proposed section 19, provides a new power of direction over holding companies. It can be exercised only if the acts or omissions of the holding company in question are having, or may have, a material adverse effect on the PRA’s regulation of an authorised firm in the holding company’s group. Furthermore, in deciding whether to give a direction, the PRA must have regard to both the desirability of exercising its powers over the authorised firm rather than the holding company, as well as to the principle of proportionality.

26. As such, the bar to the power’s use is very high, making its proactive use in the absence of a clear and immediate detriment problematic. Additionally, it is not a power to make rules. To effect the same requirement on all RFBs’ holding companies would require a direction in each individual case, each of which would be open to challenge, unlike a rule that would be of general application and cannot be challenged in this way.

27. In this context such a limited power is inadequate to the task of forcing the change to banking groups’ corporate and financial structure necessary to ensure that the Government’s objectives for banking reform are met. In particular, the PRA should have a power to make rules over financial holding companies incorporated in the UK to enable it to:

- ensure that the debt instruments necessary to absorb losses are issued by the appropriate entity within the group; and
- supervise the RFB and NRFB in the most effective way possible.

Loss-absorbing capacity and unregulated holding companies

28. The draft Bill¹³ would enable the Treasury to require the PRA to use its powers to require entities in a group that contain a RFB to issue debt instruments to create loss-absorbing capacity. This provision would not create any new power to enforce the Treasury mandate but would have to be fulfilled within the limits of the PRA’s existing powers. In respect of an unregulated holding company, our capacity to force the necessary change would be limited to the proposed power of direction in the Financial Services Bill. We do not consider this to be adequate. To ensure that the debt instruments issued by the holding company create the necessary loss-absorbing capacity, the PRA would, on an on-going basis, need the power to:

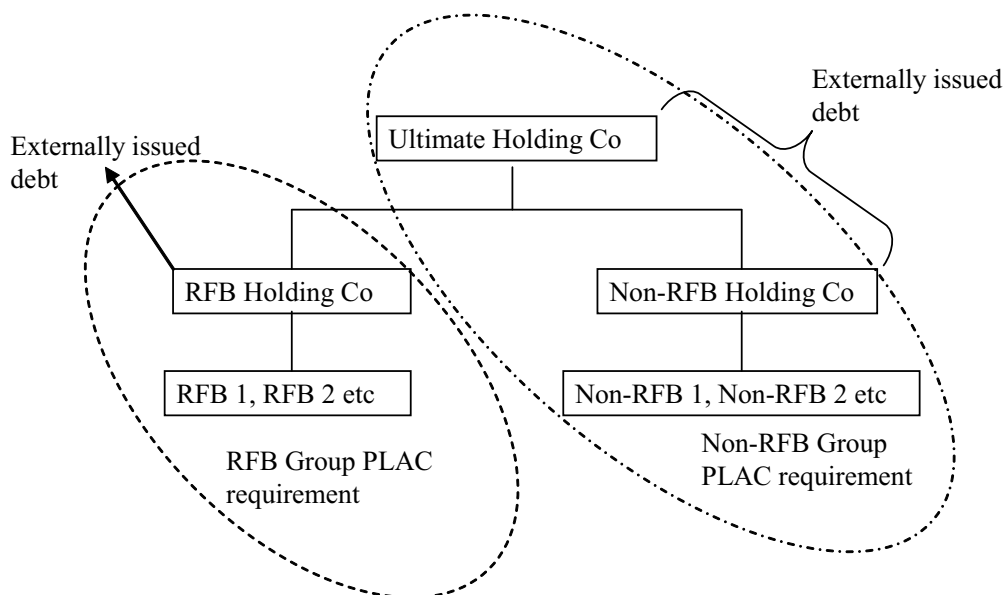
- impose rules on the holding company as issuing entity as to the terms and amount of the relevant debt instruments;
- ensure compliance with those requirements; and
- enforce against breaches directly at the holding company level.

29. We note that the IMF has reported on the lack of appropriate regulatory reach that the FSA has over financial holding companies.¹⁴ Ring-fencing will make this weakness in the UK regulatory regime even more acute.

30. We have set out below an illustration of how we might use a rule making power over financial holding companies on loss-absorbency requirements. The debt instruments necessary to meet the loss-absorbing capacity requirements of an RFB could be issued externally to the market from its parent entity (i.e., the highest entity within the RFB group). The debt instruments necessary to meet the loss-absorbing capacity requirements of an NRFB could be issued externally to the market from its parent entity (ie, the highest entity within the non-RFB group), with some flexibility for it to be issued higher up in the broader group structure (such as from the ultimate group holding company) if appropriate.

¹³ Draft Banking Reform Bill, s.142J

¹⁴ <http://www.imf.org/external/np/ms/2012/052212.htm>



31. A benefit of this approach, in contrast to generating all of the loss-absorbing capacity out of the ultimate holding company, would be to create differentiated wholesale funding costs for the RFBs and the NRFBs in line with their respective risk profiles. This is important for effectively imposing market discipline.

32. The advantage of this structure from a resolution perspective is that the RFB is better firewalled from the NRFB. It also makes separate resolution of the RFB and NRFB less challenging than if the RFB was a subsidiary of the NRFB.

Effective group supervision and unregulated holding companies as a “source of strength”

33. In the scenario outlined above, the financial holding company would act as an effective firewall between the two parts of the group. To achieve this, the PRA may need to exercise appropriate leverage directly over the holding company if, for example, we need to require channelling of group resources towards the RFB to ensure that the PRA’s continuity objective is achieved. We note that in the US, where bank holding companies are regulated by the Federal Reserve, they are required to act as a “source of strength” for depository institutions that they own. Supervisory powers over holding companies would be required if there were a desire that the holding company acts as a “source of strength” to a RFB.

34. The debt issuance strategy described above would not prevent the ultimate holding company from acting as a “source of strength” to the RFB and downstream capital to support the RFB when required. An important feature of such a regime would be the flexibility for exercising any future bail-in tool at the appropriate level in the group, not only at the ultimate group holding company level but also at the level of any intermediate holding company. This flexibility would maintain consistency with the structure of the European Commission’s proposed Recovery and Resolution Directive.¹⁵

Ownership structures

35. As we have set out, to ensure that that RFB remains sufficiently independent of the NRFB, the legislation should require that banks should have a group structure where the RFB group and the NRFB group are directly owned by a holding company. While we support the delegated powers in the draft Bill that would allow the Treasury or the PRA to prevent RFBs from owning NRFBs, in our view **the draft Bill should also give the Treasury or the PRA the delegated power to expressly prohibit NRFBs from owning RFBs.**

36. The ownership structure we are proposing (illustrated in paragraph 30) would ensure consistency with the ICB’s independence principle that states that the relationship between the NRFB and the RFB should be on an arms length third-party basis. Allowing an NRFB to own an RFB would permit a parent-subsidiary relation based on control, which would contradict this principle. Business conducted by the RFB can be reasonably isolated from the NRFB through regulation when both companies are subsidiaries of a holding company. However, it is much harder to do in a parent-subsidiary structure where the NRFB owns the RFB.

37. An ownership structure of this type would:

- Enable the authorities to deploy different resolution tools to the RFB group and the NRFB should they wish to.

¹⁵ See Article 40 of the Recovery and Resolution Directive http://ec.europa.eu/internal_market/bank/docs/crisis-management/2012_eu_framework/COM_2012_280_en.pdf

- Ensure that the potential for contagion spreading from the NRFB group to the RFB group is reduced with the ultimate holding company acting as a firewall between them.
- Help instil market perceptions of credible separation between RFBs and NRFBs.

38. In its October 2012 report, the Liikanen High-level Expert Group on reforming the structure of the EU banking sector set out its view on ownership structures. It recommended that banking groups should be structured so that holding companies own the trading entities and other bank entities. The report stated that trading entities (NRFBs) should neither own or be owned by an entity carrying out other banking activities¹⁶ and should fund themselves independently from deposit banks (RFBs). The OECD has also previously expressed its view, in a different context, that holding companies should directly own commercial banks and investment banks.¹⁷

B. Delegated powers and accountability

Division of responsibility between the Treasury and the regulators

39. We agree with the Government that legislation should set out which activities are to be undertaken within RFBs, and which are to be prohibited or excluded. These are fundamentally social and economic issues, and are therefore rightly a matter for Government and Parliament. We also agree that it is for the PRA to ensure the appropriate degree of separation between the RFB group and the rest of the group according to the policy set out by the Government.

40. The architecture of the draft Bill goes some way to demarcating the roles of the Treasury and the regulators. However, there are still some gaps where the PRA is potentially exposed to situations of making rules for social purposes without being given sufficient legislative mandate to do so. For example, the draft Bill requires the PRA to make a class of rules known as “ring-fencing rules” and specifies certain matters in relation to which rules must be made. We are content with the lists of matters on which the legislation will require the PRA to make such rules, as the draft Bill would provide the PRA with the necessary authority. However, should the PRA choose to make ring-fencing rules that are not mandated in the draft Bill, it could potentially be seen to be acting beyond its remit.¹⁸

41. In our view the draft Bill should provide “parameters” within which the PRA is given a statutory mandate to make rules to enforce the appropriate degree of separation between the RFB and the NRFB in the event that it needs to exercise its rule-making powers in ways not specified in the draft Bill. Examples of this could arise if the regulator determined that it would need to:

- set parental/intragroup funding limits (to avoid concentration risk and reputational risk from the perceived contagion between the RFBs and other group entities); or
- restrict the issuance of loss-absorbing instruments to other group companies by the RFB (to avoid concentration risk).

42. The objectives we have proposed in paragraphs 16–18 of this memo would supply such “parameters”. Alternatively, or in addition, the draft Bill could be amended to impose an obligation on the Treasury to set, by order, appropriate limitations with which the PRA must comply when making rules not specified in the draft Bill. It is our view that the requirement on the PRA to act compatibly with its continuity objective would not provide the necessary mandate to make such rules.

FCA statutory objective

43. We do not believe it is desirable for the Financial Conduct Authority (FCA) to be given a continuity objective when the only core activity is the acceptance of deposits (and services related to deposit-taking).

44. It is not clear to us how the FCA could act in such a way that could jeopardise the continuity of core services. We also believe it would be difficult for the FCA to fulfil this new objective considering its limited regulatory remit over the core services and the relevant RFBs that carry out such services. Giving the FCA an additional objective that encompasses matters and institutions it will have little direct oversight of (except from a conduct perspective) runs the risk of obscuring the FCA's purpose, remit, and its strategic and operational objectives.

45. The Government proposes to extend the power of direction of the PRA over FCA actions¹⁹ to cover FCA actions that could threaten the continuity of core services. It therefore seems unnecessary for the FCA to also be given a continuity objective.

46. We believe that, instead of giving the FCA the continuity objective from 2019, more workable alternatives are:

¹⁶ P98,99—http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf

¹⁷ P22—<http://www.oecd.org/daf/financialmarketsinsuranceandpensions/financialmarkets/44357464.pdf>

¹⁸ Draft Banking Reform Bill, sections 142E and 142J.

¹⁹ Financial Services Bill, section 31.

- legislating for the objective at a later date should the Treasury subsequently seek to use the power to increase the range of core activities to encompass activities and firms that are directly regulated by the FCA; or
- dealing with the FCA's role (if any) through the co-operation mechanisms/agreements between the PRA and FCA.

C. Ring-fence

Activities to be included in RFBs

47. We agree that deposit-taking should be classified as a “core activity” that should be undertaken in an RFB and that the Treasury should be given powers to make secondary legislation creating additional core activities. This approach allows the Government to respond flexibly to changes in the banking system.

48. However, the degree of flexibility that the draft Bill allows in the design of the ring-fence in terms of activities that can be undertaken either in RFBs or NRFBs, risks ending up with banking structures that do not go far enough in achieving the stated objectives of the policy. For example, a very narrow RFB does not put in place an adequate foundation to achieve the policy aim of making banks more resolvable because a number of critical economic functions (such as retail and SME lending) may remain in the NRFB, creating unwanted incentives for the authorities to support NRFBs in times of stress.

49. The PRA should be empowered to ensure RFBs meet this public interest test, being accountable through the objectives that Parliament considers appropriate for the draft Bill to contain.

50. As such, we favour broader RFBs that are viable not only in resolution, but also commercially. For market discipline to work it is important that the market sees them as viable balance sheets in their own right. This will ensure that funding costs more accurately reflect different risks on each side of the ring-fence.

51. We are not advocating making retail and SME lending a “core activity” as that may result in an undesirable restriction of credit provision by non-banks.²⁰ However, to address the concern that RFBs may become too narrow and not meet the policy objective of making banks more resolvable, we propose that where banking groups contain RFBs, they should conduct all of their UK retail and SME lending from those RFBs.

Activities to be excluded from RFBs

52. We agree that, at a minimum, trading in investments as principal should be an excluded activity. The draft Bill provides for other regulated activities to be excluded from RFBs if the Treasury believes they pose a risk to the continuity of the provision in the UK of core services. **We believe that any regulated activity should be excluded from RFBs if, in the judgement of the PRA, it:**

- makes it significantly harder or more costly to resolve the RFB; or
- in any other way threatens the objectives of the ring-fence.

53. We also note that the draft Bill gives the Treasury the power to make exemptions to excluded activities, so that they can be performed by RFBs where doing so does not threaten the provision of core services. **We would not support any exemptions from excluded activities that do not meet the criteria set out above. In addition, we consider that where exemptions are proposed, the conditions attached to them need to be clearly spelt out in legislation.**

54. Any hedging exemption, for example, will require consideration of limits around product type, client type, and size of activity. It is essential that any exemption is crafted with certainty to enable the PRA to effectively supervise it. Without clarity, there is a significant risk that supervising the exemption could become unachievable or extremely resource intensive. Similarly, if the exemptions become too complex to supervise then the objectives of ring-fencing may be undermined.

D. Capital levels

Group Primary Loss-Absorbing Capacity (PLAC) requirement for UK-headquartered groups

55. We agree with the Government that, in order to reduce the implicit guarantee for systemic banks, it is essential to increase the loss-absorbing capacity of these banks to mitigate the risks of potential losses. Ensuring that creditors can be bailed-in to bear losses in both RFBs and NRFBs should help impose greater market discipline on the banking sector and ensure that risk-taking is not excessive.²¹

56. We note that the draft Bill gives the Government the power to direct the way in which the PRA can implement loss-absorbency requirements. We consider that loss-absorbing capacity should apply on a whole group basis, with the ability to exempt non-EEA subsidiaries from the loss-absorbency requirement only if the following conditions are met:

²⁰ It would also raise drafting complications as the activities may not be regulated activities.

²¹ Bail-in holdings between banks outside the same corporate groups should ideally be subject to the material holdings regime. This will need to be pursued in ongoing negotiations of the European Commission's proposed Recovery and Resolution Directive.

- the group has demonstrated to the UK authorities that the UK bank(s) is sufficiently ring-fenced from the overseas entities, taking into account financial, operational and managerial interdependencies, so that these operations will not pose a risk to financial stability in the EEA;
- the UK authorities (in conjunction with relevant overseas authorities) have determined that a regional break-up is feasible for the group and have in place plans to resolve the entities in their respective jurisdictions; and
- the group would need to make the strategy public (in the annual report and in disclosures to clients, for example) in order that creditors understood that they were exposed to the firm with which they are dealing and had no recourse to other entities in the group.

57. We would be concerned if banks' non-EEA operations were exempted from group loss-absorbency requirements unless it was demonstrated that they pose a risk to EEA financial stability. Firms are best placed to make this case and it is up to them to demonstrate their resolvability globally if they want a group loss-absorbing capacity exemption. The default position should therefore be that systemic banks need to hold group loss-absorbing capacity until they can satisfy the conditions outlined above. Where the preferred group resolution strategy involves a top-down approach whereby the UK bails-in loss-absorbing capacity issued by the UK holding company (ultimate parent company) and downstreams capital as required to recapitalise domestic and overseas subsidiaries, no group PLAC carve out should be available.

31 October 2012

Written evidence from Hermes

We welcome the opportunity to comment on the draft Bill.

By way of background, Hermes is a leading asset manager in the City of London. As part of our Equity Ownership Service (Hermes EOS), we also take part in public policy debates on behalf of many clients from around the world. In all, EOS advises clients with regard to assets worth a total of £89 billion invested in companies across global markets. Our clients are significant shareholders in banks and have suffered the consequences of banking failures both directly in terms of the value of those shareholdings and also in their broader investment portfolios; we have therefore taken a particularly close interest in the discussions around the world about how to enhance banking regulation and supervision.

We are strong supporters of the conclusions of the Independent Commission on Banking—a group to which we submitted formal comments twice—and particularly favour its model of ring-fence. We believe that ring-fencing the deposit-taking, retail lending and small business activities of banks would not only have significant benefits in relation to financial stability but would also have advantages in terms of internal capital discipline within banks. Our view is that at present there is a cross-subsidy from explicit and implicit government guarantees across all elements of bank operations; this reduces the perceived cost of capital of the riskiest activities, and increases perceived returns from those activities. Ensuring that a solid ring-fence is in place would remove this cross-subsidy and encourage all the banks to apply an appropriately varied cost of capital across all their activities, removing an inappropriate incentive to take risks which are not warranted.

Subject to the comments below (particularly those in relation to risk management products), we believe that the draft legislation will deliver the Independent Commission on Banking's intentions and will deliver these important benefits for financial stability and capital discipline within banks.

We respond below to the specific questions which the Commission raises. We also attach our latest think piece on the issue of banking regulation and supervision—*Epidemiology*—which more fully develops some of our thinking in this area.

OBJECTIVES AND GENERAL APPROACH

1. *Does the draft Bill successfully give effect to the objectives set out in paragraph 1.3 of Sound banking: delivering reform and is it the most efficient and effective means of delivering those objectives?*

Yes, we believe that the Bill succeeds in delivering the necessary reform—subject to the comments below with respect to risk management products—and does so efficiently and effectively.

2. *Do any of the recommendations of the Independent Commission on Banking (ICB), which the draft Bill seeks to implement, need revision as a consequence of developments since the ICB's report?*

No. If anything, more recent events have served to reinforce the good sense evident in the ICB's proposals.

3. *Do the powers in the draft Bill and the Government's stated intentions for their use give effect to the ICB's recommendations? Are any deviations justified?*

The proposals do give effect to the ICB recommendations. The one key deviation which is proposed—that the Primary Loss Absorbency Capacity (PLAC) requirements should not apply to RWAs held in non-UK and non-EEA operations—is both a pragmatic and proportionate amendment.

4. *What should be the timetable for implementation of these measures, and should it be set out more clearly?*

Given the number of international developments, both within the European Union and internationally, we believe that there needs to be appropriate flexibility allowed in the timetable. In an ideal world, these changes would be delivered as quickly as possible, but we need to be practical and the final implementation will need to wait for more clarity on the Recovery and Resolution Directive, and perhaps also progress on the Liikanen proposals. However, we believe that there is real value in having certainty and clarity as early as is practical: certainty will build investor and client confidence and trust, helping to revive banking activity. There is also scope for the UK to set the standard for international regulation.

5. *The draft Bill proposes continuity objectives on the PRA and FCA. Are these appropriate and compatible with their other objectives?*

We believe that these objectives are necessary and appropriate.

BANKING STANDARDS AND COMPETITION

6. *What will be the impact of the proposed changes in the draft Bill on banking standards in the UK more widely?*

We firmly believe that ring-fencing the deposit-taking activities of banks would not only have significant benefits in relation to financial stability but would also have advantages in terms of internal capital discipline within banks. Our view is that at present there is a cross-subsidy from explicit and implicit government guarantees across all elements of bank operations; this reduces the perceived cost of capital of the riskiest activities, and increases perceived returns from those activities. Without appropriate costs of capital being applied the risks of activities are not appropriately priced in, and banks may continue to make mistaken assessments as to the risk/reward trade-off of certain activities. Ensuring that a solid ring-fence is in place would remove this cross-subsidy and encourage all banks to apply an appropriately varied cost of capital across their activities, removing an inappropriate incentive to take risks which are not warranted. Applying an appropriate cost of capital to different banking activities would raise standards across the industry by making more transparent the risks being taken and the genuine risk-adjusted returns being produced. The ring-fence will not deliver this on its own but it should be a catalyst for a more general move to a more disciplined approach.

Ensuring that risky activities face a heightened cost of capital such that performance is understood in a fully risk-adjusted way is necessary for any understanding of performance of both the bank and of its individual staff members. We suspect that significantly less risk would be taken once an appropriate cost of capital is applied to the most risky activities.

7. *What will be the impact of the separation of retail and wholesale banking on the culture prevailing within each?*

We believe that the separation will have a positive impact in terms of culture for both parts of the banking industry. Both portions need to reawaken a sense of client service which seems to have gone missing in recent years. One benefit of a readjustment to the costs of capital applied to different businesses may be that a greater discipline is applied in the work that is done and the benefits of that work to clients. We discuss the ways in which the culture of banking has gone awry in the attached paper *Epidemiology*, and how it needs to be remedied. We hope that a clearer distinction between retail and wholesale banking will assist in this.

By ensuring that the appropriate cost of capital is applied across the business, the separation should also ensure that remuneration more accurately reflects the risk-adjusted returns of the business, rather than being skewed by the effective government subsidy to the retail deposit-taking activities. This change in remuneration approach should have a significantly positive impact on the culture and mindset of the individuals.

8. *What will be the impact of the ring-fence on competition, both in retail and investment banking, and in other areas of financial services?*

We believe that there is scope for a positive impact on competition in the retail banking sphere as a business which has tended to be seen solely as a source of capital for the broader banking operations will move from being effectively starved of cash to instead having capital for investment in a way which should build a healthier and more robust business.

DELEGATED POWERS AND ACCOUNTABILITY

9. *The draft Bill grants a large number of delegated powers to the Government. Are the principles under which delegated powers are to be exercised sufficiently clear?*

Yes, we believe that the scope of the delegations and the ways in which they are to be exercised are sufficiently clear.

10. *Does the scope of the delegated powers in the draft Bill represent an appropriate balance between flexibility for the Government to respond to changing conditions and accountability to Parliament and the public?*

Yes, we believe that they strike the appropriate balance.

11. *Is there sufficient clarity about the Government's intended use of delegated powers, both to enable public understanding and to enable affected banks to prepare for the proposed changes?*

Yes, we believe that this is sufficiently clear.

12. *The draft Bill provides for review of the ring-fencing rules by the PRA every five years. Does the proposed review mechanism provide sufficient accountability?*

Yes, we believe that this review process strikes an appropriate balance between a period of certainty for the industry, and its investors, and the need for accountability and rational reassessments.

THE RING-FENCE

13. *Is the power to be able to exempt certain categories of deposit-taking firms from having to establish a ring-fenced bank appropriate, and on what basis should the conditions for exemption be set?*

We agree that it is appropriate to allow for exemptions from the ring-fence for activities in relation to larger companies and in relation to high net worth individuals (see below under Question 15 for comments about how these two categories are to be defined). However, the exemption as drafted in proposed Clause 142A(2)(b) is left open to Treasury decision-making, subject only to the subclause (3) requirement that it not have adverse consequences for continuity of the provision of core services. We would favour the draft clauses being more explicitly constrained to the circumstances to which the government intends the exemption to apply, such that the intention of parliament is not at risk of being subverted at a later stage.

14. *Is the range of core and excluded activities defined in the draft Bill appropriate and sufficiently broad? Are the Government's stated intentions for using powers to define further core and excluded activities appropriate?*

We believe that this is appropriate, subject to the comments that we make below in response to Question 16.

15. *Which categories, if any, of customer should be permitted to deposit with a non ring-fenced bank?*

We support the concept of having exemptions for larger companies and high net-worth individuals. We are largely comfortable with the proposed measure of turnover for a company to be deemed large enough to make a judgement as to whether it should be capable of making a judgement as to whether to deal with the bank within the ring-fence or outside it. We are not convinced that the proposed measure for high net-worth individuals is appropriate, and would suggest that the level of free and investable assets should be set significantly above £250,000—£1 million as a bare minimum. We note that the private banking sector regards around £5 million as the minimum scale for a client.

16. *The Government is considering whether to allow ring-fenced banks to offer simple derivatives to their customers. Should they be allowed to? If so, what safeguards would be necessary?*

We would not welcome there being scope to offer derivatives to customers within the ring-fence. We simply do not believe that these products will be appropriate to the bulk of clients within the ring-fence—a view that is only reinforced by recent events. The scope for larger corporate and individual clients to deal with the bank outside the ring-fence (as discussed in relation to Question 15 above) means that those corporate and individual clients which are likely to have some need for such risk management tools would be able to access them. Banks would need to convince them that the benefits of such tools made it worthwhile to deal with the bank outside the ring-fence.

17. *Are the proposed corporate governance arrangements between the ring-fenced bank and the wider group sufficient to ensure the independence of the ring-fenced bank? Are these arrangements compatible with directors' duties and principles of accountability?*

We are not convinced that there needs to be a separate governance structure for a ring-fenced bank; the structural reform itself delivers the independence which is sought, and active supervision by regulator should reinforce this. It is possible that the boards of banks which encompass both ring-fenced and non-ring-fenced activities may over time decide that they need further governance structures to assist them in their oversight of the different arms of their bank, but we believe that these should be developed over time as boards see the need rather than imposed from the outside.

18. *How appropriate are the proposed restrictions on exposures and operational dependencies between the ring-fenced bank and the rest of the group? Will these result in a sufficient degree of independence and resilience?*

It is hard to take a firm view on these questions based simply on the discussion and the powers to be given to the PRA. Only once the rules are proposed and promulgated by the regulator will it be possible to take such a view. The intention as articulated in the Treasury paper, in essence that the relationships will be required to be carried out at arm's length, seems appropriate and to introduce the necessary disciplines, but the rules will be key to understanding whether this will be delivered and be effective.

19. *Will it be possible to effectively monitor and police the ring-fence, given the degree of regulatory discretion the draft Bill proposes?*

The Bill will in effect place a significant burden on the supervisory authorities to supervise the banks vigorously and effectively. As set out in our attached paper *Epidemiology* we regard the regulatory failure ahead of the financial crisis as largely a supervisory failure rather than a regulatory failure as such—in essence, a failure to question and challenge at appropriate times—and we hope and expect that the regulatory authorities will place their focus, and focus their energies, on supervision going forwards. Only if this is done effectively will the structural reforms have their full required impacts.

20. *How effective will the provisions on corporate governance for ring-fenced banks be in promoting a wider improvement of standards? Should other measures also be considered?*

We favour bank boards being enabled and empowered to develop governance processes and approaches which seem to them best suited to delivering the appropriate effective and independent oversight of ring-fenced entities. Inevitably, the supervisory authorities will seek to debate and have input on any conclusions which boards reach on these matters.

DEPOSITOR PREFERENCE

21. *Is the proposal to prefer insured deposits in the event of a bank insolvency justified? Is there a case for broadening the scope of deposits which benefit from this protection?*

Yes, we believe that the proposed preferred treatment of insured deposits makes sense and we also believe that it should not be extended beyond the proposed level. The Treasury's paper considers the various extensions which have been proposed and we believe that it reaches the appropriate conclusions.

CAPITAL LEVELS

22. *Does the draft Bill adequately implement the ICB's recommendations on loss absorbency requirements?*

Yes, we believe it does so appropriately.

23. *The draft Bill gives the Government power to direct the way in which the regulators can implement loss-absorbency requirements. How appropriate and well-designed is this power?*

We believe that the proposed route ensures that the detailed rule-making sits at the appropriate level, particularly in light of the uncertainties introduced by the state of negotiations on the Recovery and Resolution Directive.

24. *Is the Government's stated intention for the design of loss-absorbency requirements workable? Will it provide a sufficiently well-capitalised banking system? In particular, how justified is the intention to allow an exemption for assets held in overseas operations?*

Yes, we believe it is workable and appropriate. The exemption allowing the Primary Loss Absorbency Capacity (PLAC) requirements not to apply to RWAs held in non-UK and non-EEA operations is both pragmatic and proportionate, and we accept the case made by the Treasury for this deviation from the ICB proposals.

25. *Is the Government justified in its decision not to implement the ICB recommendation for a higher leverage ratio than is required by Basel III?*

Again we believe that this is a reasonable pragmatic approach, provided that the efforts of the supervisory authorities are appropriately focused on challenging and questioning bank staff and boards on their decision-making and risk management such that the minimum ratios are seen as a foundation on which to build, not a target about which there can be no discussion as long as they are met.

RESOLVABILITY

26. Will the UK authorities have the necessary tools and powers (as a result of this legislation and other initiatives) to be able to resolve a large failing ring-fenced or non-ring-fenced bank, while maintaining financial stability and minimising the risk to public funds?

Yes, we believe that the range of new tools and powers is appropriate and sufficient. The challenge will be for supervisors to use those tools and powers effectively and appropriately.

27. What is your assessment of the Government's preferred design of "bail-in" powers needed to improve bank resolution? How likely is it that the Recovery and Resolution Directive will deliver effective bail-in powers?

We do not feel able to comment on these questions at this stage of debate on the Recovery and Resolution Directive.

IMPACT ASSESSMENT

28. Is the impact assessment of the costs and benefits credible and balanced?

29. Might there be any other unintended consequences which have not been considered?

We accept and support the impact assessment.

INTERNATIONAL ISSUES

30. What will be the impact of the proposals on the international competitiveness of UK banks?

On the face of it, there will inevitably be some drag on international competitiveness—though the pragmatic approach on the Primary Loss Absorbency Capacity in relation to overseas RWAs mitigates the worst of this impact. We believe that this reduction in competitiveness is justified in the circumstances, and will over time be mitigated by regulatory change elsewhere in the world.

On the other hand, we note that at a time when trust is at a premium in the banking sector, and there is an effective buyers' strike on bank capital, there is scope for these proposals to have a significant positive impact on the way in which UK banks are perceived and the confidence that investors can have in them. A number of large investment institutions have minimised their exposure to the banking sector, but might be tempted to return to providing capital to banks which look more like utility providers of retail and small company banking services, in other words, to banks within the ring-fence. The certainty and confidence which may be built through prompt delivery of these proposals may thus in some ways provide a competitive advantage to UK banks.

31. Are the proposals consistent with existing and forthcoming international and EU regulatory initiatives, for example the recent Liikanen Report? To what extent are they likely to be superseded or generate conflicts?

The developing nature of international rules is one reason why we believe there needs to be some flexibility in the timing of the implementation of these proposals and the flexible way in which they are implemented, though we would argue that the proposals should not be delayed excessively as there is scope to lead global regulatory reform. We agree with the Liikanen committee that the UK proposals are largely consistent with their proposals, though they approach the ring-fence from the opposite direction. As set out in our paper *Epidemiology* we believe that the UK proposals are to be preferred to the Liikanen proposals.

OTHER

32. What other matters should the Commission take into account?

We have nothing further to add.

31 October 2012

Written evidence from ICAEW**INTRODUCTION**

1. We are writing to provide evidence to the Parliamentary Commission on Banking Standards, on the Draft Financial Services (Banking Reform) Bill. ICAEW would be pleased to provide oral evidence on any aspect of its submission.

EXECUTIVE SUMMARY

2. Key points:

- Banking reform is not just about structural change. Ethics and culture must change for banking to become more stable and focused on the long-term.
- Ring-fencing may reduce the impact of financial instability. But it will not necessarily make banking safer.
- The proposed ring-fence will not protect the deposits of institutions including charities, hospitals and schools should their bank go bust. The proposal to prefer insured retail deposits in the event of a bank insolvency will make their position worse than it is now.
- Ring-fenced banks will still be able to make the risky loans we saw in the lead up to the crisis.
- The reforms won't necessarily protect taxpayers from future bail outs of complex, international banking operations.
- The EU Liikanen proposals for structural reform would come closer to achieving the government's goals than the Vickers proposals.

3. Key recommendations:

- The Commission should challenge the banking sector to develop an effective model of professional standards (see paragraph 10).
- Make it clear in the legislation that all secondary legislation will be consulted on (paragraph 12).
- The ring-fence should be reviewed at the same time as the Bank of England's financial stability strategy (every three years) (paragraph 15).
- The definition of "core activities" included in the ring-fence needs to be broadened to include banking for institutions including charities, hospitals, schools and mid-sized companies above the SME threshold (paragraph 18).

OUR RESPONSE TO THE COMMISSION'S QUESTIONS

Objectives and general approach

4. The three main objectives of the draft Bill are welcomed, and the proposed ring-fence might reduce the impact of financial instability. But we have serious concerns around the proposed approach including:

- The ring-fencing proposals include prioritising retail deposits over those from organisations including charities, schools, universities and local authorities. If a bank goes bust, retail deposits will be returned before others, meaning the deposits from socially vital institutions including those listed above might not be returned at all if their bank goes bust. This damaging position for socially vital institutions is being proposed despite the fact that retail deposits are already protected under the FSCS compensation scheme (see depositor preference section for more details, paragraph 27)
- The proposals will not prevent the kinds of risky loans that caused the recent crisis, such as sub-prime residential property loans.
- Taxpayers money is still at risk of being used in bail-outs.
- Ring-fenced banks will have higher costs. These will be passed on to the customer (individuals, SMEs, charities etc).

5. The proposals are also different to the two other banking structure reforms being proposed: Liikanen in the EU and Volcker in the US. Three different banking structures in an increasingly global market place will add to costs, and may create scope to get around the spirit of the reforms.

BANKING STANDARDS

6. Confidence in the financial services sector has been severely damaged. And trust is going to take a decade to restore. The proposals in the draft Bill do not directly address the culture or ethics of banking. No amount of legislation around banking structure can change the culture and ethics of the sector. So it is crucial that whilst structural reforms are introduced, the debate around how to encourage better culture and ethics remains a high priority.

7. ICAEW has a long history of developing and upholding professional standards, and the BBA has recently called for a professional body for banking which mirrors that of the Institute of Chartered Accountants. We are about to launch a new integrity training programme for those who work in the "back office" finance function of banks. This programme focuses on embedding ethics and integrity into banks by training their finance professionals (those at the heart of control and risk of banks' balance sheets) to lead their colleagues in a more ethical approach to banking.

8. **Recommendation:** The Commission should challenge the banking sector to develop an effective model of professional standards that supports and encourages personal and organisational integrity, is underpinned by effective monitoring and enforcement mechanisms and that can be seen to promote confidence. A sound and effective regulatory system will always be required, and should complement such a model. If the banks took

professional standards seriously (and could demonstrate that they did), government or independent regulation might become closer to a backstop, rather than a primary means of maintaining confidence in the financial system. However, it may take a generation to achieve this objective of having professional standards in banking that inspire confidence.

DELEGATED POWERS AND ACCOUNTABILITY

9. The draft Bill outlines a number of delegated powers split between HM Treasury and the PRA. It is not clear in the Bill how sufficient accountability for use of these powers to Parliament and the public will be put in place. Given that the proposed legislation relies heavily on delegated legislation even with regard to key features such as the location of the ring-fence, and given the nature of its role in economic and financial stability, more accountability for the delegated powers is required.

10. **Recommendation:** Despite HM Treasury setting out on page 53 of “Sound banking: delivering reform” that they will consult on all secondary legislation, this is not evident in the draft Bill itself. To be accountable and transparent, this should be integrated into the final clauses of the Bill.

11. **Recommendation:** The Treasury Committee should review with the PRA and Bank of England how the delegated powers are being used and what impact they are having. The review should be carried out annually in the first few years of the new structure.

12. The proposal for the PRA to review the ring-fence rules every five years does not deliver sufficient accountability. The Bank of England has to review its financial stability strategy every three years. Given the ring-fence is being put in place to help promote financial stability, these two reviews should take place at the same time so that the UK’s financial stability strategy (controlled by the Bank of England) and the new ring-fencing structure are consistent and compatible.

13. **Recommendation:** The ring-fence rules should be reviewed at the same time as the Bank of England’s financial stability strategy, every three years. The review should include formal consultation with the public, and be assessed by the Treasury Committee.

THE RING-FENCE

14. We acknowledge that ring-fencing might reduce the impact of financial instability by making it easier to identify and separate some aspects of UK banking business which are essential to the functioning of the wider UK economy. It may also increase the policy options available to the authorities should a non-ring fenced part of a banking group require resolution. However, we do have a number of concerns around the approach taken to ring fencing.

15. The “core activities” defined in the draft Bill are too narrow and do not include deposits from socially vital institutions including charities, schools and hospitals, and also mid-sized businesses. Where these institutions deposit inside the ring-fence they will be subordinated to insured retail and SME deposits, and so will have little protection if their bank goes bust.

16. **Recommendation:** The definition of “core activities” needs to be broadened to include deposits from the institutions listed above.

17. Ring-fenced banks as proposed would not necessarily be particularly safe as they will still be able to make the kinds of loans that caused the crisis, such as sub-prime residential property loans. These loans could “go bad” even though they are within the ring-fence—for example, if a large company in a town closes, and many employees lose their jobs and so can’t pay their mortgages.

18. **Recommendation:** Bank regulators should create an over-arching requirement and set of principles setting out how ring-fenced banks have a duty of care to operate prudently and safeguard depositors.

19. Ring-fenced banking will be expensive for banks and that cost will almost certainly be passed on to the customer, whether individuals or SMEs. This could hit bank lending levels and further harm economic growth.

20. **Recommendation:** Either be honest about the fact that a more stable banking system is a pricier banking system; broaden non-bank finance options like peer-to-peer equity finance; and/or move much faster to bring new entrants into the market to drive prices down.

21. Despite the proposals curtailing the “perceived implicit guarantee enjoyed by banks and financial firms”, there is no guarantee that taxpayers will not be called upon to bail out a bank which remains outside of the ring-fence, especially if it is large, complex and operating internationally. There might be insufficient liabilities which could be “bailed in” or the consequences of imposing losses through bail-in could be judged to pose an unacceptably high risk to confidence and financial stability. It is certainly possible to imagine scenarios in which the taxpayer should not bail out a bank in serious trouble, the impact on global capital flows could be as economically catastrophic as the collapse of Lehmans, creating another credit squeeze.

22. **Recommendation:** Ensure regulators hold banks’ feet to the fire to strengthen their processes, particularly risk management, and speed up efforts to implement cross-border bank resolution regimes.

23. **Recommendation:** We agree with the government that ring-fenced banks will need to be able to use derivatives in order to offer certain products to customers (e.g. fixed rate mortgages). But the regulator (PRA) should be clear with ring-fenced banks about what types of derivatives this does, and does not include, e.g. those which help in providing day-to-day service to customers and can be easily risk managed.

24. The proposals are likely to be compatible with sound corporate governance. A common difficulty with governance in financial institutions is a lack of alignment between the structures of legal entities and of management. However, the draft Bill removes that potential conflict because it makes clear that the boards of ring-fenced banks will have considerable independence and a clear responsibility to maintain the integrity of the ring fence. Such arrangements would not prevent the parent group from making strategic decisions relating to matters such as the broad size, product range, marketing approach and funding strategy of a ring-fenced bank which it owned.

DEPOSITOR PREFERENCE

25. The proposal to prefer insured deposits in the event of a bank insolvency is not justified. There is a strong case for broadening the scope of the deposits which benefit from the protection scheme.

26. The Financial Services Compensation Scheme protects individual deposits up to £85,000. So the proposals do not affect the position of most individuals. Rather, insured-depositor preference protects those who stand behind the FSCS scheme—the banks and, in some scenarios, HM Treasury.

27. The price of protecting the banks and, possibly, the taxpayer would be borne by institutions such as larger charities, hospitals, schools, local authorities, universities and lawyer/accountants' client money accounts (which often temporarily hold, for example, clients' deposits on house purchases), as well as mid-sized companies. They will not be able to use ring-fenced banks with confidence.

28. These institutions would probably be better protected by banking with non-ring fenced banks—but that undermines the idea that ring-fenced banks would cover all (or most) banking that's essential to the UK.

29. **Recommendation:** There are three ways this could be solved. Firstly, extend the FSCS coverage to all “end-user” of the banking system. Secondly, extend depositor preference to all end-users. Or, drop the “depositor preference” proposal altogether.

RESOLVABILITY

30. It is not clear from the proposals that a large failing bank (especially a non-ring-fenced bank which was complex and operating internationally) could generally be resolved by the authorities without taxpayer involvement, at least in the form of public guarantees. The challenges here include differences in resolution and insolvency regimes across borders, the difficulties of managing and un-winding large trading books, and the need to maintain confidence and hence financial stability.

31. While it is desirable that banks should be subject to market discipline, and expectations of public sector bail-outs should be minimized, it is important that preventing the use of public funds in bank resolution is not elevated into an ideology. In some cases, public support will be the least-bad option. As noted in paragraph 23, catastrophic credit squeezes are a risk, as is the spread of contagion if the public fears that their bank is about to fail.

32. The government's proposals around “bail-in” powers will be expensive for borrowing banks, because providers of funding will demand a premium for the risk that debt will be transferred into shares, exposing them to capital losses and the fact that interest would no longer be payable. These costs will almost certainly be passed on to customers, increasing the costs of banking.

IMPACT ASSESSMENT

33. It is not clear why the net benefit figure of the reforms to the UK economy (£68 billion) quoted in the White Paper has almost doubled to £118 billion in the draft Bill. The content of the two papers is similar. This illustrates the difficulty on putting a benefit figure on financial stability reforms, and suggests that we should not consider any figure quoted around the net benefit to financial stability to be wholly accurate.

INTERNATIONAL ISSUES

34. The three proposed structures for banking reform show no consensus on what needs to be done to deliver a more financially stable global banking system:

- The **Volcker** rule prevents banks in the US from engaging in proprietary trading.
- **Liikanen** proposes that banks' trading business should be placed in separate subsidiaries, suggesting the greatest risks lie in trading, despite most banking crises stemming from mis-judgements about traditional lending.

35. We believe Liikanen's proposals would come closer to achieving the government's aims than the draft legislation. In very broad terms, Liikanen would separate commercial and investment banking, and unlike the draft legislation seems to cover "essential banking".

29 October 2012

Written evidence from the Law Society of England and Wales

INTRODUCTORY REMARKS

1. The Law Society responds to this White Paper as a body whose 11,000 member firms are predominantly small or medium-sized businesses whose banking arrangements, funding and investment options would be directly affected by the proposals.

2. We also respond as a body whose member's have extensive experience in advising banks and other institutions on banking, finance and regulation, as well as businesses of all shapes and sizes and consumers. The working group represents some of the many members of the profession who advise in these areas and want to see effective and workable laws and ensure that important principles such as the rule of law are upheld. A key element of the latter is legal certainty, which enables business and financial decisions to be made with confidence. The need for legal predictability is of particular importance in the financial sector, because of the very large sums of money involved and the need for certainty as to the legal basis on which equity and debt are provided to banks.

3. In addition, we are proud of the success of English law, with its high standards and long record of legal certainty and reputation for fairness in dispute resolution. It is the international legal system of choice for many foreign businesses. The English and Welsh jurisdiction is a valuable economic asset, generating significant income for the UK. The final motivation for our response therefore, is to ensure that the UK maintains this competitive asset. It appears to us an unintended consequence of these proposals that risks arise in this area.

4. While the recent crisis has demonstrated a need for review and reform with the aim of making the banking system more stable and robust in the face of future shocks, there is also a need to ensure the banking system delivers good value for customers through competitive markets. The Law Society therefore fully supports the need to increase the robustness of the regulatory framework. It is against this background that we submit the following views to the Committee.

GENERAL POINTS

5. The reforms must be practically workable if they are to achieve their objective. In this respect, it is imperative that banks are still able to function efficiently and effectively in order to provide their customers with the services they need. The Law Society is concerned that the reforms as proposed do not achieve this end.

6. We are concerned the rules may in fact inhibit banks' ability to operate, meaning they are more likely to require resolution, albeit that such resolution may be achieved more efficiently. There are also concerns that the proposals as currently framed may prohibit access to vital banking services, particularly for SMEs.

7. While supporting the objectives of the ICB report, it should also be recognised that circumstances have changed since the investigation was carried out and its findings published. In particular, the publication of the Liikanen report indicate that UK policy may be superseded by EU policy. The Law Society considers it inadvisable to "front-run" EU legislation. To do so could lead to confusion and complication as to regulatory requirements, not least because Liikanen suggests drawing its ring-fence in a different place to that put forward in the UK proposals. This could mean, in effect, that banking institutions subject to both UK and EU legislation could be required to effect a three-way split to comply with two different sets of rules.

8. Legal certainty is an important end in itself and a key plank of a thriving economic system. Banks need to know what supervisory requirements they are obliged to comply with. Adapting to any regulatory overhaul is both costly and time-consuming. Establishing a UK regime that must then be altered to take account of EU obligations a short while later imposes additional expense and disruption for banks.

9. Both uncertainty as to the future development of the supervisory regime and concerns about the workability of the requirements themselves may put UK regulated banks at a competitive disadvantage relative to those operating via the EU passporting system. In a worst case scenario it may even result in UK banks re-organising so as to place their UK business in a bank which is regulated elsewhere in the EU and/or move their main centre of operations outside the UK, leaving only very limited activities subject to UK supervision. This would not only negate the potential benefits of UK legislation but might also have negative effects on the UK in the longer term.

10. The reliance in the draft Bill on substantial amounts of secondary legislation increases legal uncertainty, in our view. Although, we acknowledge that some flexibility in the system is desirable, in order that the UK regime can be adapted to any EU and international measures which may be introduced.

QUESTIONS

1. Does the draft Bill successfully give effect to the objectives set out in paragraph 1.3 of *Sound banking: delivering reform* and is it the most efficient and effective means of delivering those objectives? The objectives are:

- making banks better able to absorb losses;
- making it easier and less costly to sort out banks that still get into trouble; and
- curbing incentives for excessive risk taking.

1. The Law Society has reservations about the extent to which the proposed reforms will deliver the objective of enabling banks to better absorb losses.

2. Unless the rules around large exposures²² are altered, they may act to prevent banking groups pulling together in the face of problems, potentially leaving those entities experiencing difficulties more exposed, to either sink or swim on their own.

3. The proposed ring-fencing, in combination with measures such as bail-in and depositor preference, is likely to leave ring fenced banks with a high cost base and may leave some banks with an unstable economic model.

4. The attempted compartmentalisation of risk could bring a greater likelihood of failure of one of the compartments, because diversification benefits will have been lost and flows of capital and liquidity around the group will have been constrained. The extent to which the risk of failure is increased will depend on the extent of the measures required to implement the separation. With the skeletal nature of the draft Bill, this is hard to judge at this stage. However, for example, we note that any restrictions of capital or liquidity transfers²³ will deprive the non-retail part of the group of the stable funding base provided by the deposits available to the retail part. The requirement to enter into separate master netting agreements²⁴ will mean that each part of the bank is exposed to loss even where the other part of the bank would have a countervailing position which could otherwise be offset²⁵. These effects have to be balanced against the benefits expected to be gained by protecting basic banking services from exposure to more risky trading. We are concerned that the draft Bill enables a move away from balance with reinforced restrictions and is losing sight of the need of the ring-fenced banks to meet the ordinary banking needs of business customers—something the ICB fully recognised, as does the Liikanen report.

5. As the rules for splitting the business are currently proposed in the draft Bill (and more fully in the recent White Paper) it is our view that it will not necessarily be easier and less costly to sort out banks or banking groups in trouble. Indeed they may make the failure of ring-fenced banks, and the related knock to economic confidence, more likely in future.

6. It is likely that the European Commission will take forward the reforms suggested in the Liikanen report and they may become binding on the UK. This could create a complex overlapping of sets of rules, depending on how the Government choose to react. We attach a table (in annex 1) comparing the approach of HMG and the Liikanen Expert Group. We believe that Liikanen has greater regard for the needs of businesses to grow and to trade in the global economy. It is also very close in approach to the US Volcker Rule. The UK is attempting to place the ring-fence in a different place, with the banking needs of business potentially falling on either side of the divide.

7. If the EU adopts the Liikanen approach, which subject to negotiations may become binding in the UK²⁶, UK banks could face having to comply with a number of different ring-fencing systems. The result may be that UK regulated bank groups risk being divided into three or, at least, put at a competitive disadvantage to groups arrange according to the Liikanen split.

8. There should be an assurance in the Bill that subsidiary measures would leave both ring-fenced and non-ring fenced banks on a level competitive playing-field with other EU banks and not place them at a competitive disadvantage in serving customers with a need for international banking facilities, and that subsidiary legislation will endeavour to be consistent with this principle.

9. We do not consider that this legislation in itself will curb excessive risk-taking; however, the proposals may leave both ring-fenced and non-ring-fenced banks risk-averse in relation to retail customers and less

²² The current large exposures regime requires that no single exposure should be permitted to exceed 25% of the bank's capital. This rule applies in any event to separate legal entities within a banking group in relation to exposures to parties which are part of the bank's own group (subject to some exemptions). Exposures to other members of the bank's own group have to be aggregated into a single exposure where the other entities meet the rules of being "closely connected" to the bank. Source: Law Society (2012). *Banking reform: delivering stability and supporting a sustainable economy: Law Society response to the HM Treasury White Paper*, pub: LSEW: London, pg 8.

²³ As suggested in paragraphs 9 and 10 of the Annex of the ICB Interim report.

²⁴ As suggested in paragraph 9 of the Annex 1n the ICB interim report.

²⁵ Law Society (2011). *Independent Commission on Banking: Interim Report Consultation on Reform Options—response by the Law Society*, pub: LSEW: London. Pg 22.

²⁶ In our previous response to the ICB Interim report we noted that in recent years the regulatory philosophy of the EU had moved towards greater use of directly applicable Regulations and to rely less on Directives.

willing to assist growing businesses. Growing businesses may be forced, if they use a UK regulated bank, to deal with two banks, one of which is either non-UK regulated or is outside the ring-fence rules²⁷.

10. Unless reforms under Liikanen intervene to prevent it, it seems that a lot of ordinary business banking activity is set to be operated along with the riskier own account trading and market making activities of UK regulated groups.

11. As we have previously argued, restrictions on the retail product offering may have the effect of, "...[e]ncouraging attempts to use alternative avenues to access the market...that might be more systematically dangerous and offer less protections for consumers because they are lightly regulated and have no compensation scheme in the event of failure..."²⁸.

12. Furthermore, we note that aspects of the proposals could cause a significant amount of unintended damage to other related sectors, including the legal services sector. We outline our specific concerns in answer to subsequent questions.

13. In the longer-term, with the freedom of banks to utilise EU "passporting" rules and HQ themselves outside the UK, it is difficult to say what will remain UK regulated. This Bill may offer perverse incentives for customers to avoid UK regulated banks and for banking groups to minimise activities which are subject to UK regulation. A mismatch with the EU regulatory regime (even if the two can be operated simultaneously—e.g. by splitting UK regulated groups into three divisions) carries a severe risk of placing the UK at a competitive disadvantage and of making its businesses more reliant on banks regulated elsewhere. This would tend to undermine any benefits of resilience brought by the legislation.

14. For a number of reasons the risk in the system may in fact increase, for example:

- 14.1. The implementation of the proposals creates scope for regulatory arbitrage, [namely] allowing financial institutions which are subject to more lax regulation to win market share from rivals which are subject to costly or onerous regulation. This arbitrage can be to the "shadow" banking system (i.e. non-depository banks and other financial entities such as investment banks, hedge funds, and money market funds) and to non-UK regulated depository banks²⁹.
- 14.2. The impact of a reduced share of banking being provided by UK regulated depository banks may not be viewed as of paramount importance in the short term. However, in the long term it has to be recognised that the UK economy could become more vulnerable to a future downturn: foreign regulated banks could withdraw from the UK economy and their home regulator (as has been the case in Iceland) may decline to support the failing firm to the extent anticipated. This could lead to a far worse economic outcome in the event of a later financial crisis, with far less control for the UK. Such regulatory arbitrage would both distort competition and compromise regulatory measures aimed at reducing the risk and severity of future banking crises³⁰.

15. The second key reason for fostering a robust UK-headquartered banking sector relates to regulatory oversight. Whether a foreign-headquartered banking group chooses to do business in the United Kingdom through a branch or through a subsidiary, the UK regulatory oversight of the banking group's activity is likely to be less complete than in the case of a UK-headquartered banking group. Indeed, in the case of EEA institutions operating in the UK under the European banking passport, the powers of the UK regulatory authorities are severely limited. A policy which gives a competitive advantage to entities operating in the UK in this way, to the disadvantage of the UK-headquartered banking sector, will therefore lead to reduced regulatory oversight by the UK authorities. The Landsbanki and Lehman cases have both demonstrated the risks of relying on foreign regulators in times of crisis

2. Do any of the recommendations of the Independent Commission on Banking (ICB), which the draft Bill seeks to implement, need revision as a consequence of developments since the ICB's report?

16. The policy environment has moved on somewhat since the publication of the ICB report in September 2011.

17. The EU has published the Liikanen report. It covers much of the same ground, but reaches different conclusions on the nature of the ring-fence required..

18. In our 2011 response to the ICB and to the HM Treasury White Paper earlier this year, we raised concerns over the UK "front running" EU and international policy measures, which:

- 18.1. the UK may be subject to, further down the line; and
- 18.2. take a fundamentally different approach from that which the UK is seeking to adopt³¹.

²⁷ Non-UK regulated banks may still offer a single service.

²⁸ Law Society (2012). "Banking reform: delivering stability and supporting a sustainable economy: Law Society response to the HM Treasury White Paper", pub: LSEW: London.

²⁹ We note also that UK regulated banks can choose to restructure so as to relocate to other EU jurisdictions.

³⁰ Law Society (2011). "Independent Commission on Banking: Interim Report Consultation on Reform Options—response by the Law Society", pub: LSEW: London.

³¹ Please see Annex 1 for a table, setting out the essential components of the Liikanen proposals and comparing them to the UK ring-fence proposals.

19. This could cause two problems:

- 19.1. The UK banking sector may face competition from banks with cost bases unaffected by a ring-fencing requirement and able to offer a broader range of services. This possibility of lost market share for UK banks should be more thoroughly taken into account in the Impact Assessment.
- 19.2. Once further EU and international measures are implemented a very complex regulatory environment could be created. There will effectively be three different regimes overlapping with each other. We are concerned that little thought appears to have been given as to how they might be able to sensibly exist alongside one another with minimal friction. For example, if the EU threshold is simply that proprietary trading and market making must be separated from deposit taking and retail banking and the UK threshold contemplates some deposit taking and some or all non-UK retail banking being outside the ring-fence then UK banking groups could end up operating in three parts. The commercial knock-on effects of this possibility could be significant, with UK retail and deposit taking elements at a commercial disadvantage compared to other EEA banks.

20. If the desired goal is an effective law that is relatively straight forward to comply with, we believe there is a good case for either waiting and seeing what finally emerges from the EU and how it might apply to UK banks or at least ensuring the UK proposals contain enough flexibility to ensure that UK regulated groups will have the option of having all their internal operations worldwide within the economic ring-fence if a banking group so wishes and EU legislation permits this. If this is not to be done then we believe the Committee should ask the Government to undertake not to implement measures which would require UK regulated banking groups to have more than one ring fence and if required amend the draft Bill accordingly. We would be happy to discuss further with the Committee our views on the possible impacts of multiple structural reforms on request, either orally or in writing.

21. We consider that the ICB did not very fully consider the needs of business customers, but did recognise their need to access trade finance. Indeed the recent White paper proposed further restrictions on the activities of ring-fenced banks without analysing the impact of the changes on this key group. We consider that the impact on corporate lending, trade finance and the availability of foreign exchange hedging (all vital for businesses engaging in international trade) needs to be more fully explored.

22. There needs to be greater examination of the proposals for the use of bail-in. We have raised a number of serious concerns about bail-in in our response to the ICB, to the HMT White Paper and to the EU Commission³². We consider this a good opportunity to utilise the discussion in the Liikanen report, which recognises that universal bail-in carries risk of contagion spreading from a bank failure to the wider economy.

23. We believe there needs to be further analysis of the aggregate effects of depositor preference, bail-in and capital requirements on the ability of banks to lend, in the context of competition from other non-UK banks, who are not subject to the same rules. The impact assessment recognises this is a difficult subject and that its analysis contains lots of question marks. This does not offer reassurance that the legislation has a sound economic underpinning.

3. Do the powers in the draft Bill and the Government's stated intentions for their use give effect to the ICB's recommendations? Are any deviations justified?

24. The paper accompanying the draft Bill³³ and the Bill's provisions suggest that the ICB's recommendations will be followed in a number of important respects. We argued at the time that the idea of depositor preference has a number of flaws.

25. There is a danger that depositor preference creates some perverse incentives. It reduces the need for a depositor to be interested in whether their bank behaves prudently or not (because their deposit is additionally protected by depositor preference). The existence of preferred depositors (and those who stand in their shoes) could also create a conflict of interest among economic actors such as the FSCS and those responsible for its finances (financial services and prudential regulators).

26. Other creditors are either incentivised not to deal with a bank or charge a premium for the additional risk of dealing with a bank whose depositors have got a preferential position. In addition the effect of the preference is to make it unlikely that other banks and financial service operators will have to pay out in the event of a bank failure and this reduces their incentive to police the market. This is profoundly unfair to other creditors and makes dealing with a bank subject to this insolvency rule more risky than dealing with any other type of business. The fact that regulators in some other countries have imposed the same rule in their own interests is no reason for the UK to depart from important notions of fairness for all unsecured creditors, as has existed under insolvency rules for a long time.

27. It did not appear to be the original intention of HMG to adopt depositor preference, and we would strongly urge that this inroad into the current insolvency regime is removed. If included we would urge the Committee to recommend that it should be subject to separate commencement and repeal powers and also to review, depending on its effects in practice.

³² Law Society letter to the European Commission, please see Annex 4 for a copy.

³³ HMT (2012). "Sound banking: delivering reform", pub: SO: London.

4. *What should be the timetable for implementation of these measures, and should it be set out more clearly?*

28. The timetable is complicated by the parallel changes likely to be occurring at the EU level, following the Liikanen report (see Annex 1 for greater detail on the Liikanen ring-fence proposals).

29. “Front running” changes, which may then not fit with what the UK becomes bound to do under EU law would add both to uncertainty and cost for UK regulated banks and in turn detract from their ability to support economic growth.

30. If the Government “front run” EU and international developments then implementation should be gradual, there should be a lengthy transition period and the flexibility of implementation (which is very wide in the draft Bill) should be limited by a firm commitment not to place UK regulated banks at a competitive disadvantage to those regulated elsewhere in the EU and to limit implementation accordingly.

31. Ensuring a robust and consistent legal framework that avoids creating unintended problems will take time. In particular, the transition to the new regime needs to take full account of EU and other steps, which could be binding on the UK. This should be clearly recognised in ministerial statements.

32. Further, we believe the Government should set out:

- 32.1. a clear timetable for transition;
- 32.2. key staging posts highlighted;
- 32.3. extensive commitment to detailed consultation with key stakeholders, over the forthcoming secondary legislation, to ensure smooth implementation of the ring-fencing system.

33. The Bill in its present form lacks any duties which constrain the way in which implementation takes place.

34. As we have noted in previous submissions, banks and their customers will have to adapt to a range of EU and UK regulatory measures, still in the process of evolution, as well as international measures, such as Basel III³⁴. Accordingly, there would be merit in there being a coordinated and phased programme of change, including transitional provisions and a frequent review of the interaction between different measures. UK only measures may need reconsideration in the light of other developments, but the risks of unintended consequences would be much reduced if the Commission’s recommendations [and HMT proposals] addressed how their proposals would fit within the other initiatives and, where these remain uncertain as to their final form, whether their conclusions would be affected by the course taken by other measures.

5. *The draft Bill proposes continuity objectives on the PRA and FCA. Are these appropriate and compatible with their other objectives?*

35. The continuity objectives are to safeguard the provision of core services in the UK. Core services are facilities for the accepting of depositors and payments, facilities for withdrawing money or making payments and overdraft. Liabilities, all in the context of a banking account. Presumably this is supposed to relate to banking activities, rather than underlying services, such as clearing (which are not mentioned). We consider it important that the current language used in the draft Bill be clarified, in order to maximise effective compliance by banks. It is currently rather obscure as to what activities comprise a core service.

36. The continuity objectives would seem only to be relevant to banks with a large share of core services—such that capacity to provide these services would be impacted—this would be compatible with competition and EU law and to apply at the appropriate level.

BANKING STANDARDS AND COMPETITION

6. *What will be the impact of the proposed changes in the draft Bill on banking standards in the UK more widely?*

37. The ring-fencing proposals are unlikely to have a transformative effect on banking standards. These are more likely to be influenced by other factors such as:

- 37.1. Regulatory rules on conduct of business and product standards;
- 37.2. the wider criminal and civil law; and
- 37.3. culture.

38. In particular, limiting the range of activities a ring-fenced bank can undertake, may reduce the ability of the bank to be caught acting in a way which falls short of the highest professional standards. It does nothing in itself to promote adherence to those standards.

39. One possibility might be that the UK’s standards become those of the EU regulators. Although the likelihood of this, at this stage, would be very hard to predict.

³⁴ Law Society (2011). “*Independent Commission on Banking: Interim Report Consultation on Reform Options—response by the Law Society*”, pub: LSEW: London. Pg2.

40. We think that current and anticipated future regulatory requirements are more likely than the proposals in this draft Bill to have a transformative effect on banking standards in the UK.

41. Relevant regulatory requirements include the Principles for Businesses (PRIN) and Statement of Principles and Code of Conduct for Approved Persons (APER) of the FSA, the former applying at the level of FSA authorised firms and the latter applying to individuals performing “approved person” roles within these firms. Both PRIN and APER are expected to be adopted as integral parts of the rulebooks of the FSA’s successor regulators, the Prudential Regulation Authority and the Financial Conduct Authority (FCA). We would make the following points regarding PRIN and APER:

- 41.1. some of the requirements of PRIN and APER have a clear ethical basis, notably the duty to act with integrity applicable to FSA authorised firms (under Principle 1) and their approved persons (under Statement of Principle 1);
- 41.2. principle 6 of PRIN (the obligation of firms to pay due regard to their customers’ interests and to treat them fairly) was used by the FSA as the basis of its Treating Customers Fairly initiative, which involved the introduction of improved business standards across a wide range of retail financial products and services;
- 41.3. the FSA’s “credible deterrence” strategy has resulted in it bringing more enforcement cases against authorised firms and their approved persons in recent years. Many of these enforcement cases have involved alleged infringement of one or more requirements of PRIN and APER and (where serious rule breaches are found to have occurred) have resulted in more stringent civil penalties than was previously the case.

42. It seems to us that the abolition of the FSA and the arrival of a new regulator with a clear conduct focus (in the form of the FCA) presents a timely opportunity to revisit the existing PRIN and APER framework, with a view to it becoming a powerful catalyst of improved business standards across the retail banking and financial services sector.

7. What will be the impact of the separation of retail and wholesale banking on the culture prevailing within each?

43. We are concerned that, unlike the Liikanen proposals, the UK measures may not in fact isolate the “casino” activities of banks but allow them to be mixed up with business banking and non-EU retail and business banking. As business banking activities are vital to the development of the UK companies, large and small, who take banking services from UK regulated banking groups, we believe that such an outcome would run counter to the intention behind the ring-fencing proposals.

44. In light of such “mixing” of activities, the proposals could not be expected to have any effect on attitudes in any banking group outside of the ring-fenced bank. As we have stated above, regulatory measures under other legislation may be more effective than this legislation in changing attitudes within ring-fenced banks, but the narrow range of activities open to them may simply limit opportunities to demonstrate any change of culture and deny opportunities to actually achieve change. We would be happy to elaborate further on these points at the request of the Committee.

8. What will be the impact of the ring-fence on competition, both in retail and investment banking, and in other areas of financial services?

45. The type of ring-fence proposed by the Government could have negative consequences for competition in retail banking.

46. The costs of capital are likely to rise on the back of the ring-fencing model proposed. In particular depositor preference and bail-in measures may result in capital shortages for ring-fenced banks and high prices for that they capital they are able to raise.

47. In our view the impact assessments are not adequate and need to urgently consider a range of additional impacts on the sector, including:

- 47.1. the adverse effect on the incentives to enter the retail banking market;
- 47.2. the exposure restrictions which might encourage some groups to consider exiting retail banking in the UK or lead some to merge with other ring-fenced banks, or to consider restructuring to transfer business to subsidiaries regulated elsewhere in the EU
- 47.3. the activity restrictions which could impact negatively on product innovation and product availability, especially for smaller businesses;
- 47.4. cost pressures which could mean job losses and branch closures.

48. There may also be entry from EEA regulated banks that have less onerous ring-fencing requirements. Such moves would expose customers to non-UK depositor protection. Recent experience with Iceland, an EEA country, suggests that there could be serious problems and costs associated with this.

49. Further, UK regulated banks could set up new EEA banking subsidiaries to take advantage of these possibilities.

50. We make a number of further points on competition in Annex 3. We would be happy to discuss issues such as the impact of the ring-fence on competition, especially in the context of EU Single market rules, at the request of the Committee.

DELEGATED POWERS AND ACCOUNTABILITY

9. The draft Bill grants a large number of delegated powers to the Government. Are the principles under which delegated powers are to be exercised sufficiently clear?

51. The delegated powers approach has both strengths and weaknesses. For example, the significant number of delegated powers³⁵ makes for significant legal uncertainty. However, in the context of “front running” EU proposals, it does give the UK the flexibility to adapt the ring-fence in light of what emerges from the EU.

52. The high level of uncertainty associated with delegated powers will make Parliamentary scrutiny of what is actually brought into force difficult. No doubt Parliament will consider whether this form of legislation gives sufficient accountability on such an important subject.

53. Law firms advising clients on implementation will find it hard to give clear advice if the rules are going to emerge piecemeal and are liable to change at short notice. This is particularly concerning as legal certainty is a key element in the attractiveness of English law to international business and finance. We believe that Government should strive to uphold this principle when it legislates and should delay legislating if it cannot reasonably provide such certainty.

54. Further, we consider that this way of legislating runs a risk of unintended consequences. Without significant scrutiny some of these could be very significant indeed. We note that in the White Paper some of the proposals on restrictions on use of non-EEA law could damage the competitiveness of English law. The Bill appears to still allow the Treasury or FSA to forbid contracts governed by non-EEA law, with serious knock-on effects for access to certain suppliers of services and for the English legal market. The Law Society continues to seek a clearer statement that a protectionist measure of this sort will not be introduced. In Annex 2 we set out in more detail our views on the danger to the English and Welsh jurisdiction of such proposals and would be happy to provide further comment on these at the request of the Committee.

10. Does the scope of the delegated powers in the draft Bill represent an appropriate balance between flexibility for the Government to respond to changing conditions and accountability to Parliament and the public?

55. Flexibility in the ring-fence is a good thing.

56. There is merit in tailoring the implementation of the ring-fence to individual institutions to some extent, in order to minimise the damage sweeping general rules could have on a particular bank.

57. The framework should be a body of purposive rules framing the arrangements the regulator comes to with each bank.

58. This balances the certainty of a clear framework with the flexibility required for such a complex measure as ring-fencing.

11. Is there sufficient clarity about the Government's intended use of delegated powers, both to enable public understanding and to enable affected banks to prepare for the proposed changes?

59. No. There is insufficient clarity in the delegated powers in the draft bill.

60. Inevitably, when there is little detail on what the secondary legislation will contain (and EU legislation proposed which could bind UK regulated banks to another structure) there will be uncertainty. Not only does this mean banks may waste money preparing for one model and find they have another, but the situation undermines the giving of accurate legal advice, on which banks can base their plans. This prospect of confusion could raise costs even further.

61. The wide ranging use of delegated powers appears to be a function of the fact the Government is pushing this Bill through quickly, leaving little room for the detailed scrutiny that is required for such a complicated new set of laws.

12. The draft Bill provides for review of the ring-fencing rules by the PRA every five years. Does the proposed review mechanism provide sufficient accountability?

62. It is sensible for there to be periodic reviews of the ring-fence. We would support this being extended to depositor preference if introduced.

63. Once a review is published by the PRA we believe that it should be debated by Parliament and scrutinised by the Treasury Select Committee. We believe the Committee should consider suggesting that the Bill should contain a sunset clause, which would coincide with the PRA reviews. Such a clause would then force legislators

³⁵ Set out in clauses XX of the draft bill.

to actively evaluate the benefits or otherwise of the ring-fence model. We believe that suggestions along these lines will significantly increase accountability and further ensure that if the ring-fence is not working or is not cost effective, there is the opportunity to repeal or alter it.

THE RING-FENCE

13. Is the power to be able to exempt certain categories of deposit-taking firms from having to establish a ring-fenced bank appropriate, and on what basis should the conditions for exemption be set?

64. This type of exemption would be appropriate to avoid unnecessary difficulties for banks and appears consistent with Liikanen. It may have the further effect of making it easier for the UK proposals fit with the emerging EU measures. However, the competition impact of allowing some institutions to be exempted and others not has to be managed carefully.

14. Is the range of core and excluded activities defined in the draft Bill appropriate and sufficiently broad? Are the Government's stated intentions for using powers to define further core and excluded activities appropriate?

65. With so much left for secondary legislation it is difficult to know the final extent of the ring-fence and thus difficult to make a final judgement.

66. However, it is our view that many of the suggested product restrictions in the White Paper appear not to be aimed at ensuring the integrity of the ring-fence or otherwise furthering the prudential regulation of ring-fenced banks, but at consumer protection.

67. It is important to avoid the ring-fence being driven by conduct of business/consumer protection concerns. The sole motivation for deciding where to draw the ring-fence should be what is the most credible method of ring-fencing which works for bank customers and thus the competitiveness of the UK banking sector. As we have previously noted it is vital that due account is taken of proposed product intervention powers included in the Financial Services Bill and the revised form of MiFID. Cutting across these other initiatives will increase compliance costs, and result in unnecessary overlap. In Annex 2 we set out some examples, where we consider that it could be damaging if the proposed split between "core" and "excluded" activities cut across important activities carried out by banks for their customers.

68. We have argued in previous responses that if a purposive approach is adopted to defining the ring-fence and what should be included and excluded, then the need for complex exemptions for example, should be reduced. We fear a complex lists of dos and don'ts will create regulatory complexity, increase compliance costs, reduce room for innovation and lead to a "check-list" rather than a responsible approach.

15. Which categories, if any, of customer should be permitted to deposit with a non ring-fenced bank?

69. We consider that trying to restrict the customer is unlikely to work and may raise legal concerns, in relation to EU law. We believe that the restriction may work better if it falls on the UK regulated non-ring-fenced bank, not the customer. We note that if Liikanen were implemented this restriction should not be necessary or would be very narrow as the separated out proprietary trading activities of a bank would not include ordinary deposit taking.

70. We note that customers will be free to place their deposits with non-UK banks regulated in other EEA Member States. These banks are and will continue to be able to exercise their passport rights to provide retail banking services to customers in the UK (either from abroad or through UK branches) regardless of structure.

71. If the White Paper proposals are fully implemented through secondary legislation those customers who bank with ring-fenced banks could suffer a considerable diminution in the services their UK regulated banks can offer them, ranging from foreign exchange and overseas banking management to levels of return, the exact extent of which is currently unclear because of the wide range of restrictions being canvassed.

72. We also believe there are important issues in relation to adjunctive retail banking and insurance products, which we would be happy to discuss further at the Committee's request.

16. The Government is considering whether to allow ring-fenced banks to offer simple derivatives to their customers. Should they be allowed to? If so, what safeguards would be necessary?

73. Businesses need a wide range of banking services, especially exporting business. The latter often require hedging products, particularly to manage exchange rate risk and, also from time to time to manage interest rate risk. There is a danger that, if a ring-fence is drawn badly, access to the full range of business banking services by some companies could be badly affected.

74. The law can be a blunt instrument. It is important to ensure that sweeping divisions between what can be offered from within the ring-fence and what cannot do not lead to unintended negative consequences further down the line for UK businesses. These need to be considered carefully. It is our view that the various impact assessments undertaken by the ICB and HM Treasury have not adequately addressed the impact of the reforms from the customer perspective.

75. We acknowledge that the rules in relation to ring-fencing need to straddle an often tricky divide between clarity and certainty on one side and flexibility and minimising damaging consequences on the other. We do not believe that this balancing act can be adequately carried out until there is greater clarity as to what may or may not be enacted at the EU level.

17. Are the proposed corporate governance arrangements between the ring-fenced bank and the wider group sufficient to ensure the independence of the ring-fenced bank? Are these arrangements compatible with directors' duties and principles of accountability?

76. We consider that the corporate governance proposals in the White Paper would be sufficient to guarantee independence. However, in our response to the Treasury's White Paper we note that while the independence of a ring-fenced bank needs to be underpinned by strong governance, the proposals probably went further than was needed. For example the proposals in the White Paper appeared not to take into account the myriad rules that the law currently places on Directors and the governance of companies.

18. How appropriate are the proposed restrictions on exposures and operational dependencies between the ring-fenced bank and the rest of the group? Will these result in a sufficient degree of independence and resilience?

77. We believe that it is unlikely that the ring-fence the Government proposes will achieve the significant improvement in retail bank resilience which the Government intends. Indeed the restrictions between the ring-fenced bank and the rest of the group, as proposed, may reduce resilience.

78. While the introduction to the draft Bill offers some reassurance, the proposed ring-fence could still potentially have an artificially limiting effect on international services needed by the customers of a ring-fenced bank, so forcing affected customers to deal with two banks or seek out a less restricted bank.

79. However, when deciding on the restrictions on exposures and operational dependencies it is worth bearing in mind that total separation between the retail and wholesale sides of a banking group and the break-up of a single legal entity would mean that the large exposure rules will apply. These would significantly limit the flexibility of the group to move capital between the retail and the wholesale parts of the banking group. This in turn would probably require a bank to look beyond its group for funding—increasing its overall cost of funding and, in general, having a substantial impact on its capital requirements and its cost of capital.

80. In the event that, despite the large exposure limits, further restrictions are proposed, then we believe there needs to be clarity as to whether the regulator would set limits on the proportion of its funding that a ring-fenced bank receives from the rest of its group. Furthermore, we consider that the terms of that funding should be regulated on a case-by case basis or a formulaic approach in order to ensure the economic independence of the ring-fenced bank. Each has merits and potentially adverse consequences. Whatever is decided upon needs to be costed, together with the costs of complying with the large exposure rules.

81. We have a number of other concerns in relation to restrictions on exposures and operational dependencies, which we would be happy to discuss in more detail or provide further perspective on at the request of the Committee. A brief outline of them is set out in Annex 4.

19. Will it be possible to effectively monitor and police the ring-fence, given the degree of regulatory discretion the draft Bill proposes?

82. In practice the ring-fence would be easier to police, if it was placed where there was a more logical division between activities.
83. We note that the Liikanen review proposes a ring-fence in a place that is likelier to be easier to sustain and with less negative side effects.
84. Wherever the ring-fence is placed it will be important to ensure that the parameters are properly policed.
85. The key will be good regulatory oversight and effective auditing of the ring-fence. The regulators need to be clear with the banks on what they require the banks to do and the regulator needs to have the right monitoring measures in place.
86. Within such a context some discretion should make things easier, as it will allow some element of tailoring to the particular circumstances of the bank.
87. A purposive approach would help ensure this could be done as effectively as possible.

20. How effective will the provisions on corporate governance for ring-fenced banks be in promoting a wider improvement of standards? Should other measures also be considered?

88. As we have stated previously we consider that other regulatory tools will be of greater importance in promoting a wider improvement in standards in banking e.g. the FSA/FCA approach to authorising individuals.

DEPOSITOR PREFERENCE

21. *Is the proposal to prefer insured deposits in the event of a bank insolvency justified? Is there a case for broadening the scope of deposits which benefit from this protection?*

89. We believe that the existence of the FSCS negates the need for deposit preference measures. The UK scheme also extends to certain small companies and may extend to all companies if EU law so requires. We note that in Dunfermline, the Bridge Bank was able to arrange transfer on commercial terms to Nationwide Building Society of the entire relationship with a number of customers outside the initially protected class.

90. Further, it is our concern that in a non-cash-rich insolvency such preferences could be very damaging to recovery by other creditors, including unprotected depositors. It may create perverse incentives, by encouraging banks to borrow on a secured (collateralised) basis. Currently unsecured lenders can be expected to exert some financial discipline but if they were to become secured lenders they would lose the incentive to provide this.

91. In addition, the costs of bank funding would be increased if this type of statutory priority was to be put in place. This may be for a number of reasons, including the fact that it would make it difficult to conduct a reliable credit analysis and this would be likely to raise borrowing costs for relevant banks and their customers.

92. It is our view this fundamental attack on the rights of ordinary creditors is not justified merely because it might ease the carrying cost for the FSCS. FSCS is a guarantee scheme for a class of unsecured liabilities intended to be funded ultimately by the banking industry as a whole. We have seen little evidence for the case that other creditors of a particular failed bank should bear the whole burden of the guarantee being called.

93. It is important that ordinary creditors of banks are treated in the same way as ordinary creditors of other businesses which may fail: for example, there appears to be no justification for the unpaid supplier of goods and services to a financial institution being subordinated to depositors, when they would not be put below (for example) parties who had paid in whole or in part for goods not yet delivered on the failure of a manufacturing company.

94. We believe strongly in the fundamental principle of UK insolvency law that "...In principle all unsecured creditors should have the same rights in the insolvency, even if they have collateral protections (such as a deposit guarantee/insurance scheme, which is ultimately separately funded)".

CAPITAL LEVELS

22. *Does the draft Bill adequately implement the ICB's recommendations on loss absorbency requirements?*

95. As set out at paragraph 3 of the explanatory document these are being addressed largely through alternative means, not this Bill. Nevertheless we have some concerns about relying on bail-in as an important element in the proposed Primary Loss Absorbing Capacity.

23. *The draft Bill gives the Government power to direct the way in which the regulators can implement loss-absorbency requirements. How appropriate and well-designed is this power?*

96. It is better for the regulator to decide how to implement loss-absorbency requirements, subject to clear rules and principles. Once the rules are set it should not be a matter for political intervention.

97. Leaving significant discretion with the Government is likely to undermine certainty and clarity in the system. It also raises questions about the possibility of interference in cases where the decision is best made by the regulator as it is closest to the institutions in questions.

98. It should also be noted that the EU regulator may overrule the UK and therefore the discretion of the Government is limited.

99. A margin of discretion for the parties concerned is key when it comes to how banks meet their reserve requirements, and their ability to absorb losses in general.

100. While regulators should set the minimum requirements in respect of banks' loss absorbing capacity, it should be up to the banks themselves to decide what mixture of tools is most appropriate for them (including potentially voluntary bail-in which would be agreed with those providing the bank debt in question).

24. *Is the Government's stated intention for the design of loss-absorbency requirements workable? Will it provide a sufficiently well-capitalised banking system? In particular, how justified is the intention to allow an exemption for assets held in overseas operations?*

101. The Government should further review the loss-absorbency requirements as a number of questions remain outstanding in this respect. A thorough impact analysis needs to be undertaken.

25. *Is the Government justified in its decision not to implement the ICB recommendation for a higher leverage ratio than is required by Basel III?*

102. Yes. Given other policy measures currently under consideration and the current shortage of credit in the economy and of assets which may be used as collateral within banks, this seems sensible.

RESOLVABILITY

26. Will the UK authorities have the necessary tools and powers (as a result of this legislation and other initiatives) to be able to resolve a large failing ring-fenced or non-ring-fenced bank, while maintaining financial stability and minimising the risk to public funds?

103. If the reforms are put in place the authorities may have more chance of resolving a large failing bank, but paradoxically it seems to us that the chances of needing to do so have been substantially increased, at least as regards ring-fenced retail banks.

104. Their business model will be similar to the model of building societies, which have been forced to consolidate in the current climate and cannot offer vibrant competition. Former building societies with more aggressive competition models, but which did very little that would not be permitted within the proposed ring-fence, failed spectacularly. Retail banks could face similar cash-flow and profitability issues, exacerbated by their narrow business model.

105. It could reduce the implied public subsidy to some degree, but against that the cost and profitability issues of the proposed narrow retail banking model might mean that government subsidy (e.g. the proposed business bank) has to become a permanent feature. The costs of this and other incentives to encourage banks to lend to business have not been taken into account in the impact assessments we have seen.

106. With so many unanswered questions in the draft Bill it is hard to tell conclusively what the consequences are likely to be.

107. Alternative measures might be needed that will minimise systematic contagion—e.g. the wide form of bail-in that includes ordinary depositors above the guarantee limit is not consistent with all or part of a bank continuing as a going concern. The contagion of failure would thus be more widespread than in ordinary insolvencies, where customers and creditors of the sound parts of a failing business are protected from contagion by having their contracts “hived down” to a business sold as a going concern. This would not be possible where such liabilities are converted into illiquid equity and therefore more customers and suppliers might suffer from contagion.

27. What is your assessment of the Government’s preferred design of “bail-in” powers needed to improve bank resolution? How likely is it that the Recovery and Resolution Directive will deliver effective bail-in powers?

108. Bail-in raises a number of concerns and we refer with approval to the comments in the Liikanen report which recognises that adoption of the wide form of bail-in proposed in the EU RRD is not wise.

109. A bail-in policy which is limited in nature, and which is clear on the liabilities to which it applies, is the most workable. The range of liabilities which can be “bail-inable” should be defined clearly and limited to suitable classes of liability, where the value of the liabilities can be readily ascertained. Bail-in requires strict safeguards and protections, so that (i) investors and counterparties cannot be taken by surprise, (ii) funding is correctly priced and (iii) the rule of law is respected.

110. Ideally bail-in reforms need to be international, rather than confined to the UK or EU. A G20 agreement (or similar) would ensure as level an international “playing field” as is practical.

111. In the absence of a G20 (or similar) agreement the RRD is likely to be the best vehicle for implementing a system of bail-in system, if the current RRD proposals are altered and the Liikanen proposals followed. With the likely effect of bail-in risk on the cost and availability of capital for banks, we would caution against the UK introducing bail-in unilaterally. Such a move (affecting banks both within and outside the ring-fence) would be severely damaging to the competitiveness of UK regulated banks and would discourage banks from outside the EEA maintaining subsidiary banks in London. This would lead to a loss of inward investment and jobs.

IMPACT ASSESSMENT

28. Is the impact assessment of the costs and benefits credible and balanced?

112. The Impact Assessment appears to analyse the cost of each element of the ring fence from a macro-economic perspective e.g. there is no micro-analysis of the impact of the ring-fence on key bank customer groups.

113. A thorough assessment should try to evaluate the impact of the ring-fence on the ability of a UK ring-fenced bank to meet the full range of their customer’s needs, such as those who:

- 113.1. trade in non-EEA currencies (particularly US\$);
- 113.2. principally trade with partners who are outside the EEA in non-EEA currencies; or
- 113.3. need to finance and operate a manufacturing or other business facility outside the EEA seamlessly with a principal UK business.

114. It should not be forgotten that entrepreneurial SMEs may do some or all of the above.

115. Further, we have previously noted "...the rise in various forms of "shadow banking" which seek to exploit a lack of funds from traditional banking sources. These businesses currently operate outside of the banking regulatory regime...They cannot therefore necessarily form an alternative. In any event with the growth of the sector, greater regulation would be inevitable to contain risk. We note, however, that neither the impact of currently available forms of 'shadow banking' nor of greater regulation of that sector are considered. This is another gap in the impact analysis"³⁶.

29. *Might there be any other unintended consequences which have not been considered?*

116. We see two chief unintended consequences:

- 116.1. negative impact on the legal services industry if the White Paper proposals on governing law of significant contracts is adopted; and
- 116.2. wider detrimental consequences for businesses, including SMEs.

117. In 2011 legal services generated £25.5 billion of income for the UK, almost 2% of GDP and including £3.6 billion of export earnings.

118. Legal services are a vital enabling service for the banking sector and other parts of the financial services industry.

119. The general principle of limiting the exposure of ring-fenced banks to international banking services and more specifically of curtailing the ability of retail banks to contract major obligations under non-EEA laws could have an adverse effect on UK legal services.

120. These proposals could prevent ring-fenced banks from making major contracts under respected legal systems such as those of New York law or Switzerland.

121. This would prevent retail banks from making significant contracts under two of the three most important types of law for international business and financial activities.

122. The measure appears protectionist (even if this is not its motive) and invites retaliation.

123. It carries the prospect of a direct and negative impact on the volume of work for UK lawyers and legal firms.

124. In the long-run such a restriction may provoke a shift away from the UK both as a financial centre and as a centre for the resolution of international disputes, as more important international contracts would be written under other systems of law.

125. Restrictions on use of law would not reflect the UK's obligations to respect the law and jurisdiction of many non-EU countries (including Commonwealth countries) with whom the UK has entered into Treaties on the mutual enforcement of judgments.

126. They also ignore the general approach of international law to comity between nations, an area of international law in whose development the UK has played a leading part.

127. Restricting freedom of contract is a form of protectionism, when the success of the UK legal services sector depends on its openness. Such a state of affairs could lead to retaliatory action by other jurisdictions, damaging legal relations and in turn reducing the extent to which English law is used in international dispute resolution.

128. Such a restriction on use of law is unlikely to be consistent with the needs of the customers of ring-fenced banks. For example:

- 128.1. to be able to arrange clearing services in New York to enable their customers to make US Dollar payments. Large sums will be involved but it is unlikely that New York clearing banks will be willing to contract other than under New York Law;
- 128.2. to provide letter of credit and other international banking services ring-fenced banks will need relationship agreements with banks in a wide range of jurisdictions. It will not always be possible for these to be written under the law of some part of the EEA and local law will need to be used. Customers of ring-fenced banks will be at a real trading disadvantage if they cannot get comprehensive services for international business: many small UK businesses are significant exporters outside the EEA and others are in markets where the currency of account is not sterling or the euro, most commonly the US Dollar. They need to be able to access letters of credit, which are valuable instruments for international trade, including with developing countries, and to access foreign exchange services, including currency risk hedging;
- 128.3. ring-fenced banks could be limited in their ability to serve their customers and get best value for money in their procurement if they cannot use foreign laws. This could disrupt both supplements to existing contracts e.g. for IT, governed by foreign law and new contracts. Ring-fenced banks could

³⁶ Law Society (2012). "Banking reform: delivering stability and supporting a sustainable economy: Law Society response to the HM Treasury White Paper", pub: LSEW: London, pg 7.

be prevented from getting the best technical solutions or best price if these came from suppliers who prefer to use their own law;

- 128.4. when coupled with the restrictions on dealing with non-ring-fenced banks and operating outside the EEA UK retail banks may face difficulties in, for example, accessing US dollars to meet the needs of customers who deal in products priced in that currency (e.g. oil and gas, grain etc.): no proper assessment has been carried out of potential problems in this area and none of the ICB (who do not appear to have considered this particular restriction at all) or the Treasury papers give much thought to this question.

129. A large corporate customer staying with the same group will have much of its relationship with the other side of the ring-fence, but will no longer be able to get a global netting agreement, since presumably netting across the ring-fence will not be allowed. The result of this is that the cost of its banking will be much increased and the both parts of the banking group are likely to need to hold greater capital as they cannot net off deposits and loans on opposite sides of the ring-fence. On the other hand, an international bank regulated elsewhere in the EEA will be able to offer them seamless services wherever it does business and full netting.

130. Because current account management and money transmission seems likely to be a province of the ring-fenced bank, the large corporate may not be able to get all his banking relationship onto the other side of the ring fence, so as to preserve netting advantages.

131. A smaller corporate customer may suffer in the same way—for example if it has a business and an account with a member of the banking group outside the EEA.

132. A customer also has the option of placing deposits with non-UK regulated banks. EEA passported banks, regardless of structure, are free to trade in the UK (whether on a cross-border basis or through the establishment of one or more branches in the UK) and only either EU law or their national regulator could enforce that they do so with a ring-fence structure or limit their customer base.

INTERNATIONAL ISSUES

30. *What will be the impact of the proposals on the international competitiveness of UK banks?*

133. We believe that the impact of the proposals is likely to be a negative one. This is because of the substantially raised cost of doing businesses, together with a constrained business model that does not follow a natural split in types of business.

134. Following Liikanen, the proposed model seems likely to give an advantage to banks using EU passporting rules to enter or operate in the UK market.

135. The proposals will reduce the attractiveness of UK retail banks as service providers for international businesses because of the limits on the services they are able to offer as retail banks and the need for the customer to deal with two banks to obtain services currently supplied by one.

136. Rules on the free movement of capital and services and the right of establishment, mean that it would be a breach of the UK's treaty obligations to seek to prevent UK nationals or residents, UK SMEs, or UK branches of foreign registered SMEs (whether from within or outside the EEA) from dealing with less regulated passported banks, since it would effectively negate the passported banks' right of establishment in the UK under their own lead regulator to provide the full range of banking services.

137. Individuals needing accounts abroad are also likely to be affected. If a UK national is working outside the EEA (or in an EEA State where his ring-fenced bank does not have a branch) he or she might be forced to bank with a non-UK regulated bank. The branch or subsidiary of an international banking group headquartered in the UK which offers personal banking services eg in the United States, will necessarily, as the proposals are framed, be outside the ring-fence (and so will a subsidiary providing banking services within the EEA) and the fellow group member structure will subject it to a degree of UK regulation.

138. If subject to UK regulation the bank could not deal with most individuals unless exempted from the regulatory requirements.

139. If not regulated in the UK it may still—under powers in the draft Bill—be controlled in its dealings with the rest of the group. In any event the “arms-length” exposure rules would discourage the offering of seamless service to “significant individuals”.

31. *Are the proposals consistent with existing and forthcoming international and EU regulatory initiatives, for example the recent Liikanen Report? To what extent are they likely to be superseded or generate conflicts?*

140. The current proposals do not appear to place the ring-fence in some place as the Liikanen proposals and may give rise to complex overlaps and conflicts. However, without further detail on the content of secondary legislation (both UK and EU) it is difficult to tell what those specific conflicts might be.

141. Furthermore, the Liikanen proposals are themselves under consultation and will take time to be implemented. It is difficult to know what form they will take, but given the attachment of civil law countries to universal banking, they will be unlikely to follow the form of the UK proposals.

142. The complicated policy environment and the high level of uncertainty with regard to future developments support the argument against the UK running ahead of other international development and legislating, at least until it is clear what is happening elsewhere and how it will impact the UK.

143. As we have previously noted, the plan to move forward with UK rules in this area needs to take into account the potential impact of the emerging regulatory philosophy at EU level, as evidenced in the banking context by the recent establishment of the EBA. This is likely to involve increasingly detailed European legislation, greater use of Council Regulations having direct legal effect in Member States and increased restrictions on the ability of Member States to adopt super-equivalent local measures which go above and beyond the standards outlined in European legislation. This will almost certainly make it more difficult for individual Member States to adopt local measures that deviate from agreed uniform European standards. The EBA (in common with the other European Supervisory Authorities) is expected to play a significant role in adopting binding technical standards relating to European legislation and ensuring that this legislation is correctly implemented, interpreted and applied by individual Member States. We therefore imagine that, over time, the ability of Member States to add to or deviate from agreed European standards and interpretations will be progressively eroded.

OTHER

32. What other matters should the Commission take into account?

144. The Commission should take account of the need to create a sustainable banking system that can concentrate on serving its customers at a reasonable cost and meet all its customers' needs in the global economy, without ongoing subsidies from the public purse. These goals seem to have been given insufficient weight in the design of the proposed reforms.

145. It should also consider the need to preserve the attractiveness of London as a financial centre and the ability of service industries which contribute to the economy, such as the legal profession, to develop their businesses both at home and abroad.

31 October 2012

Written evidence from Lloyds Banking Group

Lloyds Banking Group ("Lloyds") welcomes the opportunity to contribute to the Parliamentary Commission on Banking Standards' call for evidence into the Government's draft Financial Services (Banking Reform) Bill.

EXECUTIVE SUMMARY

- **Recommendations of the High-level Expert Group (HLEG) on banking reform (the Liikanen Report) are worthy of careful consideration**—given the similarity of the objectives between the Liikanen Report and the Independent Commission on Banking (ICB), it is worth assessing whether it is possible to harmonise some of the recommendations, for example around "*de minimis*" exemptions and risk management products
- **Simple risk management products should be allowed to be provided alongside corporate lending relationships**—simple risk management products, such as interest rate and foreign exchange hedges, are needed by corporate customers of all sizes and reduce credit risk from those customers to the RFB—thus allowing banks to lend more and support the economy. We would suggest strict limits on the simple derivative products that can be sold by the RFB; allow them to be sold to any Mid-Cap and larger Corporate inside the RFB; with firm requirements to mitigate market risk; and with very strong conduct regulation safeguards over their sale to smaller and less sophisticated business customers.
- **Flexibility in governance arrangements is appropriate for predominantly ring-fenced banks**—we welcome the recognition in the White Paper of the case for greater flexibility where the "overwhelming majority" of a group's banking activity would fall within the ring fence. It makes sense for the board that oversees the overwhelming majority of the bank's activity being the board that is directly accountable to the group's shareholders.
- **Harmonisation with the Recovery and Resolution Directive (RRD) on loss absorbency proposals is important to ensure the continuity and stability of banks' funding**—the RRD and the Government's proposals take different approaches to limiting the effect of bail-in on the cost of wholesale funding, while depositor preference as suggested in the Government's proposals would appear to be incompatible with the current RRD. Consistency is necessary to ensure that banks can access necessary funding sources.

- **A long transition period is required**—given the complexity of the changes required to implement ring-fencing, setting an implementation date of 2019 as suggested in the ICB's Final Report is reasonable. There may be circumstances (such as third party consents which will not be granted and overseas Regulatory approvals which are subject to delay) which may delay implementation beyond 2019 for reasons outside of a bank's control. We would welcome confirmation that transitional/grandfathering provisions will be in place to accommodate such circumstances.

OBJECTIVES AND GENERAL APPROACH

1. Does the draft Bill successfully give effect to the objectives set out in paragraph 1.3 of Sound banking: delivering reform and is it the most efficient and effective means of delivering those objectives?

The draft bill provides a useful and flexible framework for implementation of the objectives set out in paragraph 1.3 of Sound banking. However, in terms of whether the draft Bill successfully gives effect to those objectives (and the underlying principles of the ICB report, as further developed in the June White Paper) it would be necessary to see the draft (or intended content) of the secondary legislation and Regulatory rules before a full assessment could be made.

A combination of ring fencing, enhanced resilience of the capital structure and credible resolution schemes would reduce both the probability and impact of bank failures and in particular help to safeguard the key economic functions performed by UK retail and commercial banks. These measures could also reduce the risk of contagion from difficulties in investment banking to UK retail banking and minimise the distortion of incentives at both retail and investment banks.

The ICB's recommendations, which would be implemented through the draft Bill and other European legislation such as the Capital Requirements Directive (CRD IV) and the RRD, deliver these objectives. As noted in question 2 below, however, other options would also give effect to the stated objectives.

2. Do any of the recommendations of the Independent Commission on Banking (ICB), which the draft Bill seeks to implement, need revision as a consequence of developments since the ICB's report?

We consider that the publication of the Liikanen Report as an important development that should be taken into account by the Parliamentary Commission.

Consistent with the objectives of the ICB, the Liikanen proposal that proprietary trading and some categories of financial institutions be placed in a separately capitalised and funded subsidiary would: reduce the complexity and interconnectedness of the "deposit bank"; prevent trading activities from being cross-subsidised by customer deposits; and enhance resolvability. At the same time, subsidiarisation rather than full separation preserves any synergies between retail/commercial and trading activities. Furthermore, the recommendations recognise that not all categories of financial institution pose the same risk to the activities of the "deposit bank".

Lloyds considers that the "de minimis" boundary proposed by the HLEG (i.e. not mandating separation for banks without significant market-making activities) is consistent with the objectives of the ICB recommendations, when taken together with the enhanced capital requirements and the RRD/living wills. If this proposal were to be adopted in the UK, this would still meet the objectives of the ICB but would ensure that UK banks are on more of a level playing field with European counterparties.

Allowing the provision of risk management products to non-bank clients from inside the "deposit bank" is a sensible way to ensure that banks are able to continue to provide essential non-speculative services to its SME and corporate customers. Separating hedging from the rest of the client relationship can increase credit risk and thereby reduce lending volumes (with knock-on implications for economic growth) and increase both complexity and risk for both the deposit bank and corporate customers. The RFB would pass market risk to third parties under collateral arrangements, and use central clearing where available.

3. Do the powers in the draft Bill and the Government's stated intentions for their use give effect to the ICB's recommendations? Are any deviations justified?

With the exception of certain loss absorbency recommendations which are to be implemented through European legislation (see question 22 below), the draft Bill provides a framework to give effect to the ICB's recommendations on ring fencing, but, as much of the detail will be confirmed in secondary legislation and Regulatory rules it is too early to say whether the proposed legislation will meet the Government's stated intentions.

4. What should be the timetable for implementation of these measures, and should it be set out more clearly?

Given the complexity of the changes required, we consider 2019 for full implementation to be reasonable (with a later implementation date of 2025 as set out in the White paper for Pension scheme related requirements). It would be desirable to have the dates included more explicitly in the legislation, as currently no dates are specified in the draft.

There may be circumstances (such as third party consents which will not be granted and overseas Regulatory approvals which are subject to delay) which may delay implementation for reasons outside of a bank's control.

We would welcome confirmation that transitional/grandfathering provisions will be in place to accommodate such circumstances.

We would welcome sight of the draft secondary legislation at the earliest possible time, however in the interim, a clarification of both the timing and intended content of the secondary legislation would be very helpful, in particular to guide implementation planning.

5. The draft Bill proposes continuity objectives on the PRA and FCA. Are these appropriate and compatible with their other objectives?

While it is not entirely clear as drafted, we understand the continuity objective to relate to vital services within the system as a whole, rather than services at any particular bank. If this understanding is correct, then the continuity objective would be compatible with the Government's goal of allowing RFBs to fail without recourse to the taxpayer.

BANKING STANDARDS AND COMPETITION

6. What will be the impact of the proposed changes in the draft Bill on banking standards in the UK more widely?

7. What will be the impact of the separation of retail and wholesale banking on the culture prevailing within each?

Questions 6 and 7 are answered together.

The introduction of ring-fencing has the potential, if carefully executed in the legislation, to help rebuild consumer trust in the banking sector and more clearly separate the different cultures of retail/commercial and investment banking. Ring-fencing will prevent investment banks from being able to be supported by retail/commercial banks, with consequent impact on the risk culture and remuneration in the investment bank. It should also be noted that investment banking has a different business model and culture as it is done deal by deal; retail and commercial banking is about relationship banking through the cycle.

8. What will be the impact of the ring-fence on competition, both in retail and investment banking, and in other areas of financial services?

One of the most important considerations from a competition perspective is whether banks are competing on a level playing field:

- (i) On the investment banking side, the ICB specifically did not recommend applying an additional Core Tier 1 buffer, on the basis that this would disadvantage investment banks vis-à-vis their international competitors which did not face this restriction.
- (ii) In retail/commercial banking, there is the potential for the ICB's recommendations to create a barrier to expansion for smaller banks just below the "*de minimis*" level proposed by the White Paper (see question 13)
- (iii) the ICB's recommendations would place UK retail/commercial banks at a disadvantage to their Continental rivals operating in the UK, as these rivals would be able to operate in the UK via branches that would not be subject to ring fencing requirements. In addition, if the Liikanen proposals are implemented across Europe then the potential interaction of the different layers of ring-fencing rules—EU/UK—would require further analysis to ensure the overall impact on UK banks is not disadvantageous from a competition perspective.

DELEGATED POWERS AND ACCOUNTABILITY

9. The draft Bill grants a large number of delegated powers to the Government. Are the principles under which delegated powers are to be exercised sufficiently clear?

The principles are not always clear or at least—they are not in any way referenced back to the principles of the Vickers report as developed by the June White Paper. By way of example, the Government is given wide discretion to define additional excluded activities (other than dealing in investments as principal) under Section 142D and similarly wide discretion to impose prohibitions under Section 142E in relation to transactions; establishment of branches and restrictions on shareholdings. Much of the detail in these areas as developed by the White paper is not specified in the draft Bill. Whilst we welcome there being scope for flexibility in secondary legislation (and regulatory rules) this must come with a degree of certainty as to the approach that will be taken in the key areas—not least so that detailed implementation planning can commence with a degree of certainty as to the direction of travel on these key areas. Detailed implementation planning will inevitably be delayed until this clarity is provided, which may in turn cause difficulties in banks meeting the 2019 timeline.

10. *Does the scope of the delegated powers in the draft Bill represent an appropriate balance between flexibility for the Government to respond to changing conditions and accountability to Parliament and the public?*

The draft Bill grants the Government considerable flexibility to adjust the ring fence to changing conditions. While some flexibility is desirable, it is important for the stability of the banking sector and its ability to support the economy that:

- (i) such flexibility not have the effect of prolonging regulatory and legal uncertainty for the sector—in the sense that, as referred to above, there needs to be sufficient clarity at an early stage as to the direction the secondary legislation will take on the key areas, so that detailed implementation planning can commence; and
- (ii) the regulator who determines the Ring fencing Rules must be subject to controls around timing of the implementation of the Rules (a phased approach on the basis of a published timetable would be preferable) and once implemented, material changes to those rules should be subject to industry/Treasury consultation and a reasonable lead in time to be agreed with banks in advance. Any changes to the Ring-fencing Rules could have a significant operational/economic impact which would need to be taken into account before any rule changes become effective.

11. *Is there sufficient clarity about the Government's intended use of delegated powers, both to enable public understanding and to enable affected banks to prepare for the proposed changes?*

By its nature, the draft primary legislation leaves significant areas to be clarified by secondary legislation and regulation. As mentioned above we would welcome clarity around the direction of travel on the key areas—either in a confirmatory paper or in an early draft of the secondary legislation and an overview of the content of ring-fencing rules. In particular it is unclear how the Treasury will use the delegated powers to implement the changes in terms of excluded activities e.g. whether an RFB's treasury activities for balance sheet management will be permitted; whether simple risk management products will be permitted; and in the Regulator's ring-fencing rules—how operational and economic separation will work in practice in areas such as group service provision; intra group contracts; governance and restrictions on shareholdings. However it would be helpful (and assist implementation preparations and planning) to have clarity that it is the current intention that the Regulator's ring-fencing rules will implement proposals as described the White paper without significant amendment.

Banks therefore do not yet have sufficient clarity to take concrete steps to prepare for implementation.

12. *The draft Bill provides for review of the ring-fencing rules by the PRA every five years. Does the proposed review mechanism provide sufficient accountability?*

As noted above, we recognise the need for the ring fence to be able to adapt to changing circumstances. On the other hand, it is important that the banking sector not remain under continuous regulatory and legal uncertainty, which would undermine its ability to support the economy.

As mentioned above—the manner of future amendments to the ring fencing rules requires some consideration as care needs to be taken that Regulators do not introduce any material changes without appropriate consultation, impact assessments and lead-in times for implementation.

THE RING-FENCE

13. *Is the power to be able to exempt certain categories of deposit-taking firms from having to establish a ring-fenced bank appropriate, and on what basis should the conditions for exemption be set?*

In order not to create an additional regulatory barrier to entry into the banking sector, we support the Treasury taking the power to exempt smaller deposit-taking firms from ring fencing requirements. The threshold proposed in the White Paper (£25 billion in deposits from individuals and SMEs) appears sufficient to achieve this goal. As noted earlier, however, ring fencing and additional capital requirements will be a modest barrier to expansion beyond this size.

We would also note that the Liikanen Report introduces another type of exemption on the basis of the quantum of a bank's trading assets, either as a percentage of total assets (15–25%) or an absolute threshold of €100 billion. Banks below this threshold, that were also able to demonstrate resolvability, would not be required to separate proprietary trading activities from the rest of the Group. As noted in question 2, we believe this is consistent with the ICB's objectives and avoids unnecessary disruption for institutions that are primarily retail and commercial banks.

14. *Is the range of core and excluded activities defined in the draft Bill appropriate and sufficiently broad? Are the Government's stated intentions for using powers to define further core and excluded activities appropriate?*

The draft Bill currently only defines one “core” activity, namely individual and SME deposit-taking, and one “excluded” activity, namely dealing in investments as principal. However, the bill allows the Treasury to

define additional activities in either category, or to make exemptions as appropriate. We understand from the Policy Overview and the HMT White Paper that the Government intends to clarify its position on core and excluded activities through secondary legislation and we look forward to reviewing this draft legislation when available.

15. Which categories, if any, of customer should be permitted to deposit with a non ring-fenced bank?

It is important that if any exemptions are made to the principle of having deposit-taking inside the RFB, that the customers concerned (individuals or SMEs) are able to withstand potential disruptions in key economic services. We therefore agree that for individuals, there should be an appropriate threshold of free and investable assets and also that qualifying individuals should be required to actively choose to bank outside the ring fence. In other words, the default option would be to have individuals and SMEs inside the RFB and for Corporates to have the option to choose.

16. The Government is considering whether to allow ring-fenced banks to offer simple derivatives to their customers. Should they be allowed to? If so, what safeguards would be necessary?

The White Paper proposal to allow RFBs to sell simple risk management products purely to SMEs was administratively tidy but, we believe, the wrong way around. There is a good economic case for allowing RFBs to provide very simple risk management products—interest rate and foreign exchange hedges—alongside lending to its corporate customers, particularly mid-caps and larger corporates who for example will be more likely to be exporters. Such simple risk management products are needed by customers and reduce credit risk from those customers to the RFB—thus allowing banks to lend more and support the economy. The RFB would pass market risk to third parties under collateral arrangements, and use central clearing where available.

So we would suggest strict limits on the simple derivative products that can be sold by the RFB; allow them to be sold to any Mid-Cap and larger Corporate inside the RFB; with firm requirements to mitigate market risk; and with very strong conduct regulation safeguards over their sale to smaller and less sophisticated business customers.

17. Are the proposed corporate governance arrangements between the ring-fenced bank and the wider group sufficient to ensure the independence of the ring-fenced bank? Are these arrangements compatible with directors' duties and principles of accountability?

We welcome the recognition in the White Paper of the case for greater flexibility where the “overwhelming majority” of a group’s banking activity would fall within the ring fence. In such a case, not having flexibility would lead to an impossible situation whereby the Group board was not in control of the majority of the operations of the Group. In practice, this would be almost impossible to operate, with severe implications for the responsibilities and duties of the Group Board to shareholders.

We would note that the “*de minimis*” proposals of the HLEG, whereby a Group without significant trading activities would not be required to separate, would avoid the governance issues discussed here.

18. How appropriate are the proposed restrictions on exposures and operational dependencies between the ring-fenced bank and the rest of the group? Will these result in a sufficient degree of independence and resilience?

The draft Bill provides that the RFB must be able to act independently of the rest of the Group and that as part of this, its dealings with the non-ring-fenced portion of the Group must be on an arm’s length basis and disclosed to the regulator. Furthermore, the rules would restrict disbursements from the RFB to the rest of the Group, which would prevent the RFB jeopardising its own capital position in support of the non-ring-fenced bank.

19. Will it be possible to effectively monitor and police the ring-fence, given the degree of regulatory discretion the draft Bill proposes?

While the Bill as currently drafted grants regulators considerable discretion, we would expect that secondary legislation and regulation would be drafted with the ease of monitoring and policing in mind.

20. How effective will the provisions on corporate governance for ring-fenced banks be in promoting a wider improvement of standards? Should other measures also be considered?

Sound governance arrangements have a role to play in restoring trust and confidence. The focus on governance has brought about positive changes but it is difficult to say whether this is due to the codes themselves or down to Directors learning the lessons for themselves. Bank Boards need to provide the leadership and, critically, ensure that they have overriding responsibility for financial soundness, customer treatments and standards/ethics. In this regard, it is important that the Board provides appropriate oversight of the “tone from the top”.

Significant progress has been made in enhancing and refining corporate governance practices in recent years. These should now have time to become established. If there is an appetite for further change, we would highlight:

- There is an opportunity to reduce the current proliferation of codes and standards by consolidating the various initiatives and removing duplication/overlapping requirements.
- A greater emphasis on the collective responsibility of the Board, consistent with legal principles.
- Greater clarity on the precise accountabilities of the Non-Executive and Executive Directors.

DEPOSITOR PREFERENCE

21. Is the proposal to prefer insured deposits in the event of a bank insolvency justified? Is there a case for broadening the scope of deposits which benefit from this protection?

The Policy Overview expresses support for the concept of insured depositor preference, whereby in a resolution scenario, the FSCS would be given priority over senior unsecured creditors. On the other hand, paragraph 2.40 also notes that the proposal to introduce depositor preference is subject to ongoing developments in relation to the RRD at the EU level.

We would note that depositor preference would appear to be incompatible with some of the objectives of the current version of the RRD, namely to minimise the impact of bail-in on banks' wholesale funding costs. Specifically, the RRD suggests that bail-in should cover a wide range of creditors (including deposit insurance schemes) so as to prevent the full cost of bail-in falling on any particular class of liabilities, such as senior unsecured funding. Depositor preference would be directly contrary to this logic, by exempting the FSCS and thereby narrowing the pool of potentially bail-in-able liabilities. Depositor preference would thus increase the cost and reduce the availability and stability of bank funding.

By the same logic, we would oppose any extension of depositor preference to cover pension funds or other individual types of counterparties. Such an extension would worsen the encumbrance of the RFB's assets and therefore make the position relative to the cost and availability of funding more challenging, with consequent impacts on the broader economy.

CAPITAL LEVELS

22. Does the draft Bill adequately implement the ICB's recommendations on loss absorbency requirements?

The ICB's recommendations in relation to loss absorbency included:

- A ring-fence buffer of 3% CT1 equity.
- A resolution buffer of up to 3% of RWAs in additional loss absorbing capacity.
- Primary Loss Absorbing Capacity (PLAC) of 17%, where PLAC consists of equity and non-equity capital plus "bail-in bonds" with a remaining term of at least 12 months.
- Bail-in of unsecured debt with a term of 12 months at time of issue.
- Depositor preference for FSCS-insured deposits.

The draft Bill empowers the Treasury to require the regulator to impose specific debt requirements on both ring-fenced and non-ring-fenced banks, which would in turn allow the imposition of the PLAC requirement. It should be noted, however, that in addition to traditional (or newly defined) subordinated loss-absorbing debt categories—where regulators have traditionally provided their banks with targets—as drafted, other forms of debt could also be required, in any amount [and at any time]. As such, the powers could be seen to go far beyond what is required to implement the policy in the HMT White Paper or the ICB Final Report, and some review of the proposal for control over the levels of non-subordinated debt may be required to ensure the going-concern operation of banks is not adversely impacted.

The Policy Overview notes that the scope of bail-in and depositor preference will be dealt with through the RRD and that the buffers can be implemented through the Capital Requirements Directive (CRD) IV. It should be noted that the RRD describes bail-in requirements in terms of a percentage of liabilities, while the ICB's recommendations were in terms of a percentage of RWAs. This potential inconsistency would need to be addressed so that the requirements on banks are clear. Please also see our previous comments on Depositor Preference in Q21.

23. The draft Bill gives the Government power to direct the way in which the regulators can implement loss-absorbency requirements. How appropriate and well-designed is this power?

As noted above, the draft Bill empowers the Treasury to allow regulators to require banks to issue any form of debt in any amount. While this would allow the implementation of the ICB's recommendations on PLAC, Treasury and regulators would have the flexibility to significantly alter either the form or content of banks' debt requirements. It would be helpful to have clarity on this as soon as possible and in particular confirmation that the intention is that the Treasury and Regulators would use this discretion only in line with the previously stated principles as set out in the ICB report and June White paper.

24. *Is the Government's stated intention for the design of loss-absorbency requirements workable? Will it provide a sufficiently well-capitalised banking system? In particular, how justified is the intention to allow an exemption for assets held in overseas operations?*

The resilience and loss absorbing capacity of banks will be significantly enhanced by the stated intention to implement the ring-fence buffer and PLAC of 17%. We agree it makes sense for regulators to give further consideration as to whether PLAC would need to be held against Non-EEA assets.

25. *Is the Government justified in its decision not to implement the ICB recommendation for a higher leverage ratio than is required by Basel III?*

We agree with the imposition of a leverage ratio as a back stop and understand that the issue is still under consideration by the Basel Committee. Because of their calculation logic, Leverage Ratios can give a distorted view of retail-based banks with large volumes of low-risk assets. Hence we would encourage the Basel Committee/Government to consider developing bank-specific targets for this ratio.

RESOLVABILITY

26. *Will the UK authorities have the necessary tools and powers (as a result of this legislation and other initiatives) to be able to resolve a large failing ring-fenced or non-ring-fenced bank, while maintaining financial stability and minimising the risk to public funds?*

It is important to remember that a RFB would be a much safer entity and so would be much less likely to need to be resolved. It will be insulated from the greater interconnectedness of investment banking activities. Applying the enhanced Basel III capital and liquidity standards to such a subsidiary would create an especially well-capitalised and well-funded entity, contributing to, and benefiting from, economic stability.

In the unlikely event that the RFB needed to be resolved, it would be simpler by virtue of being less interconnected. The Special Resolution Regime already provides for a number of resolution options, including use of a bridge bank and temporary public ownership.

27. *What is your assessment of the Government's preferred design of "bail-in" powers needed to improve bank resolution? How likely is it that the Recovery and Resolution Directive will deliver effective bail-in powers?*

As noted above, the Government's proposals specify PLAC (and by extension bail-in-able debt) in terms of a percentage of RWAs, while the RRD uses non-equity liabilities. A further difference is the scope of liabilities that would be subject to bail-in. Both the RRD and the Government's proposals seek to limit the effect of bail-in on the cost of wholesale funding, but take different approaches. The Government excludes short-term liabilities (with remaining terms of less than one year) while the RRD takes the approach of bailing-in a wider set of liabilities, with original maturities of greater than one month. While both approaches have merit, and ultimately the impact on wholesale funding costs is an empirical question, we are currently inclined to support the RRD approach.

In line with this view, we have some difficulties with the proposal being put forward by the Bank of England that, for practical reasons in a resolution situation, it may be necessary to allow a Resolution Authority to prefer one category of creditor over another, where both those creditors legally rank *pari passu*.

As to the RRD, we are confident that there is considerable impetus for the EU to deliver a crisis management regime that includes automatic conversion or right-down of capital instruments at the point-of-non-viability (PONV), and a senior debt bail-in tool for use in resolution of a failed bank. However we foresee it as likely that the RRD formulation of the senior debt bail-in tool will place limitations on the use of this tool so as to clearly detach it from the treatment mandated for capital instruments, and to restrict the role of the tool to use alongside the other post-PONV resolution tools. We believe this to be a sensible approach in order to ensure investors continue to perceive a real distinction between junior and senior debt instruments.

IMPACT ASSESSMENT

28. *Is the impact assessment of the costs and benefits credible and balanced?*

In aggregate, a full cost-benefit analysis would probably conclude that the NPV of benefits exceeds the NPV of costs for the reform package in the draft Bill. However, the CBA included in the draft Bill doesn't fully consider some aspects of both the benefits and costs of the reform package.

On the benefits side, the focus is almost exclusively on how the proposed measures would impact the probability of future crises, rather than the impact of crises should they occur. Depending on circumstances, some measures could have the effect of making a crisis that did occur more severe. For example, bail-in could reduce the availability of funding in a downturn, or depositor preference could enhance the volatility of non-preferred deposits in a downturn, adding to funding requirements in a stress.

On the costs side, the short run impact of some measures is not considered—the proposed 2019 implementation is implicitly assumed to eliminate short run impacts. Some measures proposed could depress

economic recovery between now and 2019. For example, the higher cost of senior unsecured funding due to depositor preference and bail-in increases the cost of credit, though the Government's Funding for Lending scheme seeks to alleviate the cost of funding in the immediate future. In addition, higher capital requirements (e.g. EBA stress tests) in a shorter timeframe would encourage faster de-leveraging.

29. Might there be any other unintended consequences which have not been considered?

As with any complex reform effort, there is the possibility of unintended consequences, most importantly to the supply of lending and the capacity of UK banks to support the economy. There has been growing recognition recently that measures which make banks safer in the long run, such as higher capital requirements, can have damaging side-effects in the short run, particularly when implemented quickly. A long transition period, such as envisioned in the Final ICB report, is therefore essential to help minimise the impact of reforms on the speed of recovery.

INTERNATIONAL ISSUES

30. What will be the impact of the proposals on the international competitiveness of UK banks?

As noted in question 8, the additional regulatory burden imposed by ring fencing and super-equivalent loss absorbency requirements puts UK retail/commercial banks at a disadvantage relative to European banks that are able to operate in the UK through branches rather than subsidiaries. If the recommendations in the Liikanen report were enacted, the competitive disadvantage would be reduced though not removed.

31. Are the proposals consistent with existing and forthcoming international and EU regulatory initiatives, for example the recent Liikanen Report? To what extent are they likely to be superseded or generate conflicts?

There are several cases of inconsistency between UK and EU regulatory initiatives.

As noted in question 21, depositor preference would appear to be inconsistent with the RRD. Specifically, the RRD suggests that bail-in should cover a wide range of creditors (including deposit insurance schemes) so as to prevent the full cost of bail-in falling on any particular class of liabilities, such as senior unsecured funding. Depositor preference would be directly contrary to this logic, by exempting the FSCS and thereby narrowing the pool of potentially bail-in-able liabilities. Depositor preference would thus increase the cost and reduce the availability and stability of bank funding.

Likewise, the Government's proposals specify PLAC (and by extension bail-in-able debt) in terms of a percentage of RWAs, while the RRD uses non-equity liabilities. A further difference is the scope of liabilities that would be subject to bail-in. Both the RRD and the Government's proposals seek to limit the effect of bail-in on the cost of wholesale funding, but take different approaches. The Government's proposals exclude short-term liabilities (with remaining term of less than one year) while the RRD takes the approach of bailing-in a wider set of liabilities, with original maturities of greater than one month.

OTHER

32. What other matters should the Commission take into account?

As ring fencing will inevitably involve the transfer of customers between entities, we welcome the Government's intent, in Clause 5 of the draft Bill, to amend Part VII FSMA, which is the main legislative method currently available in the UK for transfers of banking business without the need for customer consent. However we have some concerns about whether Clause 5 would effectively address the shortcomings of Part VII.

In particular we consider it is not entirely clear from the current draft of the amendment to section 106 FSMA as to whether the new category of Part VII transfer would still require there to be an element of deposit taking. We assume this is not the case but would welcome early clarification.

In addition we understand that the intention is that the PRA would conduct a pre application review of banking business transfers made under this new section. Any additional detail which could be provided on the intended process would be welcome.

We note also that the amendment to Part VII FSMA does not (and clearly could not) solve the issue of separation of businesses held in overseas subsidiaries and branches where individual customer and counterparty consents may be required. To this end we would hope that the UK Regulator would reach out to its overseas counterparty Regulators to ask for their co-operation when banks approach them to discuss the impacts in the relevant jurisdiction and offer assistance where required.

Written evidence from Nationwide Building Society

EXECUTIVE SUMMARY

Nationwide is fully supportive of the draft Bill's objectives—the plan to “carve out” building societies from the ring-fence but then to bring the Building Societies Act into line with these restrictions is a sensible approach.

With regard to firms' loss absorbency, the Government's decision to implement a 3% leverage ratio, rather than the ICB-proposed 4.06%, will avoid significant unintended consequences. Should this be reviewed, the leverage ratio must reflect material differences in institutions' risk profiles and in particular a separate class for building societies should be created. A lack of clarity also remains as to the definition of an institution's Primary Loss Absorbing Capacity.

Depositor preference should be applied to all retail depositors—not just those with balances below £85,000—to provide a clearer and more powerful message to savers.

With increasing attention on the culture and standards within the banking sector, we believe that building societies may be able to provide valuable examples of how a greater focus on customer need can be achieved successfully.

OVERARCHING COMMENTS

1. We recognise the need, following the financial crisis and in anticipation of any future crises, for significant reform of the banking sector to ensure greater financial stability. The reform package proposed by the ICB represents an important step towards this goal.

2. We have consistently emphasised the importance of effective challengers, particularly those in the mutual sector, being able to provide consumers with a competitive alternative to the listed banks. Reforms should, therefore, be guided by the following:

- They should be ambitious in delivering the Coalition Agreement commitment to “foster diversity in financial services, promote mutuals and create a more competitive banking industry”.
- They should not dilute the ability of existing and future challenger brands to compete effectively with the big banks, and they should not discriminate against or disproportionately impact lower risk business models.
- Building societies and ring-fenced banks should remain distinct—but the Government should ensure consistency, as far as is appropriate, between the permitted activities of the two.

3. In this context:

- **We are supportive of the draft Bill's objectives and general approach.** It represents an important step forward in improving the resilience of the UK's financial system and Nationwide fully supports its core objectives. We broadly welcome the Government's plans for implementing the recommendations of the ICB. Although the draft Bill itself is light on detail, we believe that this is necessary to ensure the legislation can be future-proofed. Where the ICB's recommendations are not to be implemented fully, we believe that the Government's decisions have been appropriate.
- **With regard to the ring-fence, we support the proposed “carve out” for building societies and a review of the Building Societies Act to create a level playing field with the banks.** Given the existing restrictions contained within the Building Societies Act, this is a sensible decision to avoid overlap and confusion, with the draft Bill providing a power to amend the Act to fully reflect the ring-fencing restrictions. It will be essential that these amendments are carried out simultaneously with the introduction of the ring-fence into legislation.
- **On capital levels, the adoption of a 3% leverage ratio, consistent with Basel III, will avoid significant unintended consequences.** We support the principle of a backstop capital measure, along the lines of a leverage ratio. However, the ICB-proposed level of 4.06% would become the primary driver of our regulatory capital requirements. In this situation, the only response available to us would be to shrink our balance sheet and restrict mortgage lending, or perversely, to increase our risk taking.

However, should the Commission wish to revisit this decision, we would urge strongly that the leverage ratio is calibrated based on institutions' risk profiles. Building societies, in general, have materially different risk profiles as a result of the restrictions within which they operate (section 9A of the Building Societies Act and statutory lending and funding limits) compared with unrestricted banks, and should therefore face a relatively lower minimum. This could be achieved by the creation of different classes of institutions, characterised by their risk profiles, and with corresponding leverage ratios.

- **We welcome depositor preference, but believe this should be applied to all retail depositors, not just those below the FSCS limit.** We are doubtful that this would have a material impact on the cost of wholesale funding and believe that the consumer message is much more powerful and comprehensible without qualification. In any case, we support the Government's intention (as set out in its recent Green Paper, *The future of building societies*) to use the Butterfill Act to ensure that building society depositors rank at least *pari passu* with unsecured creditors and create parity with bank depositors in this regard.
- **With regard to the resolvability of institutions, uncertainty remains as to eligibility of debt instruments to form part of an institution's Primary Loss Absorbing Capacity (PLAC)** and it will be important that the bail-in tool recognises different business models.

4. We also recognise the increasing attention on professional standards and the culture within the banking industry. Given the forthcoming establishment of the Financial Conduct Authority, Prudential Regulatory Authority and the Financial Policy Committee, we believe that these organisations should be given time to mature in their oversight of the sector before further regulatory bodies are considered.

5. Ensuring that meeting customer needs is at the heart of institutions will, however, be important to addressing concerns here. Building societies, including Nationwide, can provide valuable examples of how this can be successfully achieved. Our mutual ownership drives a business culture with a natural customer focus, supported by governance structures. For instance:

- **Our corporate ethos, which ensures our internal values set prioritises meeting members' needs, is built into our performance management processes.** It ensures we calibrate how we position our reward, performance, other employee policies and demonstrate the behaviours required to demonstrate how we "Treat Customers Fairly".
- **Customer satisfaction measures have consistently been a key component of our bonus structure for all staff (branch and back office)** and we incentivise employees to increase our independent customer service score lead over our competitors.
- **We have embedded formal customer advocates within the Society.** We have a dedicated Customer Experience division to challenge the design and execution of our products and services, including sales and customer communications.

We look to reward customer loyalty and encourage long term relationships through avoiding "brand new customers only" products and instead providing exclusive offers to those that have the deepest relationships with us.

And we aim to be as transparent and simple with our terms and conditions as possible, and through initiatives such as our Savings Promises and Savings Watch we believe we currently lead the market. There is more the industry can do to enhance transparency and ensure the level of product complexity is appropriate for the customer. Opportunity also exists to make some basic simplifications to existing product areas. For example, an equalisation of the cash and stocks & shares ISA limits would provide consumers with a simplified, fairer offer, building on the popular ISA blueprint. The current arrangements over-complicate the existing ISA proposition, especially for groups such as first time buyers and older people who can benefit from the simplicity and flexibility of cash ISA holdings.

- **We constantly aim to improve our Board's engagement with our customers** to allow for direct access and accountability. For example, in addition to our AGM (at which around eight million of our members are entitled to vote on issues such as executive remuneration), we hold member "talk backs" around the country, hosted by the Chairman, Chief Executive or other Executive Directors, and run online focus groups. This enables direct feedback from and discussions with members, as well as an opportunity to grow personal relationships. We have held well over one hundred such events since 1997.

6. Ultimately, the single biggest force for change will be a greater number and diversity of firms able to compete effectively with the big banks and incentivise a longer-term focus on the customer across the sector. The building society sector has the potential to provide this greater challenge. Nationwide will be doing more, growing our share of current accounts and entering the SME market. But to maximise the impact we can have, we need a level playing field. We would urge the Commission to consider these points as it takes forward its wider work.

RESPONSES TO SPECIFIC QUESTIONS RAISED BY THE PARLIAMENTARY COMMISSION

OBJECTIVES AND GENERAL APPROACH

Q1: Does the draft Bill successfully give effect to the objectives set out in paragraph 1.3 of Sound banking: delivering reform and is it the most efficient and effective means of delivering those objectives?

The draft Bill sets out a legislative framework for implementation of the ICB's recommendations. As the draft Bill is very high level, we will take a keen interest in the secondary legislation which will follow. The advantage of primary umbrella legislation is that it will allow flexibility across a highly diversified and complex industry as well as future proofing constraints on business activity so as not to stifle appropriate industry innovation. Building societies already operate under a similar statutory framework.

Q5. *The draft Bill proposes continuity objectives on the PRA and FCA. Are these appropriate and compatible with their other objectives?*

Yes.

DELEGATED POWERS AND ACCOUNTABILITY

Q10. *Does the scope of the delegated powers in the draft Bill represent an appropriate balance between flexibility for the Government to respond to changing conditions and accountability to Parliament and the public?*

Yes. Section 6 in the draft Bill provides sufficient flexibility to amend the Building Societies Act and related secondary legislation to ensure there is appropriate consistency between building societies and ring-fenced banks.

Q12. *The draft Bill provides for review of the ring-fencing rules by the PRA every five years. Does the proposed review mechanism provide sufficient accountability?*

This seems sensible in order to future-proof the overarching primary legislation framework. However, it will be important that there is consistency and an equivalent commitment for building societies so that its legislative framework is reviewed and any changes are similarly and simultaneously carried across.

THE RING-FENCE

Q13. *Is the power to be able to exempt certain categories of deposit-taking firms from having to establish a ring-fenced bank appropriate, and on what basis should the conditions for exemption be set?*

We do not believe that a *de minimis* threshold should apply such that institutions with a minimum level of deposits could avoid the ring-fence restrictions. This would defeat the overriding objective of implementing ring-fence legislation which, at a practical level, would be difficult to monitor and would create confusion for the public.

However, as touched on above, we believe that it is entirely appropriate for building societies to be “carved out”.

Through this decision, the Government has recognised the particular position of building societies and the fact that they already operate within a legislative framework—the Building Societies Act—that seeks to achieve similar aims. Having to comply with both the Act and the ring-fence rules would be unnecessarily burdensome and confusing. We therefore welcome the decision to “carve out” building societies from the ring-fence rules, but to revise the Act as appropriate to reflect the restrictions to be placed on ring-fenced banks.

This approach will help create a more level playing field between building societies and banks, where the aim should be to ensure both face the same restrictions on activities, whilst maintaining the distinctiveness of building societies (primarily achieved through the retention of the Act’s funding and lending limits).

We have argued strongly that further reforms are necessary to the Building Societies Act—beyond those to reflect the ring-fence restrictions—to remove inappropriate barriers to competition with the banks. We want to work constructively with HM Treasury, following their welcome intentions set out in the consultation paper, *The future of building societies*, to review the Act more fully and ensure building societies are not at a competitive disadvantage.

Q14. *Is the range of core and excluded activities defined in the draft Bill appropriate and sufficiently broad? Are the Government’s stated intentions for using powers to define further core and excluded activities appropriate?*

The draft definitions are very high level and therefore sufficiently broad. The proposed definition of core activities is more specific in that it clearly captures deposit-taking only. The reference to “core services” associated with core activity requires consideration as this was not anticipated in consultations leading up to the draft Bill. The excluded activities definition would capture a multitude of activity and transactions as well as those more traditionally associated with investment banking, so the secondary legislation which caters for permitted ancillary activity should be closely monitored. We are keen to ensure that none of the existing risk management activity allowed under building societies legislation is inadvertently excluded. Building societies have successfully used a range of risk management techniques underneath a statutory framework without jeopardising retail savings.

Q16. *The Government is considering whether to allow ring-fenced banks to offer simple derivatives to their customers. Should they be allowed to? If so, what safeguards would be necessary?*

Building societies currently have this ability which we would not want to see removed, in order that we are able to compete with ring-fenced banks. The statutory restrictions as regards purpose for entering such derivatives have ensured that retail savings are not put at risk. The manner in which derivatives are sold will

continue to be subject to regulation and will no doubt build on the lessons learnt from the FSA's recent investigation into mis-selling by the main high street banks.

DEPOSITOR PREFERENCE

Q21. Is the proposal to prefer insured deposits in the event of a bank insolvency justified? Is there a case for broadening the scope of deposits which benefit from this protection?

We fully support a move to depositor preference, ensuring retail depositors are nearer the head of the queue at insolvency. The potential burden on the rest of the industry through the FSCS charge may also be reduced and retail investors should derive confidence from their preferred position, thus supporting stability in this key funding market.

However, Nationwide has consistently argued that all retail deposits in all ring-fenced institutions should carry creditor priority, not just those up to the FSCS limit. We are doubtful that this would have a material impact on the cost of wholesale funding and believe that the consumer message is much more powerful and comprehensible without qualification.

In any event, we welcome the Government's intention (as set out in its "Future of building societies" paper) to use the Butterfill Act to ensure building society depositors rank *pari passu* with unsecured creditors, creating parity with bank depositors in this regard.

CAPITAL LEVELS

Q23. The draft Bill gives the Government power to direct the way in which the regulators can implement loss-absorbency requirements. How appropriate and well-designed is this power?

In the exercise of this power, it will be vital that higher loss absorbency requirements are applied to firms in a transparent and risk-based manner to avoid unintended consequences, as discussed below with regard to the leverage ratio.

There also remains a lack of clarity as to whether and by what magnitude the Bank of England's Financial Policy Committee (FPC) will be able to amend capital and other measures as part of its macro-prudential toolkit. We would urge the FPC to ensure that macroprudential tools are:

- Used in a proportionate manner.
- Transparent in how and why they are to be used or in what triggers their use.
- Harmonised and sympathetic to international standards in a way that does not damage the competitiveness of the UK's financial service sector.
- Used in a way which avoids unintended consequences. For example, while we are not necessarily seeking special exemption on the use of the tools, the leverage ratio has the potential to have a differential impact on low risk business models such as building societies.

Q25. Is the Government justified in its decision not to implement the ICB recommendation for a higher leverage ratio than is required by Basel III?

The ICB originally recommended a higher leverage ratio of up to 4.06% for large institutions. Such a move would have had significant unintended consequences for institutions such as Nationwide and its members.

With a balance sheet comprising predominantly low risk, prime UK residential mortgage assets, a leverage ratio at this level would become the primary driver of Nationwide's regulatory capital requirements, rather than a backstop measure, as intended. The only response available would be to restrict mortgage lending or, perversely, to increase our risk taking.

Should the decision to implement a blanket 3% leverage ratio be revisited, we believe that the leverage ratio should be recalibrated based on institutions' risk profile, with building societies in general facing a lower minimum relative to other institutions.

We agree with the principle of a "backstop" capital measure along the lines of a leverage ratio. However, it should be recognised that a business model constrained by prohibited activities, as set out in the Building Societies Act (section 9A), and with a balance sheet governed by funding and lending limits will behave differently to one that is unrestricted (i.e. a bank).

This difference, and more precisely the underlying risk characteristics, needs to be recognised in the leverage ratio to avoid an inconsistent capital backstop. The key issue therefore is to determine the extent to which a retail ring-fenced bank and a building society have different risk profiles. In the event that the profiles are materially different, then two different leverage ratios should apply.

We believe that this could be achieved by creating different classes of institutions, characterised by their risk profiles, and with corresponding leverage ratios. For building societies, we would anticipate it being no more than 3%, otherwise it will become a primary measure.

RESOLVABILITY

Q26. Will the UK authorities have the necessary tools and powers (as a result of this legislation and other initiatives) to be able to resolve a large failing ring-fenced or non-ring-fenced bank, while maintaining financial stability and minimising the risk to public funds?

The tools and powers included within the European Recovery and Resolution Directive and UK Recovery and Resolution Plans Consultation Paper, along with the changes proposed in Rapporteur Hokmark's report issued on 16 October, should enable UK authorities to resolve a large financial institution.

These tools and powers, which now include sale of business, bridge banks, asset separation, bail-in and temporary public ownership, will aid in maintaining financial stability and minimising the risk to public funds. However, the addition of temporary public ownership to the toolkit does mean that public funds may continue be put at risk in the event of future failings. The proposed amendments in the Hokmark report will need to be carefully assessed to understand the reasons behind the inclusion and how the proposals would work in practice. It is vital to ensure that the proposals do not destabilise the existing initiatives and key attributes of a successful recovery and resolution plan as set out by the Financial Stability Board.

Given the significant inter-linkages between these proposals and other regulatory initiatives, both domestically and at European level, there is a significant danger of a piecemeal rather than holistic approach developing. One of the key challenges will be to ensure that each of the initiatives are aligned to avoid significant future impacts to the UK financial sector.

Q27. What is your assessment of the Government's preferred design of "bail-in" powers needed to improve bank resolution? How likely is it that the Recovery and Resolution Directive will deliver effective bail-in powers?

Significant further clarity regarding the PLAC proposals is required before we are able to assess their full impact.

As discussed above, should a piecemeal approach develop, this will leave investors and issuers with potential areas of uncertainty due to overlaps or gaps in the overall framework. We fear that this may translate into increased pricing and/or inability to access markets with undesirable knock-on effects into the wider economy.

For example, the European Recovery and Resolution Directive provides detail on provisions dealing with point of non-viability (PONV) in the context of bail-in and resolution. However, PONV is also relevant to the definitions of capital in the Capital Requirements Directive and Regulation. Legislators need to ensure the various pieces of proposed legislation are properly linked to provide clarity to issuers and investors about the requirement for issuing compliant capital and the timescales for the introduction of the particular requirements.

We strongly encourage the authorities to try to introduce solutions in a co-ordinated fashion or, to the extent that this is not possible, to clearly signal where the gaps are, which initiative will close them and over what timescale.

Furthermore, the bail-in tool, as currently articulated, is not particularly nuanced to take account of different business models. As an example, Nationwide and the building society sector draw the majority of their funding from their retail deposit base with very little reliance, relative to the banks, on wholesale markets. Accordingly, the impact of bail-in will be more concentrated on investors in mutuals than in plcs, resulting in a higher write-down per investor. Further consideration should therefore be given to depositor preference for all retail depositors, which would create a situation where all senior unsecured debt-holders were effectively "bailed-in" on insolvency without needing to tackle the complex and potentially destabilising topic of formal bail-in of senior unsecured creditors.

31 October 2012

Written evidence from Nomura

Nomura is grateful for the opportunity to respond to the Parliamentary Commission on Banking Standards' pre-legislative scrutiny of the draft Financial Service (Banking Reform) Bill call for written evidence.

As a pure-play, international investment bank operating in London with a Japanese heritage, we believe we have a unique perspective that we hope will prove useful to the Commission.

We have played a significant role in the UK banking sector over recent years, advising several UK banks and participating in the recapitalisation of the banking industry. Our experience has given us some useful insights, specifically on bail-in, and we welcome the chance to share our views with you.

We have framed our response against this backdrop, providing opinions where we feel we can add value, rather than answering every question. We have been actively engaged in the Independent Commission on Banking and have submitted to both the Issues Paper and the Interim Report issued by it. The views expressed in this paper closely reflect our submission to HM Treasury's White Paper on Banking Reform, but we feel it would be useful to share these views directly to the Parliamentary Commission on Banking Standards

We comment on the new twin peaks supervisory structure; we have some suggestions for limiting ring-fenced banks' activities to enhance the banking system; then we explain our views on bail-in given our experience in the recapitalisation of Europe's banks.

We elaborate our points in more detail below.

Twin peaks supervisory structure: We support the new regulatory structure and are closely following the regulatory structure developments in the UK in preparation for the formal move to the Prudential Regulatory Authority (PRA) and Financial Conduct Authority (FCA). Regulatory certainty provides financial institutions with the basis they need to make important decisions about allocation of resources. We would suggest that transposition of continuity objectives should keep in mind the division of responsibilities between the PRA and FCA and minimise the opportunity for regulatory conflict.

Financial products and ring-fenced institutions: We support the measures suggested outlined in the Bill to restrict the scope and scale of securities-trading by ring-fenced banks. Given that one of the key aims of the ring-fence proposals is to make the banking system safer, ring-fenced banks should not be permitted to engage in securities markets as principals as this may increase systemic risk.

Further, we would suggest:

- Ring-fenced banks may be permitted to engage in simple interest rate swap transactions or foreign exchange hedging, but should be prohibited from engaging in equity-related, commodities or exotic derivatives products; and
- Ring-fenced banks may be permitted to engage in the above-mentioned derivatives activities only if it can be clearly demonstrated that so doing is of benefit to their customers, particularly SMEs.

Ensuring banks are adequately capitalised: Nomura understands the need for a statutory bail-in tool to ensure that some unsecured liabilities can absorb losses outside of insolvency and liquidation to facilitate a resolution. We believe the bail-in process needs to be uniform across different jurisdictions so we would fully support moves towards international implementation of the bail-in tool.

We have two over-arching comments in relation to bail-in and non-viability. First the market needs precise definitions around what bail-in is and when it would take place. Second, the market needs reassurance that the hierarchy of claims will be preserved in the event of resolution.

We would make a number of further points relating to specific questions in the consultation:

- The bail-in tool should be used only as a resolution tool and not as a recovery tool. In other words, it should be used only at the point of non-viability to facilitate the resolution of systemically important institutions.
- Banks' weighted average cost of capital has clearly been affected by the reduction in the value of the implicit Government guarantee. Before the crisis, banks' cost of capital was artificially low, thanks to taxpayer support. This allowed banks to offer artificially low cost of credit. Now that support is no longer there, the cost of capital has risen. In fact, it is higher than it might otherwise be because there continues to be uncertainty about the process under which the point of non-viability will be determined as well as the consequences of such determination. This makes investors wary about investing in unsecured bank instruments. In addition to this, the market could better screen the resolvability banks if a clear mechanism was established so that investors could recover capital through simple structures rather than complex ones. The sooner the market has clarity around this issue, the more prepared investors will be to invest in bail-inable debt, and to motivate banks to become more resolvable. This will reduce the cost of capital and with it, the cost of credit.
- In addition, there needs to be absolute clarity around bank resolution, including a strong legal framework which will promote market liquidity, lower the cost of capital for banks and reduce the cost of credit to their customers.
- Investors in banks understand that there will be no bail-out and they may have to suffer losses even outside of insolvency and liquidation. The market is generally able to assess and to price that risk but it puts a substantial premium on uncertainty and is particularly concerned by the lack of a credible mechanism for preservation of the hierarchy of claims at the point where losses have to be absorbed by fixed income instruments.
- There needs to be transparency regarding the extent of encumbrance of bank assets by, for example, the issuance of covered bonds.
- Debt issued under foreign law should include contractual provisions to ensure that, for the purposes of bail-in, they are subject to UK law. This is an existing requirement for regulatory capital-qualifying subordinated debt.

- Loss-absorbing capacity should be measured by reference to balance sheet size, as proposed by the European Recovery and Resolution Directive, as opposed to risk-weighted assets, as proposed by the Independent Commission on Banking. This will provide an additional safety valve to ensure that capital measures are not overly-dependent on internal risk-based models. This should reduce variation between jurisdictions and individual banks and therefore increase the comparability of capital ratios.

31 October 2012

**Written evidence from Professor Rosa M. Lastra, Centre for Commercial Law Studies, Queen Mary,
University of London**

INTRODUCTION

Financial legislation in this country is changing yet again. The Financial Services Bill was introduced into Parliament in January 2012 and is expected to receive Royal Assent in late 2012 or early 2013. The Bill creates a new regulatory regime that puts the Bank of England at the centre, with responsibility for financial stability and for prudential regulation via the Prudential Regulation Authority, and creates a Financial Conduct Authority—a streamlined FSA—in charge of conduct of business. (Tinkering with design though will not necessarily improve the quality of regulation and supervision; after all it was the failures in the “how” to supervise rather than “who” that contributed to the crisis). Furthermore, the Government is also working to reduce the severity of any such crisis, and to limit the damage it could cause to the wider economy through the Financial Services (Banking Reform) Bill, which was published in draft on 8 October 2012 and which is expected to be introduced into Parliament early next year). This memorandum addresses the three objectives set out in the policy document that accompanies this Draft Bill, presenting my views on effective means of delivering them. This memorandum also responds to some of the specific questions raised by the Parliamentary Commission in its call for evidence.

MAKING BANKS BETTER TO ABSORB LOSSES

1. In order to “make banks better to absorb losses”, banks can increase capital (and the benefits a simple leverage ratio are well documented) or increase the loss absorbency of debt (via bail-in and/or other instruments). In a depressed economy, however, it is difficult to raise capital, while at the same time encouraging banks to lend. Pro-cyclical regulation was a cause of the crisis but pro-cyclical capital regulation also contributes to the severity and long lasting nature of the downturn. As a result of the crisis, banks generally distrust each other; the interbank market has not been functioning properly for some time and banks have become “addicted” to central bank liquidity. Concerns about liquidity are always worrisome, since the line between illiquidity and insolvency is a fragile and dynamic one.

2. Bail-in appears to be a logical way to allocate losses amongst the banks’ creditors and shareholders, while keeping access to critical banking functions. Bail-in offers a way for rapid recapitalization and avoids value destruction by keeping an institution as a going concern. The FSB Key Attributes recommend that: “Resolution authorities should have at their disposal a broad range of resolution powers”.³⁷ Bail-in is an important instrument in this toolkit. There are two types of bail in: bail in via write down (partial wind down) of debt and bail in via conversion of debt into equity. The proposed Recovery and Resolution Directive (RRD)³⁸—due to be adopted by the end of 2012—focuses on the latter. The essence of bail in is to keep a streamlined bank (balance sheet restructuring) by allocating losses amongst bank creditors and shareholders as a going concern.

3. Bail-in by definition, however, addresses capital rather than liquidity. Hence, it needs to be complemented with liquidity provision by the central bank. Indeed, the two key challenges when discussing the effectiveness of bail in are: liquidity and credibility (given the stigma likely to be associated with the use of bail-ins).³⁹

4. The “spirit” of the bail-in technique, as well as the spirit of prompt corrective action (PCA) in the USA or the now ubiquitous concept of living wills (recovery and resolution plans) is the same: act early, act promptly, act preventively before losses are potentially inflicted upon taxpayers. (As the old English adage says: an ounce of prevention is worth a pound of cure).

³⁷ http://www.financialstabilityboard.org/publications/r_111104cc.pdf, 3.2

³⁸ See also http://ec.europa.eu/internal_market/bank/docs/crisis-management/discussion_paper_bail_in_en.pdf

As regards the bail-in tool, see memo by Lastra in <http://www.bsg.ox.ac.uk/gandf/crossborder>

The House of Lords European Union Committee—EU Economic and Financial Affairs Sub-Committee (Sub-Committee A) chaired by Lord Harrison—is conducting an inquiry into the reform of the EU banking sector, which offers interesting insights and addresses some of the issues—e.g., bail in, ring-fence and accountability—that the Parliamentary Commission on Banking Standards is examining. I submitted written evidence to this Sub-Committee A and was invited to give oral evidence on 9 October 2012.

³⁹ See IMF staff paper ‘From Bail-out to Bail-in: Mandatory Debt Restructuring of Systemic Financial Institutions’ at <http://www.imf.org/external/pubs/cat/longres.aspx?sk=25858.0> published on 24 April 2012. The paper cautions about the fact that if the use of bail-in is perceived by the market as a sign of the concerned institution’s impending insolvency, it could trigger a run by short-term creditors and aggravate the institution’s liquidity problem.

MAKING IT EASIER AND LESS COSTLY TO SORT OUT BANKS THAT STILL GET INTO TROUBLE.

5. In a market economy banks should be allowed to fail. A zero rate of failure is clearly sub-optimal. Like in forest management, where controlled fires have proven to improve the health quality of the forest as a whole, in the banking system, some institutions should be allowed to fail. The business of banking by definition is fragile and vulnerable and banks will continue to get into trouble (100% reserve banking, mutualisation of banking and other narrow banking proposals aim at reducing that fragility by fundamentally changing the business structure, but banking also needs to remain profitable to survive in a market economy). What is essential is that we do not involve taxpayers' money in the resolution of banks. We need both functional separability and geographic separability to facilitate an orderly resolution.

6. Geographic separability has inspired the FSB Key Attributes and the RRD. We need market discipline in regulation, but we also need market discipline in protection. Capitalism relies on the lure of wealth and the discipline imposed by the fear of bankruptcy. Risk is at the essence of finance and, by definition, risk brings return and risk entails failure. Financial institutions may claim to be global when they are alive, but they become national when they are dead. In the aftermath of Lehman Brothers, no one wishes another "chaotic" resolution. The alternative, i.e., a "bail-out" package, is equally unpalatable. There is however, a viable solution between chaos and bail-out and that is an orderly resolution.⁴⁰ The concept of "living wills" is a very welcome development in this regard.

7. Functional separability has inspired the Volcker rule, the Vickers Report and the Liikanen Report. A return to Glass Steagall, i.e., complete legal separation between commercial banking and investment banking business seems impractical (given the funding structure of modern banks, the interconnectedness, the use of derivatives markets, etc.), though in my opinion it is not impossible. Glass Steagall had three benefits: first, legal clarity and predictability; secondly, it contributed to the depth, volume and diversification of the US financial market, in contrast to the [universal] bank dominated systems in Continental Europe. (I contend that the strength of the US capital markets and securities firms/registered broker dealers was fostered by Glass Steagall) and, thirdly, it established clear expectations amongst depositors and investors about the scope of protection of their deposits and investments, by establishing clear legal lines of separation (lessening the incentives to game the system). The demise of Glass Steagall in 1999 coincided with the increase in excessive risk practices (securitisation and others) that together with other factors contributed to the Great Financial Crisis.

8. The common denominator behind the Liikanen Report, the Volcker rule and the Vickers Report, is to prevent the use of depositors' money to finance risky trading activities. However, the existence of different proposals is problematic. First, such differences may provide incentives for financial institutions to go "jurisdiction shopping", opportunities for regulatory arbitrage. While Liikanen proposes the ring-fencing of trading activities, Vickers recommends the ring-fencing of retail activities, and the Volcker rule limits proprietary trading, without ring-fencing. [Of course, in the case of the UK, if Liikanen becomes law, the UK will have to adopt the Liikanen proposals⁴¹—as long as it remains in the EU and committed to the obligations of the single market]. Secondly, (and this applies both to Liikanen and to Vickers), whenever a fence or boundary is established, there is an incentive for institutions to place themselves or part of their business inside or outside the boundary depending on what appears to be more advantageous or beneficial for them.⁴²

9. The third and perhaps major concern is that none of the proposals go far enough to address the loss of faith in banking as a respectable business. The competing demands between competition and regulation, the existence of highly protected and oligopolistic banking markets, and more radical proposals such as the mutualisation of the financial industry (as proposed by Lawrence Kotlikoff) are all issues that should be discussed further, leading then, where appropriate, to adequate structural reforms.

10. Emphasis on capital—important as it is—should not obscure the fact that capital is only one element that contributes to bank's safety and soundness. The quality of the asset portfolio, the integrity of management, the composition of earnings, risk diversification, adequate liquidity management and incentives are all elements that can make banks safer.

CURBING INCENTIVES FOR EXCESSIVE RISK TAKING

11. The efforts to address the too-big-to-fail (TBTF) issue have so far focused on the "to fail" part of TBTF. But we also need to address the issue of size (the "too big" of TBTF), which requires adequate competition law and policy. The reasons for saving troubled banks these days go beyond the protection of insured depositors. If we want to reduce taxpayers' liability, we must also address the issue of size. No institutions should be too big or too complex to fail (as discussed above). If that requires smaller size or simplicity then that should be the solution we should contemplate, regardless of vested interests. The implicit government guarantee must stop. We must simplify banks ex ante. The emphasis should be on prevention.

⁴⁰ See generally Lastra, *Cross Border Bank Insolvency* (OUP, 2011).

⁴¹ Liikanen endorses the loss absorbency of debt via bail in instruments, in line with the proposed Resolution and Recovery Directive. This is of course a very positive aspect of the report, which requires that the subsidiary with the ring-fenced risky trading activities develop a recovery plan. After all, it was the failure of an investment bank (Lehman Brothers) that triggered the great financial crisis.

⁴² See generally Lastra and Charles Goodhart, "Border Problems", *Journal of International Economic Law*, Vol. 13, No. 3, September 2010, pp. 705–718.

12. Compensation structures need to align the long term interests of the firm (and its very survival) with the incentives of bankers. This can be done via regulation, via tax incentives or disincentives and via corporate governance. To begin, both gains and losses should be “privatised” (ending “the privatisation of gains—socialisation of losses” that has created so much resentment). Beyond that, this alignment requires a careful examination (and not populist policies of “banker-bashing”) of whether the short term pressures of focusing on current performance and equity prices continue to trigger the sort of incentives that made many traders and investment bankers search for short term profits, often ignoring any medium to long term scenario. The well documented criticism of compensation packages—where salaries of investment bankers are the smallest part of such packages, dwarfed by the bonus payments—is already triggering changes in an industry where people are smart: salaries are already larger and all sort of tax incentives are being considered to address the tax implications of the new compensation packages. But the profitability of the industry will continue to dictate the level of pay packages.

13. Changes in corporate structure and corporate governance are needed. Whether the public limited company, *société anonyme*, should continue to be the corporate form of banks should be discussed further. Mutualisation of the financial industry as proposed by Kolitkoff⁴³ appears as a radical solution. But clearly focusing on the interests of shareholders and managers ignores the interests of many other stakeholders that are crucial for a healthy banking business: depositors and other creditors, taxpayers, pensioners etc. The problem is the level of protection afforded to banks. The public interest in banking is not aligned with the private interests of managers and shareholders.

OTHER ISSUES (RE ACCOUNTABILITY, ETHICS AND THE EUROPEAN DIMENSION)

14. At a time of rapid change in the EU and Eurozone, national legislative proposals that are not aligned with European legislative initiatives are likely to be short-lived. Hence, Britain must fully “engage” in the current negotiation of the Capital Requirements Directive (CRIV), the RRD and the changes to deposit guarantee scheme that are to be adopted by the end of 2012. For example, depositor preference (a good idea in my opinion and a recommendation of the FSB’s Key Attributes) is not compatible with the current RRD. Britain must also engage in the banking union proposals, which will grant very significant supervisory powers to the European Central Bank and may end up rendering the European Banking Authority irrelevant. Furthermore, the interaction between the European System Risk Board, the ECB and the Bank of England ought to be debated and clarified.

15. We need ethics in banking and finance. The banking culture must change. There are a number of concepts—credibility, confidence, fairness—that should permeate through different layers of regulation and influence the behaviour of bankers and financiers. Regulation should be designed in good times, when rapid credit expansion and exuberant optimism cloud the sound exercise of judgment in risk management, rather than in bad times, in response to a crisis. We must also remember that markets are part of the solution since it is well functioning markets that generate growth.⁴⁴

16. My last comment relates to accountability (who exams the examiners?), more specifically concerns about the accountability of both the Bank of England and the ECB, given their hugely expanded mandate. Article 17 of the proposed ECB Regulation (of 12 September 2012) simply requires: “The ECB shall be accountable to the European Parliament and to the Council for the implementation of this Regulation in accordance with this Chapter”. Is that enough? The answer, in my opinion, is No. With power comes responsibility; Lord Acton’s dictum remains true.

26 October 2012

Written evidence from the Royal Bank of Scotland Group

SUMMARY

The draft Bill remains necessarily broad and general in nature. Therefore it is difficult to assess with precision the extent to which it will deliver the Government’s banking reform objectives. Its general direction, however, appears aligned with the aims the Government has set out.

Because of the draft Bill’s general nature, it remains difficult for banks to plan in detail for implementation of the far-reaching structural changes it will entail. Creating a retail ring-fence will be a complex restructuring involving the potential migration of many retail and corporate customers, and will need to be carried out at the same time as a number of other important change programmes, many of them involving mandatory regulatory programmes. Customer impacts may be amplified if the restructuring is carried out too hurriedly (see response to Q4).

We remain concerned that ring-fencing may unintentionally amplify some of the financial stability problems the Government’s banking reforms are intended to address. For example, ring-fencing could exacerbate the

⁴³ Laurence J. Kotlikoff (Wiley, 2010), *Jimmy Stewart is Dead. Ending the World’s Ongoing Financial Plague with Limited Purpose Banking*.

⁴⁴ See generally Lastra <http://www.law.qmul.ac.uk/podcast/lastra2011.html>

implicit Government guarantee for certain banks (see paragraph 1.4) or increase the risk of financial contagion (see paragraph 18.4).

We support continued efforts to achieve as much harmonisation as possible between the UK's proposals on loss-absorbency and bail-in and the framework that will be applied more broadly throughout the EU once the European Recovery and Resolution Directive (RRD) has been completed. We welcome the Government's intention to introduce bail-in and loss absorbency measures through the legislation that will implement an eventual RRD.

It will be important to bear in mind the consequences of the proposed measures for customer services when designing the more detailed secondary legislation and regulations relating to ring-fencing. Of particular concern is the interaction of restrictions on a ring-fenced bank's geographical activity and on its exposure to financial institutions, which may significantly impair its ability to support UK businesses trading overseas, particularly SMEs, through services such as trade finance and liquidity management.

RESPONSES

Objectives and general approach

Q1. Does the draft Bill successfully give effect to the objectives set out in paragraph 1.3 of Sound banking: delivering reform and is it the most efficient and effective means of delivering those objectives?

1.1 RBS remains supportive of the extensive reform agenda that has been pursued since 2008, most notably through the Basel Committee on Banking Supervision. This agenda includes higher capital ratios, changes in risk weightings, and redefinitions of capital; the addition to the Basel standards for the first time of rigorous global liquidity standards; the application of capital surcharges to systemically important banks; improvements to market clearing infrastructure; enhanced transparency and disclosure; enhanced resolution powers for regulators, including separation and bail-in mechanisms; and enhanced coordination to ensure consistency among international regulators.

1.2 This agenda is well-designed to make banks better able to absorb losses; to make it easier and less costly to sort out banks that still get into trouble; and to curb incentives for excessive risk-taking. Its implementation is already well under way.

1.3 RBS continues to have reservations about the consequences of ring-fencing, as proposed by the UK's Independent Commission on Banking. We believe it is will tend to weaken banks' credit ratings, could have negative economic impacts and, if not carefully executed, cause disruption to customers, while bringing at best modest incremental gains in resolvability, over and above the more targeted measures already in train through the Recovery and Resolution Planning Process.

1.4 Of particular concern is the significant risk that ring-fencing will, contrary to the intentions of the ICB or the Government, cement and make more explicit the perceived Government support for the ring-fenced bank. We welcome the Government's confirmation (paragraph 2.10) that ring-fencing "does not mean that there should be a 'zero failure' regime for ring-fenced banks." This may not, however, be the public perception.

Q2. Do any of the recommendations of the Independent Commission on Banking (ICB), which the draft Bill seeks to implement, need revision as a consequence of developments since the ICB's report?

2.1 Care will be needed to ensure that UK legislation remains harmonised with any eventual European legislation implementing the ring-fencing proposals outlined recently by the High-level Expert Group on reforming the structure of the EU banking sector ("the Liikanen Group"). Though the two variants of ring-fencing appear compatible in some respects, there could also be some divergences.

Q3. Do the powers in the draft Bill and the Government's stated intentions for their use give effect to the ICB's recommendations? Are any deviations justified?

3.1 In our view, the draft Bill gives sufficient effect to the ICB's recommendations. It provides powers for the Treasury and regulators to define (inter alia) the scope of ring-fenced bodies and the rules to apply to such bodies, and gives preferential creditor status to deposits within scope of the financial services compensation scheme. It also provides powers for the Treasury to require relevant bodies to issue or hold debt instruments.

3.2 Since the draft legislation is framed as an enabling Bill, it is not possible (beyond the high level of generality specified above) to talk of any deviation from the Government's stated objectives. The extent to which these objectives are met will depend on how secondary legislation and regulatory rule-making is, in practice, defined and implemented. It remains difficult, nevertheless, for banks to plan extensively for the implementation of ring-fencing on the basis of the high-level primary legislative language contained in the draft Bill.

3.3 There remain some significant potential problems: for example, it is not our impression that either the ICB or the Government intended ring-fencing to inhibit the provision of export finance to UK exporting companies, particularly SMEs, whose deposits will be required to be placed inside the ring-fence, yet there

remains a significant risk that the restrictions on dealings between a ring-fenced bank and other financial institutions will have this effect.

Q4. What should be the timetable for implementation of these measures, and should it be set out more clearly?

4.1 The structural changes involved in ring-fencing will require a significant implementation effort over a number of years, and will need to be executed alongside a number of other important change programmes, many of them mandatory to meet regulatory requirements. Implementation of the ring-fence will be a complex process involving considerable disruption to customers, for example, potential migration of several million retail customers and tens of thousands of UK corporate customers to new account numbers and sort codes. Legal entities and contractual arrangements will also require significant restructuring. Customer impacts will be amplified if the restructuring is carried out too hurriedly. Some aspects cannot be properly planned until the legislation has taken a clearer shape so the target date of 2019, while potentially achievable, will represent a significant challenge.

4.2 By way of comparison, RBS is currently engaged in the transfer of a substantial part of the business activities of RBS NV, its Dutch affiliate, to RBS plc. While much smaller in scale than the implementation of ring-fencing, this project similarly involves the transfer of assets and liabilities between legal entities, changes to customer arrangements and court and regulatory approvals. Following one year of detailed planning the Group Board approved the full project plan in April 2011, and completion of the transfers is expected at the end of 2013.

4.3 Creating the necessary levels of loss absorbency at each level of the Group may take longer, as this may entail not only migrating existing debt and regulatory capital instruments between legal entities but also potentially issuing the necessary quantities of compliant instruments into a market of as yet uncertain depth.

4.4 Given the difficulties of separating pension funds and the potentially large costs that could arise from enforced separation at a time when most such funds are in substantial deficit, a longer timescale appears essential for completion of this element. Although the details of bail-in mechanisms are, as we understand it, intended to be included in subsequent legislation implementing the Recovery and Resolution Directive, we note that if bail-in is to be applied in the first instance only to debt instruments that explicitly provide for this, as envisaged in the Government's White Paper and in the Liikanen report, then it will be difficult by 2019 to establish a sufficiently deep and liquid market to enable issuance in the volumes that are likely to be required.

Q5. The draft Bill proposes continuity objectives on the PRA and FCA. Are these appropriate and compatible with their other objectives?

5.1 The continuity objective is framed solely in relation to core services and activities. However, it is conceivable that in the event of a failure of a major group, it may be important to maintain the continuity of certain non-ring-fenced services and activities, if only for a limited period of time, in order to maintain financial stability and thus the safety and soundness of PRA-regulated persons (the PRA's general objective). For instance, it is quite possible that a resolution authority may wish to maintain the trading operations of a failed bank, until such time as an orderly running-down or sale of a trading book can be effected. Whilst the narrow scope of the continuity objective would not of itself necessarily prevent such action from being taken, a more broadly defined continuity objective that recognises potential risks to financial stability arising from outside the ring-fence and the need to manage these as well, would help regulators meet their wider objectives.

BANKING STANDARDS AND COMPETITION

Q6. What will be the impact of the proposed changes in the draft Bill on banking standards in the UK more widely?

6.1 We see three possible adverse consequences of the proposed changes on banking standards:

- To the extent that ring-fenced banks are perceived to be safer and to benefit from implicit Government protection, this could give rise to moral hazard and could encourage additional risk-taking behaviours.
- By dividing universal banks, ring-fencing could lead to divided resources and increased volatility; this could also affect the ability to sustain customer support in difficult times.
- By increasing costs, ring-fencing may also put further pressure on bank profitability; this may also affect behaviours as banks seek to restore profitability levels.

Q7. What will be the impact of the separation of retail and wholesale banking on the culture prevailing within each?

7.1 We do not believe that it can be confidently predicted that separation of retail and wholesale banking will have any measurable impact on culture. Many of the influences on culture within retail banks that have attracted criticism in recent months are derived more from retailing than from investment banking. We would be concerned if the impression were gained that ring-fencing amounted to a panacea for the cultural issues

facing the banking industry. We remain concerned that placing a ring-fence between retail and wholesale banking could exacerbate the inaccurate perception that ring-fenced banks will be safe, while non-ring-fenced banks will be less safe. Evidently, the great majority of financial crises in history have been associated to a considerable extent with housing and real estate lending, which would in most cases fall inside the retail ring-fence.

Q8. What will be the impact of the ring-fence on competition, both in retail and investment banking, and in other areas of financial services?

8.1 There is a risk that the perception of Government protection for ring-fenced banks will entrench their competitive position and give them an advantage over smaller competitors or new entrants. While the Government has confirmed that it is not its intention that there should be a “zero failure” regime for ring-fenced banks, it is clear that many of our customers view ring-fenced banks as likely to offer a significantly safer home for their money than any bank not subject to the same regime. This could result in an adverse impact on competition.

8.2 The proposed *de minimis* exemption from the requirements of ring-fencing is likely to open up competitive opportunities for smaller banks, particularly in customer segments such as wealthier individuals and more sophisticated SMEs, who may be able to obtain a more comprehensive set of products and services from an exempted bank than they would from a ring-fenced bank. It may also lead to the migration of some business lines to the shadow banking sector.

8.3 While these exempted banks would not be subject to the incremental capital buffer proposed for ring-fenced banks, we do not anticipate that this would have any practical effects, as the ratios required of ring-fenced banks are likely to set a market norm which other banks would also be expected to meet.

8.4 UK investment banks will be placed at a competitive disadvantage to other investment banks not subject to the same restrictions, though it is possible that this competitive imbalance may be at least partially redressed by any ring-fencing measures introduced across the European Union as a result of the Liikanen proposals.

DELEGATED POWERS AND ACCOUNTABILITY

Q9. The draft Bill grants a large number of delegated powers to the Government. Are the principles under which delegated powers are to be exercised sufficiently clear?

9.1 The stated intention is, of course, for the Bill to be enabling legislation, but it operates at an extremely high level—arguably too high. Whilst some of the principles and parameters under which some of the delegated powers would be exercised are explained in the policy overview section accompanying the draft text of the Bill, these are generally not replicated in the Bill itself. We elaborate on this below.

Q10. Does the scope of the delegated powers in the draft Bill represent an appropriate balance between flexibility for the Government to respond to changing conditions and accountability to Parliament and the public?

10.1 We recognise the need for the Government to retain a certain amount of flexibility in order to respond to changing conditions. We would also note the difficulty of taking forward legislation and progressing policy in advance of the landscape at the European level becoming clear. Whilst the European Commission’s High Level Expert Group under the chairmanship of Erkki Liikanen has recently reported on its own ring-fencing recommendations, these remain ambiguous in a number of respects, and the European Commission itself has not yet indicated how it intends to respond to the report.

10.2 Although the policy overview chapter accompanying the Bill is helpful in articulating the basis on which the Bill has been drafted, the key concepts linked to ring-fencing and a PLAC are, in fact, loosely defined in the Bill, with the authorities having been delegated broad powers to craft these concepts. For instance, the Bill does not narrowly define “core services”, “core activities” and other key terms. Similarly, the authorities have broad discretion in s142A (3) to dis-apply ring-fencing to certain institutions; we would welcome greater clarity as to the parameters within which such discretion might be applied. Further clarity would also be welcome in relation to the definition in section s142J (3) of which instruments qualify as loss absorbent, aligning it to the more specific description offered in paragraph 2.57 of the policy overview.

Q11. Is there sufficient clarity about the Government’s intended use of delegated powers, both to enable public understanding and to enable affected banks to prepare for the proposed changes?

11.1 As touched on above, in giving discretion to the authorities to craft secondary legislation and rules, it would have been helpful in our view for the Bill to have provided more specific parameters to help frame the discretion provided for.

11.2 For instance, the exemption in s142A (3) specifies that classes of UK institutions may be exempted from ring-fencing if the Treasury are of the opinion that such an exemption “would not be likely to have a significant adverse effect on the continuity of the provision in the United Kingdom of core services”.

11.3 Such an approach will make it difficult for oversight and challenge to be applied to the exercise of such discretion by the Treasury—ie whether such delegated powers have properly been applied. This is particularly significant given that the use of such delegated powers in many cases could significantly impact the ability of individual institutions to compete in the market.

Q12. The draft Bill provides for review of the ring-fencing rules by the PRA every five years. Does the proposed review mechanism provide sufficient accountability?

12.1 While we are conscious of the danger of increasing and extending market uncertainty about the franchise value of ring-fenced banks, on balance we consider it appropriate to establish a mechanism for reviewing the effects of ring-fencing and other associated reforms, which are far-reaching and will have significant impacts on the business and operating models of affected institutions.

THE RING-FENCE

Q13. Is the power to be able to exempt certain categories of deposit-taking firms from having to establish a ring-fenced bank appropriate, and on what basis should the conditions for exemption be set?

13.1 We acknowledge that the additional costs ring-fencing would entail for banks with only small amounts of mandated deposits could be disproportionately heavy, and might in some cases not be justified by the limited increase in resolvability that ring-fencing would bring for a bank of this size.

13.2 Nevertheless, if the intention of ring-fencing is to improve the possibility of resolving firms without taxpayer support, then it would appear that this ought also to apply to firms with less than £25 billion of insured deposits. We note that Northern Rock, at the end of 2006, had £22.6 billion of retail deposits, yet the Government of the day took the view that it was necessary to take Northern Rock into temporary public ownership.

13.3 In principle, our view is that ring-fencing should be applied to ensure that all firms authorised to accept deposits in the UK operate on a level playing field. RBS is concerned that this principle will be undermined if there is a £25 billion threshold of mandated deposits below which firms will not be subject to the ring-fencing requirements, and so will be able to offer a more extensive and flexible product offering, by utilising prohibited services, than would be available to firms that are required to comply with the ring-fence principles. This same concern as to prejudicing equal treatment extends to the Government's proposal to exempt non-EEA headquartered firms from the ring-fencing requirements. If firms below a certain size are to be exempted from the requirements of ring-fencing, we, therefore, suggest consideration should be given to a lower threshold than that proposed by the Government.

Q14. Is the range of core and excluded activities defined in the draft Bill appropriate and sufficiently broad? Are the Government's stated intentions for using powers to define further core and excluded activities appropriate?

14.1 The draft Bill appears to give the Government ample scope to define both the baseline core activities and any additional activities that might subsequently be considered core (see above para10.2). It should be noted that transferring activities of this kind from one legal entity to another may entail significant execution difficulties and disruption to customers, so adjustments to the perimeter of core activities should not be undertaken lightly.

Q15. Which categories, if any, of customer should be permitted to deposit with a non ring-fenced bank?

15.1 From the customer's point of view, it is important that the ring-fencing regulations balance the competing priorities. On the one hand, it is clearly necessary to protect the interests of those customers who are not well-placed to cope with a disruption of supply, and who would be likely to benefit from the perceived security afforded by the ring-fence. On the other, those clients with more complex financial requirements should not be unduly restricted in their freedom to be served within a single bank, if they should so choose. This will have implications in particular for two categories of customer: wealthy individuals and more complex SMEs.

15.2 *Wealthy individuals*

Whilst an opt-out mechanism provides a means of balancing these interests, it is important that the criteria be clear and certain, in order to reduce the risk of retrospective challenge. We agree with the White Paper's view (paragraph 2.17) that the client needs to actively choose to place his or her deposits outside the ring-fence. We also support a sophistication test along the lines proposed in paragraph 2.17, and agree that a financial threshold based on free and investable assets with a single bank will be much easier for banks to apply than a definition based on total client assets, so reducing the risk of accidental non-compliance. The calibration of the opt-out threshold is more problematic. At the upper end of the band proposed in the White Paper (£750,000), 11% of our Wealth division's UK clients would potentially be eligible to opt out of the ring-fenced bank. At the lower end (£250,000) an additional 15% of UK clients would be eligible, capturing many professionals after 10–20 years of career in middle management. In more buoyant economic conditions, some

clients lacking the appropriate sophistication might be attracted to non-ring-fenced banks. Since the White Paper favours an exemption from ring-fencing requirements for banks with less than £25 billion of insured deposits, covering a very large portion of institutions competing in the high net worth market, it is particularly important that the opt-out mechanism provides a workable means for the very few banks that will be affected by ring-fencing to continue to provide an appropriate level of service to more sophisticated clients, to avoid competitive distortions. Ensuring full compliance with all opt-out requirements for the larger client segment would be likely to create additional operational complexity and costs.

15.3 SMEs

Some customers categorised as SMEs by virtue of their turnover have an operating model that demands access to a complex product suite. Typically, these customers are found within the Professional/Financial Institution/Real Estate Sectors, who in RBS's case make up 18% of the SME portfolio segment. The cost of accessing such products (via a non-ring-fenced provider) may increase for these customers were their deposits to be mandated within the ring-fence. We are also wary of imposing restrictions on customer choice without compelling reasons. This suggests either a low turnover threshold for defining core SME deposits, or alternatively a mechanism permitting a small number of customers defined as SMEs to opt for service from a non-ring-fenced bank.

15.4 We are mindful of the practical difficulties in implementing "opt-out" provisions. At a minimum, tight processes and controls would need to be in place, including, but not restricted to, mechanisms to ensure that opt-outs were only possible at customer instigation; controls to ensure that no incentives, direct or indirect, were in place to influence opt-in/opt-out decisions. Legal rigour would also be needed to ensure that the option was exercised solely in the customer's own interests. Nevertheless, we consider that an opt-out mechanism would be a necessity if the turnover threshold were set at the higher £25.9 million level discussed in the Government's White Paper on Banking Reform, to protect the interests of customers with more complex financial requirements whose access to appropriate services would otherwise be harmed. In some instances these customers could retain access to a broader set of services through agency arrangements, but they would be likely to suffer some cost impact.

15.5 An alternative would be to set the turnover threshold at £6.5 million, which we understand was broadly supported by respondents to the White Paper. This would maximise access to products for customers with complex needs. It would not provide the mandated protection to the majority of customers who would be unaffected by issues around access to more complex products. However, as the White Paper notes (2.11) firms above the threshold could of course choose to place deposits in ring-fenced banks if they wished. We also anticipate that, as a matter of practical customer segmentation, we would in any case continue to serve many customers with turnovers in excess of £6.5 million from within the ring-fenced bank, just as today there are a number of customers with turnover greater than £25.9 million who we would, nevertheless, currently serve within our Business and Commercial Banking business as their financial needs tend to be more straightforward.

15.6 We recommend that, for companies forming part of a group of companies, any assessment of the requirement to bank with a ring-fenced bank should take place at group level.

Q16. The Government is considering whether to allow ring-fenced banks to offer simple derivatives to their customers. Should they be allowed to? If so, what safeguards would be necessary?

16.1 We agree both that the provision of certain derivatives to third parties should be exempt from the general prohibition on trading in derivatives, and that with appropriate safeguards the ring-fenced banks should be permitted to sell retail investment products.

16.2 There is a clear benefit to any client (particularly smaller clients) to be able to source all banking product from one provider. A split banking proposition under the proposed model (loan from the ring-fenced bank, hedge from the non-ring-fenced bank) would result in additional costs for the client given that the non-ring-fenced bank will require collateral to cover the risk in the derivative contract.

16.3 Retail mortgage customers currently have access to products that enable them to manage interest rate/currency risk. The final definition should allow retail clients the same range of currency/interest rate risk management options they currently have. Corporate customers served by the ring-fenced bank should also have access to interest rate and currency risk management products.

16.4 We propose a model where the ring-fenced bank would act as principal in the derivative transaction, while backing out the market risk, through a fully-collateralised ISDA arrangement, to a non-ring-fenced entity. The ring-fenced bank would receive client trade revenues and retain the full credit risk, while the non-ring-fenced bank would receive revenues from the hedge trade, while retaining the market risk. This is in line with commentary in the White Paper and draft Bill; it would also make it easier and less costly to sort out banks that still get into trouble as any market risk exposure is fully collateralised, making it readily transferable to a third party. Doing this on a portfolio basis is a lot simpler than to novate thousands of individual contracts to a new third party.

EXPOSURE SAFEGUARDS

16.5 In practice, it is extremely difficult to define “standardised” or “simple” derivative products. In particular, the proposal in 2.41 of the White Paper to use the accounting fair value hierarchy to define the restriction does not appear appropriate, since this could exclude innovative products of material benefit to clients.

16.6 A robust approach would be to define the product restriction in terms of the net market risk and credit counterparty risk remaining in the ring-fenced bank.

16.7 The ring-fenced bank could provide derivatives (and, in particular, structured retail deposits) wherever the ring-fenced bank is able to:

- 16.7.1 Mitigate entirely the resultant market risk by laying off the risk on a back-to-back basis with the non-ring-fenced bank;
- 16.7.2 Ensure the contract with the non-ring-fenced bank is covered by standard documentation (Credit Support Annex and ISDA); and
- 16.7.3 Mitigate any counterparty credit risk through full collateralisation of the net derivative position with the non-ring-fenced bank with daily margin calls.

16.8 The resilience and resolvability of the ring-fenced bank would, therefore, be maintained and ring-fenced banks could deliver products demanded by their clients. If the non-ring-fenced bank were to fail in an idiosyncratic event, the collateralised portfolio of hedges could be readily sold in the market in a reasonable timeframe given the number of competitors and scale of competition

16.9 These restrictions could be supported by a materiality threshold on how much of the ring-fenced bank’s business could be taken up by these client-originated products—for example, a cap on the proportion of the ring-fenced bank’s revenues or gross balance sheet devoted to such products. This would address concerns about the impact of providing these products on the resilience and resolvability of a ring-fenced bank in a more general market crisis.

CONDUCT SAFEGUARDS

16.10 The assessment of the suitability of any product for a particular client is overseen by the FCA under Conduct of Business regulation. Therefore, there should be no need for further restrictions on the type of client to whom products can be sold.

16.11 In the model we have proposed, the client transacts directly with the institution it is used to, through the relationship manager it knows. The relationship manager is best placed to understand the client’s needs, suitability of products and can introduce to professionally qualified product specialists where appropriate.

Q17. Are the proposed corporate governance arrangements between the ring-fenced bank and the wider group sufficient to ensure the independence of the ring-fenced bank? Are these arrangements compatible with directors’ duties and principles of accountability?

17.1 The draft Bill states that Ring Fencing Rules must make provision about the corporate governance of the ring-fenced body with a view to securing as far as practicable its ability to act independently of other members of the group. The ICB recommends that independence is protected through rules requiring at least half the board of the ring-fenced bank, excluding the Chair, to be independent of the non-ring fenced Bank. A board member should not have had a material business relationship with the ring-fenced bank, or the rest of the group within the previous three years. In addition it is proposed that no more than one-third of the members of the ring-fenced bank’s board should be representatives of the rest of the group (either as board members of the wider group or executives).

17.2 RBS fully understands the requirement to protect the independence of the ring-fenced bank. However, we believe it is also important to reflect appropriately the ring-fenced bank’s obligations to its shareholder within an integrated group structure.

17.3 We consider that companies should retain the flexibility to determine their own corporate structures provided that operational separability and resolvability can be maintained.

17.4 As to whether these arrangements are compatible with directors’ duties and principles of accountability, structural considerations and the cross-membership between ring-fenced and parent boards highlight the requirement to consider and clarify the legal responsibilities of each board in order to minimise conflicts arising as a result of directors’ duties to each company and their respective shareholders. We believe ring-fencing rules must give practical clarification of responsibilities in this regard. RBS believes that decisions relating to the strategic direction of the group must lie with the board of the parent company as it is ultimately, and solely, responsible to external shareholders for the performance of the entire group, including the ring-fenced entity. Day-to-day decision making within the confines of implementing the strategic plan should be the responsibility of the ring-fenced bank.

Q18. How appropriate are the proposed restrictions on exposures and operational dependencies between the ring-fenced bank and the rest of the group? Will these result in a sufficient degree of independence and resilience?

18.1 We agree with the RRD proposals to allow intra-group support arrangements, but with specific approvals for agreements concluded in times of disruption. As alluded to in the White Paper, this should also be aligned with developments of the BCBS Large Exposures Group, ensuring that UK banks are not placed at a competitive disadvantage.

18.2 It is important that a group has flexibility to re-balance funding across the group to manage business cycles. Restrictions should not create an incentive to perversely take on additional risk to utilise available funding. They should also not pressurise groups to re-organise business so that assets are aligned with funding already raised. This disrupts customers and places banks at a competitive disadvantage.

18.3 The Government should also consider how seasonal trends, which are likely to be similar for ring-fenced banks, will be accommodated within market flows. A process under which balances simply flow between the ring-fenced segment and the non-ring-fenced segment via third parties may not provide a material improvement in the effective independence of these two segments, certainly if compared to a collateralised intra-group funding model.

18.4 We believe that exposures between the ring-fence and the rest of a group should, at a minimum, be treated the same as on a third party basis as proposed by the Government. However, we believe that this limit should be higher than for third parties, to provide groups with the ability to manage the seasonality of its group business. Unduly restricting intragroup exposures would tend to exacerbate the systemic risk the ICB's proposals were intended to address, by increasing intergroup linkages and so raising the risk of contagion.

18.5 It is important that exposures are measured on a "net of collateral" basis as would be the case for third party Large Exposures. Collateral should also be of sufficient quantity and quality and should at least include assets that the ring-fenced bank is permitted to hold. Eligibility of collateral should also be reasonably broad so that banks are able to maintain adequate collateral availability for discount window facilities. The proposal to measure exposures gross of collateral contemplated by both the ICB and the Government, appears perverse, as it would intragroup exposures on a more restrictive footing than those between groups.

18.6 Governance requirements for a ring-fenced bank provide strong measures to protect the independence and resilience of the ring-fenced bank. These should safeguard management of credit risk as well as any incentive to mis-state the value of collateral for internal transactions.

18.6 The Government has previously stated (White Paper paragraph 2.59) that banks should be free to organise their operational structures as they choose, so long as they remain consistent with separability of the ring-fenced bank and have regard to the need to continue the provision of its services. We are keen to see early clarification of a number of elements related to operational structures, including the basis on which an operational subsidiary of the ring-fenced bank might be approved, and whether it is intended that a ring-fenced bank would be prohibited from owning a non-banking operational subsidiary outside the European Economic Area.

Q19. Will it be possible to effectively monitor and police the ring-fence, given the degree of regulatory discretion the draft Bill proposes?

19.1 The draft Bill proposes very wide discretion for the assumption of regulatory powers. However, given that the parameters for the nature of the ring-fence are as yet insufficiently clear, it is difficult at this stage to determine with certainty how easy it will be to police effectively.

Q20. How effective will the provisions on corporate governance for ring-fenced banks be in promoting a wider improvement of standards? Should other measures also be considered?

20.1 In addition to the comments made in response to Q17 we believe that a degree of commonality of membership between the board of the ring-fenced and the board/s of the holding company/non ring-fenced entity is essential. This commonality will promote consistency and coherence, promote the interests of the ring-fenced bank with the main group, avoid conflicts and reduce duplication. However, the ICB requirement to have both a majority of independent directors on the ring-fenced board and also to ensure that two thirds of the board have no connection with the rest of the group raises practical and operational concerns. It is fundamental that there is strategic coherence in the manner in which the ring-fenced and non-ring-fenced banks operate, and this can only be achieved where there is a reasonable degree of cross-membership between the decision-making entities within the group.

20.2 Under current proposals, to have even a limited degree of common membership across both boards could lead to unwieldy boards, with a large number of new independent members. For example, it would not be unreasonable to have three individuals on the ring-fenced board who were also representative of the wider group/non-ring-fenced board. Applying the requirements as set out in the White Paper, this would result in a ring-fenced board of at least ten, comprising an independent chairman and five entirely new independent members. The remaining member (potentially an executive of the ring-fenced bank) would also be unable to

represent the rest of the group. While *prima facie* this may not appear unduly onerous, the requirement increases proportionately with each “dual-hatted” member.

20.3 Furthermore, current board directors could not make up the independent membership (even if they no longer represented the non-ring-fenced bank), given they have held a material business relationship with the wider group in the preceding three years. Practically, sourcing and recruiting the appropriate number of new independent directors who possess the correct skill set is likely to prove difficult. Restrictions on the available talent pool, the need to consider diversity targets and/or the need to limit boards to a manageable size is likely to serve to limit common board membership and the number of individuals on the parent board who are representing the interests of the ring-fenced bank.

20.4 Provided responsibilities are clear, and conflicts policies are understood, RBS believes that policies implemented should support a level of common membership that allows, practically and operationally, the successful adoption of dual board governance. In order to maintain continuity it is important that flexibility in arrangements, in particular the ability to consider existing holding company directors for positions on the ring-fenced board, is supported through transition and implementation.

20.5 Subject to the above, RBS believes that together with appropriate regulatory oversight, these measures will promote separability, will improve standards and will provide protection to the ring-fenced entity.

DEPOSITOR PREFERENCE

Q21. *Is the proposal to prefer insured deposits in the event of a bank insolvency justified? Is there a case for broadening the scope of deposits which benefit from this protection?*

21.1 The proposal to prefer insured deposits in the event of a bank insolvency is in our view of questionable benefit. We are concerned that the UK proposal on depositor preference may be a) inconsistent with EU policy and b) incorrectly positioned as helping depositors, when it would in fact only benefit deposit guarantee schemes. Depositor protection comes from the Financial Services Compensation Scheme (FSCS) and not through any preference on liquidation. Preferring insured depositors results in the FSCS being preferred, as the depositor loss that it covers would only materialise after other senior creditors have absorbed losses first. This makes it a remote possibility that the FSCS would be used and alters the previously *pari passu* status it shared with other senior creditors in the creditor hierarchy. The preservation of the creditor hierarchy is an important principle agreed by the industry.

21.2 If the principle of depositor preference is retained, it should ideally be limited to as narrow a scope as possible. Broadening the scope further increases the pool of preferential creditors, decreasing the rights of other creditors and, therefore, making the UK banks less able to conduct business.

21.3 It is important that preferred status is limited as far as possible, to ensure that sufficient eligible liabilities are available to absorb losses through bail-in, while preserving as far as possible that no creditor should be worse off than in liquidation.

21.4 Rather than granting the FSCS this preferred status, or enabling the FSCS to assume the preferred status of the depositors it is insuring, deposit guarantee schemes should, as in the EU RRD proposal, be included in a bail-in regime as a senior unsecured creditor, similar to their status in liquidation. This would ensure that the pool of eligible bail-in liabilities is as broad as possible to absorb potential losses. It would also ensure that all banks are able to meet any bail-in requirements set by regulators, and would be in the best interests not only of other creditors but also of the FSCS itself, since the purpose of a bail-in is to preserve more value than would remain for all creditors in the event of a disorderly and protracted liquidation.

21.5 “Rather than a Deposit Insurer having to wait to discover its losses until the end of the process of a potentially destructive realisation of the bank’s assets, it would hear up front how much it had lost. Its losses should be smaller that way. And it might gain a stake in a surviving business, which it could sell once conditions had calmed.”⁴⁵

CAPITAL LEVELS

Q22. *Does the draft Bill adequately implement the ICB’s recommendations on loss absorbency requirements?*

22.1 We believe that bail-in is best achieved through statutory application to as wide a range of bank liabilities as possible, though with clarity around the hierarchy within which bail-in would apply. We believe that the best way of achieving an appropriate loss absorbency regime will be through alignment with CRD IV/CRR and the RRD, rather than setting out a standard minimum loss absorbency requirement.

22.2 We support the Government’s acknowledgement of loss-absorbing capital in the Basel III accords, for implementation across the EU through the CRD IV/CRR. We also support the Government’s recognition of the RRD proposals on requirements for banks to hold “minimum eligible liabilities”.

⁴⁵ “The role of deposit insurance in building a safer financial system”, speech by Paul Tucker, chairman of the Financial Stability Board’s Resolution Steering Group, 25 October 2012.

Q23. The draft Bill gives the Government power to direct the way in which the regulators can implement loss-absorbency requirements. How appropriate and well-designed is this power?

23.1 Our view is that the most appropriate means of achieving an effective loss absorbency regime is through alignment with CRD IV/CRR and the RRD, rather than setting out a standard minimum loss absorbency requirement.

23.2 We believe it is important that the Government works through the RRD process to achieve a harmonised loss absorbency regime across at least the major economies, ensuring consistency and enforceability.

Q24. Is the Government's stated intention for the design of loss-absorbency requirements workable? Will it provide a sufficiently well-capitalised banking system? In particular, how justified is the intention to allow an exemption for assets held in overseas operations?

24.1 We support the introduction of a loss absorbency regime, but believe that some aspects of the design would be more effective if aligned with CRD IV/CRR and RRD proposals.

24.2 We believe that, in the unlikely event that capital requirements are insufficient to absorb losses, a regime that is sufficiently broad will be capable of providing a well-capitalised banking system.

24.3 We agree with the Government's proposal to allow an exemption for overseas operations that pose no likely threat to UK or EEA financial stability. We believe this exemption should be based on the relevant regulator's assessment of a group's resolvability and its loss absorbency requirements.

24.4 We support the RRD proposal for loss absorbency requirements to be set by the individual bank's regulator. The regulator will be able to consider the minimum eligible liability requirement after taking into account the risk profile of the individual bank and its loss absorbing capital held through CRD IV/CRR. A standard minimum across the industry can result in perverse fund-raising purely to achieve minimum eligible loss absorbency requirements.

24.5 We support the Government's view that categories for loss absorbency should include regulatory capital, subordinated debt and senior unsecured debt and believe that the pool of senior unsecured creditors should be made as broad as possible to ensure that there is more than enough debt available to absorb losses.

24.6 We do not support an exclusion of liabilities based on "term remaining". This will lead to confusion on which debt is included when loss absorbency is triggered. We believe that an exemption based on "original maturity" would provide clarity at the time of initiating the liability, on which liabilities will be included in the loss absorbency regime.

24.7 While we feel that a term maturity exclusion may not be necessary, as a result of the liquidity regime having been greatly strengthened and of the increased costs that longer term senior creditors would demand for bearing a greater risk of loss, we feel that on balance, excluding liabilities with an original maturity greater than six to twelve months may reduce a run on any bank in times of stress and thereby limit contagion.

Q25. Is the Government justified in its decision not to implement the ICB recommendation for a higher leverage ratio than is required by Basel III?

25.1 We agree with the Government's decision not to increase the leverage ratio beyond the Basel III level to maintain consistency with international standards.

25.2 We note that the Basel Committee, in its initial recommendation of a backstop Tier 1 leverage ratio, was far from certain that this figure was correctly calibrated. Therefore, it proposed an observation period to 2017, to allow more precise calibration through the cycle. It would be premature to conclude that a higher ratio is required. The Basel Committee observed that, while the data it had examined "provide a sense of recent historical trends that is useful background for calibration, they do not lead directly to suggested regulatory requirements."

25.3 We also note that neither the original Basel Committee data nor, as far as we can determine, the ICB analysis supporting its recommendation of a higher leverage ratio, matched the definitions ultimately adopted by the Basel Committee, which includes, in addition to total assets, undrawn exposures. It is puzzling that the ICB should be so certain, to two decimal places, of the appropriate ratio, while ignoring this substantial change to the denominator.

RESOLVABILITY

Q26. Will the UK authorities have the necessary tools and powers (as a result of this legislation and other initiatives) to be able to resolve a large failing ring-fenced or non-ring-fenced bank, while maintaining financial stability and minimising the risk to public funds?

26.1 We are of the view that UK authorities will have the necessary tools and powers to carry out resolution while maintaining financial stability and minimising risk to public funds. These add to the powers already introduced under the SRR for sale of assets and a bridge bank.

26.2 In particular we would point to the proposals under CRD IV/CRR to provide capital and liquidity strength and resilience, as well as loss absorbency capability.

26.3 We would also point to a well-designed loss absorbency regime that provides for broad loss absorbency and recapitalisation to avoid risk to public funds. If this regime is not defined through requirements to issue specific instruments then it is even more likely to be established.

26.4 A “retail” ring-fence may also add to resolvability and financial stability by aligning activities supporting depositor business and essential services. However, care should be taken to ensure that this alignment does not negate the benefits that a group offers, enabling support across the group as proposed by the RRD to manage peaks and troughs in business activity.

Q27. What is your assessment of the Government’s preferred design of “bail-in” powers needed to improve bank resolution? How likely is it that the Recovery and Resolution Directive will deliver effective bail-in powers?

27.1 We support the Government’s intention to deliver a bail-in regime through the transposition of the EU RRD, resulting in a broadly consistent design of bail-in tool across different jurisdictions, particularly the EU, US and Asia.

27.2 We believe that the design of the bail-in environment should take into consideration aspects commented on in Qs22–24 above, so that there is broad bail-in eligibility that provides maximum loss absorbency and recapitalisation.

27.3 We believe that good progress has been made through industry working groups to propose a workable bail-in regime, which if adopted by the RRD may deliver effective bail-in powers. Key here is for the authorities of the different jurisdictions to agree on a harmonised legal framework.

IMPACT ASSESSMENT

Q28. Is the impact assessment of the costs and benefits credible and balanced?

28.1 Like the ICB’s cost/benefit analysis before it, the impact assessment tends to apply a narrower and more selective filter for the estimated costs than for the putative benefits.

28.2 The estimates of costs, although open to discussion on some points, are itemised. The estimates of benefits, on the other hand, are dependent on a broad hypothesis relating to the growth impact of financial crises and the frequency of such crises. The impact assessment’s analysis draws heavily on the ICB own cost/benefit analysis, which in turn draws heavily on analysis conducted by the Basel Committee on Banking Supervision.

28.3 Such analyses tend to estimate the cost of financial crises on the basis of an extrapolation of pre-crisis growth trends, without adjustment for the unsustainable credit booms that generally precede them; and to attribute the entirety of the output gap to the financial crisis. We note that the International Monetary Fund’s latest estimates now acknowledge that actual output in 2007, a period the Government has itself described as characterised by unsustainable levels of leverage, debt and credit growth, was in fact 3.6% above sustainable potential output. This means that the gap between forecast potential output and pre-crisis trend potential output is smaller (because the starting point is lower; it also means that the economy benefited for a while from above trend growth, which is not factored into the impact analysis).

28.4 The benefits of reducing the probability and impact of financial crises have been claimed many times over by official impact analyses. The BCBS analysis⁴⁶, on which both ICB and the Government Impact Analysis draw, estimated that increasing the ratio of Tangible Common Equity to Risk-Weighted Assets from 6% to 10%, combined with improved liquidity ratios (meeting the Net Stable Funding Requirement) that fall far short of the improvement in fact achieved by UK banks, would reduce the probability of systemic banking crises from 4.8% (close to the 4.5% figure used by ICB and the Government as a central baseline) to 1.2%. The only portion of this 75% reduction in probability that could properly be attributed to the ICB’s recommendations would be the marginal increment in capital ratios from the 9.5% CT1 ratio that will apply to systemically important banks to the 10% CT1 ratio proposed for ring-fenced banks. There is no obvious basis for positing that ring-fencing measures would reduce the probability of crises. Yet the Impact Assessment assumes that existing reforms will only have delivered a 30% reduction in the probability of financial crises and suggests that the measures in the draft Bill might deliver a further 10% reduction.

28.5 Put another way, the Impact Assessment calculates that to produce an incremental benefit to GDP of 0.1% (the upper end of the estimated range of GDP costs) would require the measures in the draft Bill to reduce the probability of future crises by 2.6%. The BCBS study suggests that the same reduction might more easily be achieved by an increase of approximately half a percentage point in capital ratios, without the disruption to customers ring-fencing will entail.

⁴⁶ “An assessment of the long-term economic impact of stronger capital and liquidity requirements” BCBS August 2010.

Q29. Might there be any other unintended consequences which have not been considered?

We have a number of concerns relating to the consequences of ring-fencing for certain customers. There is, for example, a real danger that a section of mid-market clients find that they no longer have access to a range of essential products, or have access only at a much increased price. For example:

29.1 If the ring-fenced bank were to be prohibited from selling basic risk management products, these would only be available from the non-ring-fenced bank or from international banks in the UK that operate below the ring-fencing threshold.

29.1.1 Such non-ring-fenced banks/international banks mostly focus on the large corporate/financial institution market. They do not have the infrastructure (sales force, credit processes) or risk appetite to service a broad corporate client base across UK.

29.1.2 Clients that fall outside their target demographic are likely to find no provider of risk management products, or at best no effective competition in the market for these services

29.1.3 Clients who are able to access risk management products are likely to be obliged to fully collateralise exposures, given the non-ring-fenced bank will have limited risk appetite for mid-market credit exposures.

29.1.4 This will significantly increase the cost and complexity of risk management for UK corporates.

29.2 Retail investors currently have access to a range of investment options, including capital guaranteed, equity-linked deposit products (structured investor products).

29.2.1 Should the ring-fenced bank be restricted to selling only “standard” term deposit products, then such capital-guaranteed deposit products would no longer be available to UK retail investors.

29.2.2 There is a danger that such investors would turn to either offshore providers or other higher-risk investments to find alternative investment solutions.

29.3 Larger corporate clients may be obliged to operate a “split banking” arrangement with the ring-fenced bank providing domestic clearing and the non-ring-fenced bank providing access to capital markets and risk management solutions.

29.3.1 The high ring-fence proposal will limit the ability of the ring-fenced bank and the non-ring-fenced bank to work in tandem to support client needs.

29.3.2 Clients are likely, therefore, to be obliged to separately collateralise exposures to each entity, as their banks will be unable to rely on intra-group limit structures to “share” pools of collateral.

29.3.3 Each bank is likely to price services in isolation—potentially driving up cost of funding for corporates.

29.4 We remain concerned that the interaction of restrictions on a ring-fenced bank’s geographical activity and exposure to financial institutions may significantly impair its ability to support UK businesses trading overseas, particularly SMEs, who will only be permitted to place their deposits with ring-fenced banks but may not be able to access trade services from the ring-fenced banks. We urge the Parliamentary commission to give the most careful consideration to ways of ensuring that ring-fenced banks will be able to provide trade finance and liquidity management services to exporters and other businesses trading outside the UK.

INTERNATIONAL ISSUES*Q30. What will be the impact of the proposals on the international competitiveness of UK banks?*

30.1 Given the Government’s intention to allow for a *de minimis* exemption for any bank with less than £25 billion of insured deposits, the impact of the proposals is likely to be limited to a small handful of larger UK banks. There is likely to be some detrimental impact on the international competitiveness of this small number of affected UK banks.

30.2 The ICB did not deny that the impact on UK banks’ competitiveness would be negative but took the view (Final Report 5.82) that the question of competitiveness should be construed not in relation to UK banks but more broadly in the context of the wider City financial industry, arguing that:

“The historical record does not suggest there is any strong link between the success of UK banks in wholesale/investment banking and the success of the City.”

30.3 The Commission may take a different view of the consequences for competitiveness, employment and the wider UK economy of differentially handicapping UK-based banks in relation to their foreign competitors.

30.4 Absent a harmonized bail-in regime across key jurisdictions (certainly including Europe and the US) there may also be significant variance between different banks’ funding costs, depending on how the bail-in tool is embedded in the statutory regime in each jurisdiction and on regulatory guidance on how the tool would potentially be used.

Q31. *Are the proposals consistent with existing and forthcoming international and EU regulatory initiatives, for example the recent Liikanen Report? To what extent are they likely to be superseded or generate conflicts?*

31.1 While the Liikanen Report states that its own recommendations are compatible with the proposals in the draft Bill, it should be emphasised that they start from a different philosophical perspective. Whereas the Vickers proposals are based on the concept of ring-fencing those core activities that governments wish to protect, Liikanen takes the opposite perspective, recommending the ring-fencing of those trading activities it wishes to quarantine. The Liikanen recommendations are still at a very early stage of elaboration, and could emerge in somewhat different form once the European Commission has got to grips with some of the more detailed practicalities of implementation with which the UK Government has been engaged since the ICB published its final report. There is, therefore, a risk of conflicts emerging between the UK measures and any subsequent EU legislation giving shape to the Liikanen recommendations.

31.2 As an example, Liikanen gives no consideration to geographical scope. This might, therefore, potentially mean that a UK bank's US or Asian deposit-taking branch or subsidiary would be prohibited from Vickers retail ring-fence, because it was outside the European Economic Area, and also prohibited from the Liikanen trading ring-fence, because of its deposit funding.

OTHER

Q32. *What other matters should the Commission take into account?*

We would draw attention to the following points:

32.1 Primary Loss Absorbing Capital (PLAC)

- 32.1.1 The Policy Overview (paras 2.54 to 2.60) sets out the detail of the Government's proposals in relation to PLAC, which include defining the categories of PLAC as being regulatory capital, subordinated debt and senior unsecured debt with at least twelve months' term remaining and which the resolution authorities are confident can be bailed-in. However, S142J of the draft Bill does not reflect the important detail set out in the Policy Overview as the Bill refers only to the Treasury being able to order a "relevant body" to issue any debt instrument or to hold debt instruments of a particular kind. The Government has taken the decision to specify "senior unsecured debt with at least twelve months' term remaining" as being eligible to count toward PLAC if the resolution authorities are confident that the debt can be bailed in. However, the EC RDD proposal is only to exclude from bail-in unsecured debt with a maturity of less than one month?

32.2 Liikanen

- 32.2.1 The Policy Overview (para 2.4) notes that Liikanen Group's proposal for ring-fencing of trading activities from deposit-taking has many similarities with the recommendations of the ICB, and that the Government's plans for ring-fencing of UK banks are compatible with the Liikanen recommendations.

32.3 Core Activities

- 32.3.1 S142(B)(2) states that the "regulated activity of accepting deposits (whether carried on in the United Kingdom or elsewhere) is a core activity unless it is carried on in circumstances specified by order made by the Treasury." This does not mirror paragraph 2.15 of the Policy Overview which specifically states that the Government believes that accepting deposits from individuals and SMEs should be a "core activity". We would argue that the primary legislation could make it clear that the "core activity" will cover accepting deposits from individuals and SMEs, subject to the exemptions and threshold limits to be introduced for HNWI and SMEs.

32.4 S5 Banking business transfer schemes

- 32.4.1 S5 of the draft Bill introduces a new type of transfer scheme with the specific purpose of avoiding a ring-fencing contravention. Is the intention of this additional scheme to permit both (i) an institution that is licensed to accept deposits to transfer business to an entity outside of the ring-fence where the transferring business does not include any deposits; and (ii) an institution not authorised to accept deposits to transfer parts of its banking business to a deposit taking and/or non-deposit taking institution? This drafting may require amplification, more particularly as the transitional mechanisms put in place by the legislation will be of critical importance to minimizing the substantial organisational and customer impacts that transferring large numbers of customers between legal entities would otherwise entail.

32.5 Risk management/hedging

- 32.5.1 Whilst the Policy Overview acknowledges that the process of accepting deposits and extending loans is inherently risky and that the ring-fenced banks will need to be allowed to manage this risk by means of hedging, derivatives and so on, the detail of what the ring-fenced banks will be allowed to undertake has still to be decided upon by the Government. In setting out the conditions for risk management the Government is requested to give thought to the practical implications of any restrictions that it is looking to impose as, for example, the proposal for derivatives contracts to be

allowed only if they are centrally cleared (paper 2.27) is not likely to be a workable option until CCPs have had time to embed across the majority of institutions.

32.6 S410A Fees to meet certain expenses of the Treasury

- 32.6.1 Further detail is requested from the Government on S410A and the wide power that it affords to HMT to introduce regulations that will allow each of PRA, FCA and the BoE to require payment of fees for “relevant expenses” (stated to include expenses of a capital nature) incurred in relation to activities around financial stability or financial services.
- 32.6.2 An indication of the level of fees anticipated and the time at which fees will be imposed should be provided to avoid market concerns on what could potentially prove to be a new and substantial bank levy.

32.7 Pensions

- 32.7.1 UK banks carry substantial pension liabilities, and in the current economic climate their defined pension funds have substantial deficits. Whilst we accept that to ensure an effective ring-fence, banks will need to separate the liabilities of their pension funds between those that relate to the ring-fenced bank and those that sit outside, it is important that this is managed over a long time period and without imposing further cash or capital requirements on banks at a time when that capital could be better used to generate economic growth in the economy.
- 32.7.2 In achieving the pension fund split it may well be that the banks will trigger the payment of debts under Section 75 of the Pensions Act. We believe that an exemption from Section 75 debts should be legislated for as part of separation.
- 32.7.3 It may also be that the separation of a bank’s pension liabilities can be effected by segregation of the pension fund’s liabilities into two separate sections, rather than through complete separation of the pension fund. Segregation would allow the combined bank to benefit from a single governance structure and economies of scale. Therefore, we suggest that segregation is a permitted option as well as full separation.
- 32.7.4 In the current economic climate it is important to give banks sufficient time to achieve the separation or segregation of the pension liabilities. However, while we can understand why 2025 is proposed, we would support a later date for required separation. Even given a longer time period to separate pension schemes, banks still may not reach the point of fully funding their pension funds by this time if current economic conditions remain for a sustained period. We would, therefore, suggest that flexibility is given to allow the Government of the day to postpone the final date if difficult economic conditions prevail.

31 October 2012

Written evidence from RBS Pension Trustee

DRAFT BANKING REFORM BILL—POLICY DOCUMENT. RESPONSE TO QUESTION 32 “WHAT OTHER MATTERS SHOULD THE COMMISSION TAKE INTO ACCOUNT?”

- The Fund has 223,000 members of whom 55,000 are pensioners 121,000 are deferred members and 47,000 are active members. Membership of the Defined Benefit schemes run by the four biggest UK banks total 787,000.
- The Royal Bank of Scotland Group, together with some other banks, has a consolidated, group-wide scheme which comprise members of both the proposed ring-fenced and non ring-fenced operations. In this situation, the implications of achieving separation will be complex and significant.

(1) Separation of pension schemes

We recognise the importance of dividing the pension scheme liabilities between the ring-fenced and non ring-fenced operations to avoid one part being liable for the pension debts of the other part. Sectionalisation within the existing pension scheme (as distinct from creating two separate and discrete pension schemes) would achieve the aim of avoiding joint and several liability. Employees of the ring-fenced bank would comprise the membership of one section and the employees of the non ring-fenced bank would comprise another.

However it must be recognised that ring-fencing will could lead to individually weaker businesses (and respective employer covenants to support the pension liabilities). This consideration together with the preference afforded to depositors (which has the effect of relegating the claims of pension schemes) will require trustees (in respect of each section of the pension liabilities) to consider, in accordance with guidance from the Pensions Regulator, whether to adopt more prudent actuarial assumptions and/or a more conservative investment policy. Both of these factors will increase deficits and leave trustees to require larger contributions and, possibly, security for the deficit (the “Prudence Scenario”). This will impact the separate businesses adversely who are already trying to balance the requirements of increased capital reserves and the demands of shareholders and the wider capital markets.

We would therefore suggest that sectionalisation is a permitted option as well as full separation. However the impact of separation of the businesses upon the pension liabilities, which will lead to weaker employer covenants, should be borne in mind in structuring more detailed aspects of the secondary legislation.

(2) Apportionment of liabilities

Pension scheme members of both the ring fenced and non-ring fenced bank should be treated fairly. There is a risk that the apportionment all the historical pension liabilities of the employees of one business to the pension section attaching to that business will not be equitable, particularly if the covenant of the employer, say the non ring-fenced bank, supporting that section is weaker than the covenant of the other scheme.

A solution might be to apportion the liabilities across both sections, so that members receive pension payments from each of the new sections. Individual members will then have exposure to the covenants of both the ring-fenced and wider banking groups both before and after the separation. As well as being equitable between different groups of members, this approach removes the practical issues around availability of data and the need to make subjective judgements about where members should be allocated which will arise if each member is allocated to one scheme or other

The division of pension liabilities, despite its complexity, should be carried out by the trustees of the scheme rather than the employers. Trustees owe a fiduciary duty to their members to act in their collective best interests and will strive to achieve a balanced approach in the long term interests of members. To leave this decision to the employers runs the risk of the employers making decisions based upon business considerations rather than the interests of employees.

In addition, legislation should contain provisions to protect trustees from subsequent legal liability for any decision made in dividing or apportioning the pension liabilities between schemes or sections.

(3) Timing of Separation

Division of the Bank's business and the apportionment of the liabilities of the pension scheme should be seen as elements of the same decision. Whether actual separation of the pension scheme assets and liabilities could be deferred to a later date is a different issue so long as the basis of apportionment is agreed at the time of the division of the business.

We would prefer a situation where the trustees have the power to determine the timing of the apportionment of pension liabilities. Such timing could be made the subject of consultation with the sponsoring bank (and the approval of the Pensions Regulator).

30 October 2012

Written evidence from TheCityUK

1. I write to submit TheCityUK's response to the Parliamentary Commission's call for written evidence on the draft Banking Reform Bill.

2. TheCityUK is a national membership organisation representing the UK's financial and related professional services sector. Our members are drawn from across the banking, insurance, asset management, exchange and other financial and related professional services sectors. Our purpose is to promote and explain the role and value of the sector in society and the economy, and to promote the sector abroad. TheCityUK's members are committed to:

- Restoring public and policymaker confidence in the financial services sector
- Fully implementing the regulatory reform programme that is underway
- Demonstrating the crucial contribution of financial and related professional services to economic growth, the lives of people in Britain and the UK's place in the world.

3. Instead of addressing the detailed, banking-focused questions that the Commission has posed we would like to take this opportunity to consider the elements of the Draft Banking Reform Bill in its wider context. In particular, we would urge the Parliamentary Commission to:

- Be mindful of the context of on-going reform at the UK, European and international level
- Carefully consider the impact proposed reforms will have on economic growth and bank's customers, including savers, SMEs, corporates and the wider financial services sector
- Recognise the importance of sound corporate governance to driving good practice and appropriate culture, including the importance of maintaining the integrity of corporate governance structures
- Encourage domestic competition and international competitiveness of UK financial services

Context of on-going reform

4. As you are aware, a number of important initiatives are underway impacting the financial services sector. It is important that the draft Banking Reform Bill is considered in the context of on-going UK, European and international programme of regulatory reform, including its interaction with Dodd-Frank Act and any measures flowing from the proposals of the Liikanen Group.

5. The Parliamentary Commission is well placed to consider this wide-ranging programme of regulatory reform holistically. The Banking Reform Bill introduces a number of significant reforms to the banking sector. These are some of the greatest changes to the UK's banks in a generation. Getting this right is crucial. Poorly considered regulatory change will lead to higher costs for consumers, blunt the competitiveness of the financial sector and will not correct the underlying systemic issues that the UK's and other governments are committed to resolving.

6. High standards, including robust and effective regulation, are an asset to the UK's financial sector. TheCityUK is currently undertaking research considering the impact of various factors on UK competitiveness in financial services and will share this work with the Parliamentary Commission when it is completed.

Impact on customers

7. The UK's future prosperity depends on driving growth by investing in innovation and creating new jobs, and maintaining improvements in living standards even as our society ages. A strong financial and professional services sector enjoying confidence and trust is key to these goals. Financial intermediation—and in particular the process of maturity transformation, through which short-term deposits are channelled to finance longer-term investment—is essential to the modern economy.

8. The total amount of loans made available by major banks to UK businesses totalled £214.9 billion in 2011, including £74.9 billion lent to SMEs. Besides bank lending to businesses, financial institutions provide a variety of other services, from alternative types of financing to investment management to risk management. For example:

- UK companies have raised a total of £307 billion in issues of shares and private equity since 2005, allowing them to invest in creating jobs, training and developing people.
- Private equity funds managed in the UK currently back around 3,800 companies, employing around 1.2 million people across the world, of which 515,000 in the UK.
- The UK general insurance industry in 2010 paid out £60 million a day in claims including motor, property, accident and health care.

9. It is important that financial regulatory reform is implemented with a view to macroeconomic circumstances and the principle of counter-cyclicity. A focus on proportionate, internationally co-ordinated regulatory policy will help to provide the stable framework the international markets require to operate successfully. It is vital that any financial reform, including the delegated powers in the Draft Banking Reform Bill, is embedded with appropriate accountability mechanisms and that the interaction between different legislative packages is studied carefully.

Corporate Culture & Corporate Governance

10. There have undoubtedly been failures of management control and the sector is committed to learning the lessons of past mistakes. Those firms needing to change must demonstrate the changes that they have made in recent years and how they will continue to embed them in their organisations. It is crucial that firms and individuals adhere to the highest standards at all times, not just because this is right in itself, but also because of the impact a reputation for honesty and fair dealing has on the standing of the sector in overseas markets. Alongside the seriousness of the crisis and of recent failings, it is also important to acknowledge that many organisations, and their thousands of employees, continue to serve their customers in an ethical and conscientious manner.

11. We believe that the Boards of companies are best placed to deliver further change by working with shareholders, regulators and policymakers. To this end, it is important that the Draft Banking Reform Bill does not undermine the integrity of group corporate governance structures. TheCityUK is currently undertaking a review of recent changes to corporate governance practices in the financial sector and looks forward to sharing these with the Commission in due course.

Competition and Competitiveness

12. Regulatory barriers to entry necessarily limit the number of businesses meeting the standards necessary to operate in the financial sector, though it should be recognised that this also has the effect of limiting competition in the sector. Increasing the burden of regulation will increase barriers to entry and potentially restrict competition. It is essential that the right balance is struck so that new firms are able to enter the market and existing firms are able to develop innovative products to meet the needs of business. In particular, TheCityUK is concerned that the UK supervisory authorities should not apply a regime to foreign banks

seeking authorisation in the UK that is different or more onerous than that offered in other EU member-states, unless there are clearly stated and transparent prudential or other policy reasons for doing so.

13. We encourage the Commission to be mindful of the international competitiveness of the sector and its position as the nation's leading net export earner, its role nationally as a major employer, and the fact that the sector has many different aspects to it that extend well beyond banking (insurance, asset management, investment etc.) when conducting its deliberations. We believe that avoiding unintended consequences and determining the impact of any proposals you make will ensure the sustainability of the many benefits which our society can and does obtain from the banking and wider financial services sectors.

31 October 2012

Written evidence from Schroders

OBJECTIVES AND GENERAL APPROACH

We believe that the UK banking sector is in need of reform. However, we are concerned about the speed with which this legislation is being introduced. This is very complex legislation with far reaching ramifications. Ring fences have not been introduced on this scale in any other countries. The short timetable and lack of wide public consultation creates the risk that flaws and loop holes are not spotted which could lead to damaging unintended consequences.

The amount that has been deferred to secondary legislation makes it difficult for us to comment on the overall impact of the proposals. For example key issues over the "height" and the "scope" of the ring fence are yet to be determined.

While we realise this is an Enabling Bill, we have concerns about the amount of powers that the Treasury is being given to implement policy through secondary legislation. In particular we have concerns that section 142E Power of Treasury to impose prohibitions, is too wide ranging.

DEVELOPMENTS SINCE THE ICB'S REPORT.

We are concerned that UK's proposed ring fencing of retail and SME deposits is not fully comparable with the Liikanen recommendations. The High-level Expert Group endorses ring-fencing, but takes the opposite approach of the UK by proposing the ring-fencing of trading activities rather than "essential activities." We believe that there is a risk that the EU and UK move in incompatible directions. In the long run UK banks could face enormous complexities of administering different ring fences.

In addition we believe that any ring fence or decisions on depositor preference should be compatible with the final version of the EU's Recovery and Resolution Directive (RRD), which is due to get European Parliament approval in late November. We would advocate delaying legislation to ensure that ring fences are developed in parallel and a level playing field is maintained.

SPECIFIC ISSUES

Intragroup Funding

We note that the bill calls for the regulator to set tough intra group large exposure limits. We continue to believe that this is an area that requires consideration, particularly in the context of the potential volatility of funding which could result from the presence of the ring fence. We propose that collateralised exposures do not count towards large exposure limits where collateral is of appropriate quality with appropriate and regular haircuts in line with existing third party limits and posted daily. We are concerned that without this the presence of a ring fence could materially increase liquidity risk for banks in times of crisis.

Capital

We agree that PLAC of up to 17% of risk RWA for the EEA operations of UK headquartered banks is appropriate. While the government's views on the type of instruments that count toward this are sensible and consistent with the RRD, we would urge delaying a final decision until the EC has finalised rules. We are encouraged that the RRD Rapporteur report has endorsed a risk-weighted asset based calibration of required bail-inable capital and debt.

Depositor Preference

We understand that it is likely the RRD will effectively reject depositor preference by including provisions for the bail-in of the deposit guarantee schemes. The FSCS insurance already provides effective preferred status to insured depositors from their point of view, and we do not believe an additional benefit is gained by giving preferred creditor status to the insurance scheme itself and would put the UK at odds with the EU. We are concerned that at the margin that the proposals in the Draft Bill could increase the cost of wholesale funding for UK banks' ring-fenced entities against European competitors, at a time when these entities already have to undertake additional wholesale funding to meet standalone PLAC requirements.

Covered bonds

We also seek more clarity on the issue of covered bonds issued out of the ring fenced entity and how they would rank in relation to the FSCS, in the event that the FSCS had preferred status. We feel that this is likely to become an issue given the likelihood of the mortgage book sitting within a ring fence.

16 October 2012

Written evidence from United Food and Commercial Workers Union

INTRODUCTION AND SUMMARY

As part of its endeavours to promote global best practice across the sectors in which it represents its members, the United Food and Commercial Workers Union (UFCW) of the United States has read with interest the Parliamentary Commission on Banking Standards' call for written evidence to its pre-legislative scrutiny of the Draft Financial Services (Banking Reform) Bill. The UFCW has 1.3 million members in the USA, Canada, and Puerto Rico and represents members in financial institutions, retail stores, manufacturing, drug stores, and car rental firms, alongside its core of food retail, distributions and processing members. It works with fellow trade unions, consumer advocates, and other allies to promote global best practice.

This submission addresses the Commission's detailed questions pertaining to the ring fence, in particular questions 14, 17, and 18.

The UFCW supports the many positive steps to increase competition contained in the consultation, but would like to share concerns based on experience in the United States and urge the UK Government to learn from mistakes in the US and extend consolidated supervision to non-financial parents of regulated financial firms.

Wholesale re-thinks of the financial sector are infrequent and so any such exercise should be wide in its scope. The Banking Reform White Paper began to address the failures of the existing and historical financial regime but the pre-legislative scrutiny process is equally a chance to learn from inadequacies experienced in other financial markets around the world and to safeguard against other risks.

The UK Government has taken positive steps to increase competition but should act to ensure that supervision is not weakened. The Government has placed utmost importance on introducing new competition into the oligopolistic financial services sector, and has taken several strong steps in that direction. These steps include creating strong challengers via the sale of Northern Rock to Virgin Money and the divestment of Lloyds, lowering barriers to entry, and creating a new current account redirection service to make it easier for customers to switch banks.

However, it is also important for new entrants to be adequately supervised by the regulators. Under the current Financial Services Bill (Clause 25, as in HL Bill 25, 2012–13), new entrants like Virgin Money and Tesco Bank would not face regulation at the holding company level. Rather, holding company supervision only extends to financial parents in the current Bill, which means that such regulation would only cover the traditional banks. It is important that new entrants are as well supervised as the incumbents. There are many ways to promote competition. Offering some firms lighter-touch regulation than others should not, in our view, be one of them, as it carries risks that could impact the consumer and the taxpayer.

As some parliamentarians have argued while debating the Financial Services Bill, it is important to address proactively the potential risks from allowing financial and commercial firms to blend together in conglomerates under giant holding companies.

Historical failures in the UK with the failure of so-called "secondary banks" in the 1970s, in the United States with Wal-Mart's aborted attempt to acquire a bank in the 2000s, and in Ireland in the 2000s with Anglo-Irish bank, illustrate, in our view, some of the risks of allowing deposit-taking banking to blend with commercial conglomerates without consolidated supervision of the entire group.

INCREASING COMPETITION WITHOUT WEAKENING SUPERVISION

1. The Government has placed utmost importance on introducing new competition into the oligopolistic financial services sector, and its several pro-competition initiatives are steps in the right direction. These steps include creating strong challengers via the sale of Northern Rock to Virgin Money and the divestment of Lloyds, lowering barriers to entry, and creating a new current account redirection service to make it easier for customers to switch banks.

2. However, it is also important for new entrants to be adequately supervised by the regulators. In the late 1960s and early 1970s, the UK Government and the Bank of England welcomed new competition from so-called "secondary banks," seeing them as desirable rivals to the then oligarchy of the large banks. But the Bank of England's supervisory power did not keep up with the growth of the new banks, contributing to the secondary banking crisis of 1973–75 and subsequent "lifeboat" bailout.⁴⁷

⁴⁷ Reid, Margaret. *The Secondary Banking Crisis 1973–1975*. 1982, p. 4.

3. Under the current financial reform plans, new entrants like Virgin Money and Tesco Bank would face different regulation at the holding company level than traditional banks, but it is important that new entrants are as well supervised as the incumbents. There are many ways to promote competition: offering some firms lighter-touch regulation than others should not, in our view, be one of them.

THE RISKS OF UNREGULATED COMMERCIAL-FINANCIAL CONGLOMERATES

Exposing the deposit protection system to commercial risks

4. To ensure confidence in the financial system and prevent bank runs, most national financial regulators guarantee bank deposits through deposit protection systems. Under deposit protection systems, corporate conglomerates with bank subsidiaries may have incentives to shift risks from other parts of the conglomerate to the banking subsidiary, and the Government's deposit protection scheme. If risks in a commercial parent company should spread to the financial subsidiary, this threatens a costly and improper expansion of the public safety net, intended to protect depositors and maintain confidence in the financial system, to commercial firms, which should be subject to market discipline.

It's happened before: US savings & loan crisis bankrupted the deposit protection fund

5. The risk is not theoretical: applying free market principles without adequate safeguards to a system distorted by deposit protection contributed to the savings & loan crisis in the US. Between 1986 and 1995, more than 1,000 banks with total assets of over \$500 billion failed, bankrupting the deposit protection fund created to insure customer deposits. The crisis ultimately cost taxpayers \$124 billion.⁴⁸

6. Savings and loans companies (S&Ls), which had been strictly confined to making mortgage loans, were allowed to expand into other activities in the 1980s. Trying desperately to attract customer deposits with high interest rates, S&Ls invested those deposits in risky commercial enterprises like shopping malls, housing developments, fast food franchises, wind farms and even Nevada brothels. As one commercial banker facing competition from S&Ls complained, "Evidently you don't have to run an S&L well as long as you have it insured [with government deposit protection]."⁴⁹

Potential for unfair competition and conflicts of interest

7. Deposit protection is also important because, along with access to the central bank's lender of last resort functions, it renders banks' liabilities less risky, allowing banks to raise funds at reduced, subsidised rates. When the bank is located in a commercial holding company or group and is allowed to lend or transfer dividend payments to the parent company, that subsidy spreads to other subsidiaries in the holding company. The conglomerate earning subsidies in one market can then exploit this advantage in the other, leading to unfair competition.

8. We believe that there are other potential opportunities for anti-competitive abuses of market power by commercial/bank affiliations, such as:

- a bank subsidiary refusing to extend credit on favourable terms to customers of a competitor;
- a commercial firm coercing its suppliers to finance supply contracts with credit from its bank subsidiary.

9. Furthermore, commercial-financial conglomerates could potentially undermine the arms-length relationship appropriate to most financial transactions, such as a bank subsidiary lending to its parent or other members of its group on dangerously easy terms.

It's happened before: Bank of England rescue of Slater Walker

10. Slater Walker Securities, which featured prominently in the British secondary banking crisis, was an investment firm with wide ownership interests in various non-financial corporations. It also owned Slater Walker Bank, 75% of whose advances were to companies in which Slater Walker Securities had, or previously had, an interest, or to individuals to finance shareholdings in those companies. This led to poor lending decisions, insolvency, and eventually to the Bank of England's takeover of Slater Walker Bank.⁵⁰

It's happened before: Anglo Irish Bank's entanglement with part-owner Sean Quinn contributed to bank's collapse

11. During Ireland's property-fuelled credit boom, banks loaned freely to builders like industrialist Sean Quinn, who built an empire from his base manufacturing the materials used in the construction boom to create a massive, far-flung conglomerate. In the late 1990s, Quinn expanded his empire to financial services, and in 2006 he began building an ownership stake in Anglo Irish Bank through derivative instruments, eventually

⁴⁸ Amadeo, Kimberly. "Savings & Loan crisis." http://useconomy.about.com/od/grossdomesticproduct/p/89_Bank_Crisis.htm

⁴⁹ Phil Rigney, CEO, First National Bank. Qtd. in Kathleen Day, *S&L Hell: The people and politics behind the \$1 trillion savings and loan scandal*. May, 1993. P. 229.

⁵⁰ Reid, Margaret. *The Secondary Banking Crisis 1973–1975*. 1982, p. 184.

controlling 29% of the shares.⁵¹ Anglo-Irish then reportedly loaned billions of Euros *back* to Quinn,⁵² much of it allegedly intended to cover the margin calls on Quinn's investment in Anglo itself.⁵³ When the property market collapsed and took Quinn's empire down with it, the Irish state guaranteed the deposits and creditors of all its banks, leading to the need for an EU and IMF bailout. Anglo's ultimate cost to the state was estimated to be between 29.3 billion to 34.3 billion Euros.⁵⁴

It's happened before: Japanese banking-commerce groups contributed to bubble, and collapse

12. Japan, for example, has allowed commerce and finance to blend, both through the *keiretsu* system of cross-shareholding between banks and commercial firms, and in allowing banking and commerce to blend within single firms. This allowed troubling relationships between firms to flourish and contributed to that country's economic crisis in the early 1990s. To cite one example of abuse of these relationships, finance subsidiaries of commercial firms in banks' *keiretsu* groups bought the banks' debt in the late 1980s to help those banks meet capital requirements. That is, the banks lent money to their traditional customers at cheap rates, and the companies, via their finance subsidiaries, then lent the banks their own money back at a slightly higher interest rate.⁵⁵ Needless to say, this is not how regulators prefer capital requirements to be met.

THE FINANCIAL SERVICES (BANKING REFORM) BILL SHOULD GIVE REGULATORS CONSOLIDATED SUPERVISION POWERS OVER COMMERCIAL-FINANCIAL CONGLOMERATES

13. The mixing of commerce and banking within a single conglomerate poses unique challenges to regulators. The first of these is the lack of consolidated supervision. Without consolidated supervision of both the parent company and the bank subsidiary, the financial regulators will not be able to oversee risks in the unregulated commercial business that could spread to the deposit-taking subsidiary.

Consolidated supervision of financial conglomerates

14. Policymakers regularly invoke the importance of consolidated supervision with regard to financial conglomerates. According to a Financial Services Authority policy paper from 1999, "There is a clear need for regulatory oversight of a financial conglomerate as a whole," since there may be "risks arising within the group [...] that are not adequately addressed by any of the specialist prudential supervisory agencies that undertake their work on a solo basis."⁵⁶

This is because, according to the paper:

"Many of the threats to the solvency of the institution can be assessed adequately only on a group-wide basis. This includes the assessment not only of whether the group as a whole has adequate capital, but also of the quality of its systems and controls for managing risks, and the calibre of its senior management. [...] Moreover, there needs to be an effective exchange of information and a co-ordination of regulatory requirements across the regulators responsible for different parts of a conglomerate's business, as well as mechanisms for co-ordinated action when problems arise in a conglomerate."⁵⁷

15. Furthermore, regulators may learn about transactions between the parts of a corporation only after the fact, as the recent saga of MF Global's alleged "missing money" has made all too clear,⁵⁸ making pro-active supervision of the entire conglomerate essential. Related-party transaction rules or other regulations may not be sufficient to monitor transactions between the regulated entity and other entities owned by the same holding company.

Consolidated supervision of commercial-financial conglomerates

16. Not only do these very same problems arise in the case of commercial firms holding financial subsidiaries; we believe in many cases that they may be exacerbated. Holding companies, for example, may be allowed to own entities that the financial institution itself might not be allowed to hold, such as other unregulated financial institutions or commercial enterprises.

UFCW part of coalition raising concerns about Wal-Mart opening bank

17. The lack of consolidated supervision was a key issue raised in objection to Wal-Mart acquiring a bank in the US. In 2005, Wal-Mart applied to federal and state regulators for a licence to own an industrial bank, a type of banking licence allowed in certain states in the United States. The UFCW joined in a coalition with

⁵¹ Carswell, Simon. *Anglo Republic: Inside the bank that broke Ireland*. 1993. P.114

⁵² Ibid, p. 191

⁵³ Ibid, p. 128.

⁵⁴ Ibid, p. 314.

⁵⁵ Wood, Christopher. *The Bubble Economy: Japan's extraordinary speculative boom of the '80s and the dramatic bus of the '90s*. 1993, p. 28.

⁵⁶ Briault, Olive. "The rationale for a single national financial services regulator." *FSA Occasional Papers in Financial Regulation*. May 1999.

⁵⁷ Ibid.

⁵⁸ Stump, Dan. "MF Global trustee: customer funds missing days before bankruptcy." *Dow Jones Newswires*, 6 February 2012.

bankers, real-estate agents, and legislators of both parties in opposition. While Wal-Mart's application was pending, the then Federal Reserve Chairman, Alan Greenspan, without naming Wal-Mart, called on Congress to examine the loophole in the existing law that allowed some commercial firms to own industrial banks, on the grounds that the loophole prevented the Federal Reserve from having the power to oversee the parent company and the bank subsidiary on a consolidated basis.⁵⁹ The Federal Deposit Insurance Corporation (FDIC)—the US supervisory body that guarantees the safety of deposits in banks—imposed an unprecedented moratorium, also without naming Wal-Mart, on applications for the type of licence that Wal-Mart sought. Legislators in Congress introduced bills to prohibit commercial firms from owning banks. Wal-Mart subsequently withdrew its application, claiming the timing of its withdrawal was a “coincidence”.⁶⁰ This is a clear example of risks foreseen by regulators, lawmakers and stakeholders worthy of UK legislators' close attention in the context of the Financial Services (Banking Reform) Bill.

THE RETAIL BANK RING-FENCE SHOULD APPLY TO COMMERCIAL-FINANCIAL CONGLOMERATES

18. Different regulatory regimes may be appropriate for different divisions of a single conglomerate containing financial services subsidiaries:

- most commercial regulation, including securities trading, investment banking, and commerce, is based on market discipline: including, *in extremis*, that firms must be allowed to fail;
- retail banking regulation, however, is much more robust, being based on a regulatory compliance system. This is necessary because of the overriding need to maintain confidence in the financial system. It is preferable to have banks satisfy regulators rather than face bank runs from jittery depositors.

19. The differences in appropriate regulatory regimes have informed the Draft Financial Services (Banking Reform) Bill's provision that financial conglomerates be forced to “ring-fence” their securities trading and investment banking arms from their traditional deposit-taking retail banking arms: the former must be allowed to fail, without taking the retail bank with it. The same reasoning applies to commerce and banking: commercial firms must be subject to market discipline and be allowed to fail without jeopardising the deposit-taking and lending activities of retail banks. If retail banks should be ring-fenced from broker-dealers within a financial conglomerate, so too should they be ring-fenced from department stores and supermarkets.

THE FINANCIAL SERVICES BILL AND THE RING-FENCE: AN INCOMPLETE SOLUTION

The Financial Services Bill (currently before the House of Lords, at time of writing) fails to extend consolidated supervision to commercial-financial conglomerates

20. The coalition Government has a plan to reform the UK's financial regulatory system. The first component is the current Financial Services Bill, which includes a provision giving the new financial regulators powers to supervise the parent companies of regulated financial firms. Surprisingly, this power only applies to financial parent companies: retail and other corporations with bank subsidiaries would be untouched. Part 2, Clause 25 of the legislation (“Powers of regulators in relation to parent undertakings”) gives the Treasury the option to extend the jurisdiction of the regulators to non-financial firms by Order, but refrains from giving these powers to the regulators directly.⁶¹

21. However, in its policy overview explaining the principles behind the Draft Financial Services Bill prior to pre-legislative scrutiny in June 2011, the Treasury gave the following as an example of when the regulators might find it necessary to use this power:

“During severe stress, the different priorities and responsibilities of the board of a parent undertaking relative to the regulated company boards can be exposed. [...] The FSA does not have legal powers to require action at the level of the parent undertaking. This could mean a number of potential recovery options are unduly dismissed. For example, it may be appropriate for the parent undertaking to provide additional capital or liquidity to improve the position of the regulated entity.”⁶²

22. In our view, it is not difficult to imagine precisely the above conflict of interest arising between a retailer and its bank subsidiary. The draft version of the Bill from June 2011 was unclear about whether this power would apply to non-financial “parent undertakings”. Unfortunately, the Financial Services Bill that ultimately emerged in early 2012 following pre-legislative scrutiny, does not directly give the power to regulate non-financial parent companies to the regulators.

23. By only giving the Treasury the option to extend the regulators' jurisdiction, a signal is sent to new entrants that their regulation would be “light touch”. Moreover, by not making the oversight of non-financial holding companies an issue upfront, this opens the possibility that this power will not be enacted until there is already a problem—when it is too late to prevent it. In short, if a company wants to become a bank holding company and own a bank, we believe that it should be regulated as a bank holding company.

⁵⁹ Alan Greenspan letter to Rep. James A. Leach. 20, January, 2006.

⁶⁰ Wysocki, Bernard. “How broad coalition stymied Wal-Mart's bid to own bank.” *Wall Street Journal*, October 23, 2006.

⁶¹ Financial Services Bill (HL 25, 2012–2013). http://www.publications.parliament.uk/pa/bills/lbill/2012-2013/0025/lbill_2012-20130025_en_1.htm

⁶² HM Treasury. “A new approach to financial regulation: a blueprint for reform.” June, 2011.

Parliamentarians raise questions

24. During debate on the Financial Services Bill in both Houses, MPs and Peers raised questions addressing just these types of issues. For example, in the Commons committee stage Shadow Economic Secretary to the Treasury, Cathy Jamieson MP, expressed concern about the “loophole” in the Financial Services Bill:

The Bill enables the new regulators to oversee parent companies that own financial subsidiaries. [...] That is a welcome move; we do not have a principled objection to it. However, I am keen to hear the Minister’s views on the Bill’s seeming inconsistency, because some parent companies will be exempted. We were somewhat surprised that the Bill grants the power of consolidated supervision only to parent companies that are classified as financial institutions by the Treasury. [...] Given the emergence of new-entrant, non-traditional banking firms, which are often the subsidiaries of non-financial parent companies, that loophole risks creating an inequitable situation, and it could be dangerous.⁶³

25. Ms Jamieson pointed out that closing the loophole would be quite easy, and would not extend the reach of the regulators into the non-financial aspects of these commercial conglomerates. For example, in the case of a bank owned by a supermarket or an airline, it would not give the financial regulators the power to tell these businesses how to stock their shelves or plan their routes.⁶⁴

The ring-fence leaves retail banks exposed to potential risks from commercial activities

26. The second component in the Government’s financial reform plan is the ring-fencing of investment banking and securities trading from retail banking, as proposed in the Vickers Report and the Treasury’s Banking Reform White Paper. The ring-fence should be extended to protect deposit-taking retail banks from commercial risks as well.

CONCLUSION: COMPLETE FINANCIAL REFORM BY REGULATING COMMERCIAL/FINANCIAL CONGLOMERATES AND RING-FENCE DEPOSIT-TAKING BANKS FROM THE REST OF THEIR GROUPS

27. The Government’s proposals to reform the financial system are designed to address the causes of the devastating 2008 financial crisis, in which universal banks torpedoed the financial system. Thus, the Financial Services Bill aims to bring a form of consolidated supervision to financial conglomerates, and the Banking Reform White Paper recommends ring-fencing retail banks from riskier activities. These measures are wise, but in our view they are not enough to safeguard against probable commercial developments in the UK’s financial sector originating with non-banking entrants to the sector.

28. As the commercial/bank conglomerates grow larger, under the proposed legislation there is a risk that they will not face the same level of regulation as financial conglomerates. We believe this is a mistake with potentially damaging consequences for consumers, the financial sector and the taxpayer alike. Consolidated supervision and ring-fencing should in our opinion apply to commercial/financial conglomerates as well.

29. While it is vitally important to increase competition in financial services, it is also essential that all companies in the market face the same levels of regulation. In her history of the secondary banking crisis, Margaret Reid said “the benign attitude of the Bank of England towards the extension of London’s banking fraternity at a time when its own surveillance capacity was not growing in step with that community’s rapidly expanding size” was an “encouraging factor” to the crisis.⁶⁵

30. That mistake must not be repeated. We believe Parliament should have amended the Financial Services Bill to increase the powers of consolidated supervision and make sure they apply to commercial conglomerates as well as strictly financial ones, and retail banks should be ring-fenced from the rest of their groups, regardless of whether these conglomerates contain investment banks or supermarkets. Should that opportunity be missed, this matter should be addressed by the Draft Financial Services (Banking Reform) Bill.

31 October 2012

Written evidence from Santander UK

1.1. Santander UK welcomes the opportunity to respond to this call for evidence.

1.2. Santander UK supported the objectives of the Independent Commission on Banking to make banks better able to absorb losses, make it easier to resolve failing banks and to curb excessive risk taking. The proposals have the potential to protect ring-fenced banks from a degree of interconnectedness risk, making them safer. We support the Government in its efforts to implement these objectives and have enjoyed a constructive relationship with the Treasury.

1.3. Neither Santander UK nor the Santander Group has ever needed a state-funded bailout. Santander UK believes that the taxpayer should never have to bailout troubled financial institutions. To this end, Santander

⁶³ Transcript of Public Bill Committee Debate re: Financial Services Bill, Clause 25. *Thursday 8 March 2012* (Afternoon).

⁶⁴ *Ibid.*

⁶⁵ Reid, Margaret. *The Secondary Banking Crisis 1973–1975*. 1982. p. 4.

was one of the first banks in the world to agree a recovery and resolution regime with regulators at a Group level and in all its core markets.

1.4. In this response, we have sought to answer the questions which particularly affect Santander UK. Santander UK stands ready to assist the work of the Parliamentary Commission as best it can. Where there are areas where more detail would be helpful, Santander UK encourages the Parliamentary Commission to contact us directly.

2. Design of the ring fence

2.1. Santander UK plc operates a UK ring fence around it and its subsidiaries. This ring fence would be effective in shielding the UK-based businesses of the wider Santander Group from systemic or idiosyncratic risk elsewhere in the wider group. This arrangement has also demonstrated that ring fencing can be guided by clear principles and robustly implemented and maintained through both self-imposed corporate governance arrangements and effective domestic regulatory oversight by the FSA.

2.2. The Santander UK ring fence reflects the subsidiary model operated by the Santander Group. This subsidiary model involves autonomous Santander subsidiaries operating in core markets (such as Santander UK) where each local unit is autonomous as to liquidity and capital, without reliance on Santander as the parent bank.

2.3. Santander UK generates funding and liquidity for the purposes of its UK banking business primarily through UK retail and corporate deposits, as well as in the financial markets through its own debt programmes and facilities. It does this in reliance on the strength of its balance sheet and profitability and maintaining its own network of investors and credit ratings with the major credit ratings agencies. It does not rely on a guarantee from Santander or any other member of the Santander Group to generate this funding or liquidity.

2.4. The Santander UK corporate governance model reinforces the independence of the Santander UK business and ensures that its board and the management make their own decisions on liquidity, funding and capital, having regard to what is appropriate for its business and strategy.

2.5. Santander UK has enhanced the Santander Group subsidiary model by agreeing a regulatory ring fence around its UK activities with its lead regulator, the FSA. The ring fence creates formal firewalls between Santander UK and the rest of Santander Group, thereby reducing systemic risk and the risk of problems in other markets or units impacting Santander UK.

2.6. Specifically, the regulatory ring fence restricts the provision of liquidity and capital by Santander UK to the rest of the Santander Group and limits the extent of exposures to the Santander Group that it can assume. This ring fence is explicitly reported on and monitored by the FSA on a frequent basis.

2.7. This model has demonstrated that the regulator has the tools and the experience to implement a ring-fence which limits the relationship between banking entities in the same group in order to protect the stability and resolvability of that entity.

2.8. Santander UK believes that it represents a practical example of a well-functioning and robust ring fence, firmly rooted in clear principles, which is implemented and policed cooperatively by Santander UK and the FSA.

3. About Santander UK

3.1. Santander UK is mainly a retail and commercial bank: some 90% of profits after tax are derived from retail and commercial banking activities. Santander UK is a wholly owned subsidiary of Banco Santander S.A. As explained above, Santander UK is self-sufficient in capital, funding and liquidity and operates autonomously from its Spanish parent company.

3.2. Santander has invested more than £16 billion into the UK economy through the acquisitions of troubled financial institutions including Abbey National (c.£9 billion, 2005), Alliance & Leicester (£2.3 billion, 2008), and Bradford & Bingley (£612 million) and a recent capital injection of £4.5 billion (2010) to further develop its business in the UK.

3.3. Santander UK is embedded in communities throughout the UK with some 25 million customers, 24,500 employees, 1,350 branches, and 1.6 million UK-based shareholders.

3.4. Santander UK is dedicated to earning and keeping the trust of its customers. Trust is the cornerstone of the Santander business model and the foundation of its corporate values. Santander UK is working to build a full-service, diversified retail bank around the needs and interests of its customers. Santander UK is also making a significant contribution to economic growth by focusing on growing its lending to small and medium-sized enterprises in the UK, which it did by 20% in the first nine months of this year.

3.5. Santander UK has maintained the strengths of its building society heritage in savings and mortgage products and is growing its presence in the current account market and SME banking. By doing so, Santander UK is bringing significant competition to the UK high street as the first serious challenger to the incumbent “Big Four”.

3.6. Santander UK's balance sheet is one of the most UK-focused with an exposure of less than 0.5% of assets to eurozone periphery countries. More than 99% of customer assets are UK-related and 85% of its customer loans are prime residential mortgages to UK customers, with the balance being to UK businesses.

QUESTIONS

4. Question 4: What should be the timetable for implementation of these measures, and should it be set out more clearly?

4.1. While Santander UK strongly supports the Government's decision to define much of the detail of the ring-fencing rules in secondary legislation and regulation, further clarity on the timeline for implementation would be helpful.

4.2. Once the rules have been finalised, banks will need to make significant strategic decisions on how best to structure their respective organisations. This restructure will come at a high cost and likely with some disruption to customers given the scale and complexity of the task.

4.3. With this in mind, the Government should keep its deadline for implementation under review to ensure that banks have a reasonable amount of time to implement these rules diligently and with as little disruption as possible to customers.

5. Question 9: The draft Bill grants a large number of delegated powers to the Government. Are the principles under which delegated powers are to be exercised sufficiently clear?

5.1. Yes. Santander UK considers that the best way to implement the Banking Reform Bill effectively is to enshrine in legislation clear and robust principles. These should be used to guide the Government and regulators so that they have enough adaptability to ensure that the rules remain relevant and workable in future years.

5.2. The banking market is constantly evolving to adapt to changing customer needs and technological efficiencies. For instance, a significant number of Santander UK's customers now access their accounts using mobile technology and online services, many of which were not a feature of banking only five years ago. In a market where products and services change so rapidly, effective legislation must retain the adaptability necessary to meet future challenges.

5.3. Furthermore, legislation which avoids a "one-size-fits-all" approach provides customer choice and competition in the market. A degree of regulatory discretion in the implementation of the Banking Reform Bill is the best way of achieving this goal by allowing different banks to pursue different structures while staying within the principles outlined by the Independent Commission on Banking.

5.4. Santander UK considers the principles in the draft Bill to be sufficient to guide the Government and regulator without being overly prescriptive.

6. Question 10: Does the scope of the delegated powers in the draft Bill represent an appropriate balance between flexibility for the Government to respond to changing conditions and accountability to Parliament and the public?

6.1. Yes. As noted above, regulatory discretion is paramount for the Bill to be effective. Santander UK considers that sufficient accountability is provided through the very clear statement of principles established in the draft Bill.

7. Question 11: Is there sufficient clarity about the Government's intended use of delegated powers, both to enable public understanding and to enable affected banks to prepare for the proposed changes?

7.1. Santander UK considers that the very clear principles of ring-fencing and securing the continuity of vital banking services provide sufficient clarity to enable public understanding of the proposed changes. There is no need to be familiar with the detail of how banks will be split for this policy to be understood.

7.2. As yet there is not sufficient clarity in the rules for banks to begin preparing for the proposed changes. While the purpose and principles of the Bill have been made clear, the mechanics of a separation are extremely complex and will require further detail from the Government.

7.3. While this detail should properly be provided in secondary legislation and regulation (rather than in primary legislation), Santander UK encourages the Government to publish greater detail as soon as possible. Splitting the UK banking sector into ring-fenced and non-ring-fenced entities will clearly prove to be a significant challenge. The Government must ensure that it gives banks adequate time to implement these rules carefully and with due attention to the possible unintended consequences which might arise.

8. *Question 12: The draft Bill provides for review of the ring-fencing rules by the PRA every five years. Does the proposed review mechanism provide sufficient accountability?*

8.1. Yes. Santander UK considers five years to be an appropriate time frame. It provides the necessary balance between continuity in the regulatory environment and the flexibility to ensure the rules remain relevant in a changing market.

9. *Question 16: The Government is considering whether to allow ring-fenced banks to offer simple derivatives to their customers. Should they be allowed to? If so, what safeguards would be necessary?*

9.1. Yes. Santander UK considers it essential that ring-fenced banks are able to offer simple risk management products to all its business customers. Simple risk management products are extremely important for many SMEs and mid-caps. Santander UK agrees with the Government that complex derivatives should not be offered from within the ring-fence.

9.2. If businesses are unable to access simple risk management products from ring-fenced banks, Santander UK believes that SMEs and mid-caps will not be able to access them at all, or will only be able to access them from institutions outside the ring fence. These institutions are unlikely to have the same close relationship and long term commitment to the business as the ring-fenced bank. Furthermore, as SMEs will also have to post additional collateral to entities outside the ring fence for these services, they will also be more expensive, and likely prohibitively so. In order to preserve choice for SMEs, it is essential that ring-fenced banks are able to provide simple foreign exchange and interest rate risk management products.

9.3. Santander UK believes that safeguards would be necessary and has previously proposed a set of principles (see paragraph 9.16) to ensure that these products can be offered without threatening the stability or resolvability of a ring-fenced bank, thereby ensuring that their provision does not impede the continuity of core banking services.

9.4. Santander UK is mindful that products similar to those which we argue should be inside the ring-fence have been missold to SMEs in the past. However, most of these products (structured interest rate collars) were complex and would likely not be included in the ring-fence under the principles outlined in the Government's White Paper. In this submission, Santander UK proposes further principles to inform conduct regulation in order to ensure that these products are always sold in a transparent and fair manner (see paragraphs 9.17–9.23 below).

Scope of simple risk management products

9.5. As per the Government's White Paper, Santander UK proposes that only simple hedging products necessary to manage interest rate and foreign exchange rate risk should be sold to customers by a ring-fenced bank.

The importance of simple risk management products to SMEs

9.6. Interest rate and foreign exchange risk management products are essential for businesses of all size, including very small business.

9.7. Foreign exchange risk management products allow importing and exporting businesses which need to make and accept payments in foreign currencies to have certainty as to the sterling value of those payments when they are made. Without access to these products SMEs would be less likely to begin exporting or to make investments in overseas markets.

9.8. Interest rate risk management products are also important to business as they allow them to manage their financing costs while also providing flexibility which cannot be found in a fixed rate loan. It is clear that some businesses prefer to take a floating rate loan and then manage a part or all of that risk with a separate risk management product. This is a legitimate and positive choice for some SMEs. Santander UK believes that the Government should not act to close off this financing option for those SMEs which choose to use it.

SME access to simple risk management products

9.9. If SMEs cannot access simple risk management products from a ring-fenced bank, Santander UK is extremely concerned that they will not be able to access them at all due to the relatively small size of the contract they will be seeking and the increased cost which they are likely to incur.

9.10. Non-ring-fenced banks will deal with very large corporate clients and other financial institutions. It is therefore unlikely that they will be inclined to offer these products to SMEs given the relatively small scale on which they will be required. Furthermore, it is unlikely that a non-ring-fenced bank will take the time to get to know their clients in the same way that the primary relationship bank is able to, or be able to provide the network of support and advice which a ring-fenced bank can provide through branch networks and local business managers. SMEs right up to the very highest end (£150 million annual turnover by Santander UK's estimates) rely upon this local relationship approach for doing this kind of businesses. Santander UK would consider pushing small and relatively unsophisticated SMEs to investment banks for simple derivative products to be an unintended outcome of banking reform.

9.11. Even if non-ring-fenced banks do offer these products to SMEs, it is likely that they will be considerably more expensive than if offered by the primary relationship bank (which Santander UK expects will be the ring-fenced bank) due to a lack of common security in the non-ring-fenced bank.

9.12. For instance, when the ring-fenced bank provides FX execution and hedging, it does so alongside other credit lines which the customer has open (e.g. a loan facility). This enables the ring-fenced bank to offer longer term foreign exchange hedges without requiring any additional security from the customer. If an SME was forced to access foreign exchange hedges from a third party provider (i.e. a non-ring-fenced bank or an internet provider) then they would be very unlikely to be offered the same secured credit lines. In this case, the only option for the SME would be a shorter term or unsecured derivative which would be less effective for cash management and, in many cases, unaffordable.

9.13. The challenges with interest rate hedges are very similar. Without access to common security, non-ring-fenced banks would require cash backed or carved out security packages—both of which an SME would be unlikely to be able to offer. In particular, requiring an SME to post cash collateral would expose its cash position and day-to-day operations to short-term movements in financial markets; something which is clearly highly undesirable for most SMEs. Where ring-fenced banks can't offer these products, most SMEs would be forced to take fixed rate loans which do not offer the flexibility provided by simple interest rate risk management products.

Principles to protect the stability and resolvability of ring-fenced banks

9.14. Santander UK considers that the key question is whether ring-fenced banks can provide these products while preserving the principles and objectives of resilience and resolvability set out by Sir John Vickers. Santander UK believes that they can.

9.15. Santander UK considers that simple derivative products can be offered by ring-fenced banks without significantly increasing the interconnectedness risk to which the bank is exposed or complicating the resolvability of the bank, thereby causing no impediment to the continuity of core banking services.

9.16. In March 2012, Santander UK proposed the principles below for the regulator to use to restrict the provision of simple risk management products by ring-fenced banks to business customers to ensure that resolvability and stability are protected.

PRINCIPLES FOR THE REGULATION OF THE PROVISION OF SIMPLE RISK MANAGEMENT PRODUCTS BY RING-FENCED BANKS

1. Ring-fenced banks may provide a limited set of vanilla risk management and trade finance products and services where they meet the following conditions:

- (i) The product or service is required by customers to manage risks to which they are exposed as a result of their business operations.
- (ii) The product or service does not expose the ring-fenced bank to categories of counterparty and market risk to which it is not already exposed as a result of its day-to-day risk and liquidity management activities.
- (iii) The product or service uses financial instruments traded in deep and liquid markets where there is evidence of this liquidity being maintained under periods of extreme stress.
- (iv) The product or service is not provided to a financial institution.

2. In the delivery of the products specified in (1), ring-fenced banks may be exposed to market risk where the capital requirement for this exposure (as calculated for regulatory purposes) does not exceed 5% of total capital requirements

3. In the delivery of the products specified in (1), ring-fenced banks may be exposed to counterparty risk where this exposure is restricted to 5% of total capital requirements (as calculated for regulatory purposes) excluding where a transaction is conducted with a central counterparty regulated by or equivalent to the provisions of the European Markets Infrastructure Regulation⁶⁶

PRINCIPLES TO PROTECT CUSTOMERS

9.17. In addition to ensuring that simple risk management products can be provided by ring-fenced banks without compromising the objectives of the ICB report, Santander UK also considers it important that regulators are confident the products can be sold to SMEs appropriately.

9.18. Santander UK is keen to work with regulators to demonstrate that best practice principles for the selling of risk management product can ensure that they are always sold transparently, fairly and in the best interest of the customer.

⁶⁶ REGULATION (EU) No 648/2012.

9.19. Santander UK's sales process for risk management products is dictated by a set of principles which we believe protect the customer from the risk of misselling. We believe that these principles can be used to guide the provision of risk management products from within the ring-fenced bank.

9.20. Santander UK believes that the fundamental purpose of these products should always be to enable customers to reduce or remove exposure to variable rate linked interest costs associated with their borrowings from Santander UK. The following principles reflect this:

Santander UK proposed conduct principles for the selling of interest rate risk management products to non-sophisticated clients

- (i) **Compliance oversight:** The principles for selling interest rate risk management products must be overseen by the company's Compliance division.
- (ii) **Appropriate persons:** All advice to clients must be provided by staff who are FSA registered **and** deemed competent under Santander UK's internal policies.
- (iii) **Restricted products:** Only simple risk management products may be offered and sold.
- (iv) **Speculation:** Products provided must not allow clients to "speculate" on interest rate risk⁶⁷.
- (v) **Limited terms:** The term of the risk management product must not be longer than the term of the loan.
- (vi) **Limited value:** The notional value of the risk management product must not be greater than the loan.
- (vii) **Limited rate:** The underlying rate of the risk management product must be the same as the loan.
- (viii) **Review and enforcement:** Compliance division must undertake a quarterly review of a sample of advice provided to clients to ensure that these principles are being adhered to.
- (ix) **Client strategy:** Santander UK advisers are required to send clients a "Strategy Letter"⁶⁸.
- (x) **Legal and tax advice:** Clients are encouraged to seek their own legal and tax advice in addition to that provided by Santander UK.

9.21. The sales process of these products to non-sophisticated clients is always "advised" and Santander UK staff must follow a sales process dictated by the principles above to ensure that the product is always in the client's interest and only used to manage the risk arising from floating interest rates.

9.22. With principles to protect the ring-fenced bank from interconnectedness risk, and principles to protect customers from the risk of misselling, Santander UK believes that removing access from these products entirely for SMEs would be disproportionate and unjustified.

10. *Question 17: Are the proposed corporate governance arrangements between the ring-fenced bank and the wider group sufficient to ensure the independence of the ring-fenced bank? Are these arrangements compatible with directors' duties and principles of accountability?*

10.1. The draft Bill does not provide any detail on the governance arrangements between the ring-fenced bank and the wider group. The details of these measures will be for the regulator to define.

10.2. Santander UK strongly endorses this position. We do not believe that prescriptive rules on the nature of board composition would be desirable or necessary in primary or secondary legislation. A "one size fits all" approach embodied by prescriptive rules is likely to result in counter-intuitive and unintended consequences. For instance, one set of rules would have a very different impact on a listed UK banking group than on a wholly owned independent subsidiary of an EEA headquartered banking group, such as Santander UK.

10.3. There are a variety of tested and proven mechanisms available to regulators which ensure the independence of a board and board functions from the rest of a banking group which do not require overly prescriptive and "one size fits all" rules on board membership.

11. *Question 19: Will it be possible to effectively monitor and police the ring-fence, given the degree of regulatory discretion the draft Bill proposes?*

11.1. As noted above, Santander UK believes that the degree of regulatory discretion in the draft Bill will enhance the effective monitoring and policing of the ring fence. The core principles of resilience, resolvability and competition can and should be enshrined in primary legislation. However, the evolving nature of the banking market in terms of technology, practice and customer preference mean that overly detailed rules which take a "one-size-fits-all" approach risk becoming obsolete and unenforceable.

⁶⁷ This is to mean that the product provided is only to be used to manage the financial risks the client faces in their day to day business, not as a means of potentially generating greater returns.

⁶⁸ A Strategy Letter is produced following a face to face meeting where a full fact find has been undertaken. It confirms the advisors understanding of the client's financial exposures and requirements, the agreed or potential course/s of action and indicative pricing. The relevant Product Fact Sheets are attached. Compliance and legal issues are also discussed in relation to their FSA classification and ISDA documentation. The provision of this letter is not a formal regulatory requirement.

11.2. Santander UK believes that the key to successfully implementing the Banking Reform Bill lies in strong and effective regulators with the scope to work with banks to ensure that the principles of the legislation are met in a way that reflects the particular circumstances of each institution.

12. *Question 22: Does the draft Bill adequately implement the ICB's recommendations on loss absorbency requirements?*

12.1. Yes. The draft Bill provides the framework to implement the loss absorbency measures agreed in the Recovery and Resolution Directive of the European Union (RRD).

12.2. This section necessarily provides for a degree of flexibility as the RRD has yet to be agreed. Santander UK maintains that the Government must seek to implement loss-absorbency measures in line with the rest of the European Union.

12.3. While we appreciate that a strong and predictable regulatory environment in the UK is in the interest of all parties, there nevertheless remains a risk of regulatory arbitrage and a very serious threat of damaging UK banks' ability to raise funds if these rules are not harmonised across Europe and, to as high a degree as possible, with the major financial jurisdictions across the world.

13. *Question 23: The draft Bill gives the Government power to direct the way in which the regulators can implement loss-absorbency requirements. How appropriate and well-designed is this power?*

13.1. As noted above, this power is necessary to allow the Government to achieve maximum harmonisation with the EU and other financial jurisdictions. Following the global financial crisis of 2008–9, the importance of internationally agreed and implemented financial regulation is well understood.

14. *Question 25: Is the Government justified in its decision not to implement the ICB recommendation for a higher leverage ratio than is required by Basel III?*

14.1. Yes. Santander UK agrees with the Government that to apply a higher leverage ratio than that agreed by the Basel Committee on Banking Supervision (BCBS) would be inconsistent with international standards and the methods underpinning those standards.

15. *Question 27: What is your assessment of the Government's preferred design of "bail-in" powers needed to improve bank resolution? How likely is it that the Recovery and Resolution Directive will deliver effective bail-in powers?*

15.1. Santander UK strongly welcomes the Government's commitment to implement bail-in rules through the Recovery and Resolution Directive of the European Union, rather than unilaterally.

15.2. Like other UK banks, Santander UK raises its funding in international markets. Therefore, a UK-only statutory bail-in power would not give clarity to market participants, many of whom would be operating outside of the UK's jurisdiction. A bail-in instrument of the kind described in the Government's White Paper can only be viable if it is internationally agreed and implemented.

15.3. In order to promote a sustainable market for bail-inable debt, clarity of legal and contractual arrangements and clarity on the events which would trigger a bail-in are essential. Given the cross-border nature of bank debt, Santander UK believes that these will be best achieved as part of an international agreement on bail-in.

16. *Question 32: What other matters should the Commission take into account?*

16.1. Santander UK is concerned that the current legislative framework for the transfer of a deposit taking business is ill suited to achieve a ring-fenced bank. Santander UK therefore strongly recommends that the Government amend the current FSMA Part VII process or, instead, puts in place bespoke (primary or secondary) legislation.

16.2. Part VII of the Financial Services and Markets Act (2000) ("FSMA Part VII") deals with banking and insurance portfolio transfers from one bank or insurer to another.

16.3. FSMA Part VII enables such transfers to take place through a Court approved process. This means that assets, liabilities and certain third party contracts can be transferred from one bank to another without the consent of each individual customer or contractual counterparty having to be obtained.

16.4. Currently, the only feasible way to implement the ring-fencing rules is to use the FSMA Part VII process. In this context, we consider this process to be problematic due to the tensions which could arise between the role of the Court and the object of the FSMA Part VII process, the Court time and resource that would be taken up and confusion this process could create for customers. Santander UK would be happy to provide more information on this point on the Commission's request.

Written evidence from HSBC Holdings

GENERAL COMMENTS

1.1 You have asked us to consider whether the draft Bill will successfully give effect to, and is the most efficient and effective means of delivering, the main objectives set out in the policy document accompanying the draft Bill (*Sound banking: delivering reform*):

- (a) making banks better able to absorb losses;
- (b) making it easier and less costly to sort out banks that still get into trouble; and
- (c) curbing incentives for excessive risk taking.

Our detailed comments on the specific questions are set out below but, as requested we have the following high level comments.

1.2 We acknowledge that HM Government is fully committed to a policy of ring-fencing retail and SME banking and we are likewise committed to taking all the steps necessary to implement that policy decision. We are wary however of overstating the incremental impact that ring-fencing operations within a single jurisdiction will have in terms of delivering the main objectives set out in the draft Bill. It is also somewhat hypothetical to estimate whether ring fencing is the most efficient and effective way of achieving the objectives set out in the draft Bill, as the cost/benefit analyses of both ring-fencing and its alternatives are highly subjective. On top of this, determining the incremental contribution of ring-fencing to the aggregate benefit from all the other structural and regulatory changes in train would be conjecture.

1.3 Accepting that HM Government wishes to pursue a form of ring-fencing which insulates banking services to individuals and SMEs from shocks elsewhere in the financial system and has a further continuity objective around uninterrupted provision of vital banking services in the UK, we would however urge it to consider carefully developments in both Europe and the US. It is important as far as possible to agree a globally consistent approach to structural reform, if we are to reduce the risk of both regulatory arbitrage and excessive complexity and therefore cost in delivering structural reform. We believe there are a number of actual and potential inconsistencies between the approach proposed by the Liikanen Group and the ICB (as developed by HM Government) which would need to be “ironed-out” to achieve this.

1.4 There have been welcome modifications made to the ICB’s original recommendations necessary to address issues which arose in the detailed consideration. Importantly, changes to the Group PLAC requirements reinforce the Government’s position that the UK should not be considered financially responsible for overseas subsidiaries, and the reversion to the international leverage ratio of 3% is both consistent with the views of the Basel Committee and consistent with the narrower focus and lower risk profile of the proposed ring-fenced bank.

1.5 We believe that the timetable for implementing a structural change of this magnitude must reflect the significant legal, financial and operational challenges in creating these new financial institutions. It is important that an ambitious timetable does not divert resources and put the continuity of customer services at risk or limit capacity to support the Government’s growth agenda.

1.6 From an HSBC perspective, we do not believe that separation of retail and wholesale banking will have a material impact on the culture of the firm as neither side was dominant; there are undeniably distinctive characteristics of retail and investment banking and these will endure in the two new banks. The most senior management that sat astride both parts of the firm would regard themselves as universal bankers, not advocates of one particular business line and that too will remain in the new configuration. We do, however, believe that the separation will have an impact on investors’ appetite for UK wholesale banking—and this must have been an objective of the structural reform—when compared to investment opportunities elsewhere in a universal banking model. Government should keep a watching brief over time as to whether contraction in the UK based wholesale banking sector creates longer term vulnerability to the actions of foreign firms with broader capabilities to serve UK based multinational companies.

1.7 The draft Bill necessarily gives many delegated powers to the supervisory authorities to adjust the scope and parameters of the ring-fence once it has been established. We think this provides essential flexibility and trust that these delegated powers will be exercised with sufficient consultation, within an appropriate implementation timetable, and subject to due scrutiny by and accountability to Parliament.

1.8 On the specific proposals presented in the draft Bill and White Paper, we believe that the *de minimis* limit for firms which has been suggested to identify firms to be excluded from the ring-fence requirements may be too high. We look forward to seeing more clarity on the Core Activities of the ring-fenced bank and the Excluded or Prohibited Activities as soon as possible so that we can make decisions on where our ring-fence should be positioned to best serve our customers. We support HM Government’s proposal that the ring-fenced bank should be able to offer simple derivatives given the potential consequences of concentrating all risk management activities for the real economy into a limited number of non-ring fenced banks and foreign firms.

1.9 There is a strong case for depositor preference but this would create a subordination of other creditors and the impact of this on funding markets needs to be understood. Furthermore, this would seem to be inconsistent with existing European proposals. More thought is needed on this issue.

1.10 In our opinion, the majority of the benefits in terms of improving financial stability (as set out in the objectives above) are derived from regulatory initiatives other than ring-fencing, making it difficult to assess the incremental impact of the ring-fencing structural reform. Improved loss absorbency has been achieved by the introduction of bail-in powers on non-common equity capital and other creditors, and we believe this should also be extended to deposit guarantee schemes. Curbing incentives to take risks has been achieved, *inter alia*, through the introduction of private sector bail-in and changes to remuneration structures. It is difficult to show how ring-fencing has incrementally improved the ability to “sort out” a failing bank given the resolution options available and the likely timetable over which these will be applied but we accept that the public policy benefits of making the separation, in terms of helping to restore public trust in the industry, are undeniable.

RESPONSES TO SPECIFIC QUESTIONS

Objectives and general approach

Q1. *Does the draft Bill successfully give effect to the objectives set out in paragraph 1.3 of Sound banking: delivering reform and is it the most efficient and effective means of delivering those objectives?*

1.11 *Loss Absorbency*: The draft Bill (and the stated intentions for secondary legislation) reinforces the resolution framework established under the Special Resolution Regime and should ensure that banks will be better able to absorb losses in the event of a further crisis through the introduction of Primary Loss-Absorbing Capacity (PLAC) or bail-inable term unsecured debt. However, it is difficult to say whether this is the most efficient and effective means of achieving this objective as the incremental impact of the structural reform on top of other regulatory changes is impossible to measure. Given that other jurisdictions are adopting different approaches it is possible that experience will, in due course, show that one structural solution is more successful than another, but hopefully all the other reform measures will prevent future crises arising in the first place.

1.12 In terms of detail, we would favour a broader definition of bail-inable liabilities along the lines suggested by the European Commission in their proposed Recovery and Resolution Directive, without the specific focus on PLAC. Covering a wider range of creditors gives greater flexibility and avoids creating what is *de facto* another class of capital. Within this broader range, we also believe that HM Government should consider establishing a framework for the bail-in of the deposit guarantee scheme in the UK. This would restore its role in bearing losses in the event of the failure of a firm, even if that firm has been resolved by the Authorities rather than entering into liquidation.

1.13 *Resolution of Banks*: The ring-fencing of certain functions considered critical to customers who are unlikely to have access to alternative suppliers (such as individuals and SMEs) is intended to make banks easier and less costly to resolve and facilitate the uninterrupted provision of vital banking services. In a way, ring-fencing contributes to this goal as it allows different resolution approaches to be considered for the two parts of the bank. Indeed, unless different resolution approaches are available, it is difficult to see the additional benefits offered by separation compared to simply requiring UK banks to have (i) more loss absorbing capacity—which could be in the form of Tier 2 capital, bail-in debt, other creditors or the bail-in of the deposit guarantee scheme—and (ii) effective recovery and resolution plans which allow for the *ex post* dismantling of the failed bank.

1.14 Unfortunately, it is difficult to see, *ex ante*, the practical difference which would arise from the structural distinction which has been created. We recognise that the objective for resolution of a ring-fenced bank would be a rapid recapitalisation through the bail-in of PLAC with continuous operation of the bank during this period. But a similar bail-in scenario is also likely for the non-ring fenced bank given liquidation is not likely to be seen as a realistic option for a number of reasons:

- (a) Unless wholesale banks in London shrink substantially in size (and we believe The City of London’s role would diminish in such circumstances), they will remain a key part of both the UK and international financial systems. The importance of London maintaining its leading international position in financial services has been continuously reinforced by HM Government so we take this to be a foundation of the UK’s economic positioning. While it is essential that there is a mechanism to resolve wholesale banks so that they can be wound down without public sector support, pending completion of an effective cross border resolution framework, which is currently far from complete, any requirement in the meantime for a wholesale bank liquidation would have material issues for other parties such as investors and counterparties (including central clearing counterparties and, through them, ring-fenced banks) and further impacts on other non-ring fenced banks in terms of confidence and funding.
- (b) Corporates will in the future be transacting the majority of their risk management activities with a non-ring fenced bank and so be exposed to the credit risk of the failure of that bank; the explicit discipline of this exposure is part of the objectives of regulatory reform but it is also likely to see business increasingly concentrated into the most systemically important counterparty banks. Although channelling most standard activity in due course through central counterparties will alleviate much of the credit risk in the event a systemically significant firm is put into resolution, a

myriad of OTC derivative contracts which make loans affordable or foreign transactions bankable, through hedging interest or exchange rate risks, would suddenly be removed with potentially severe consequences.

- (c) Given the wide scope allowed for the non-ring fenced bank, this bank will also likely contain the main banking relationships for a significant tranche of UK middle market and larger corporates and these could not be unaffected by the failure of the non-ring fenced bank. Importantly these firms are the customers and suppliers to the SMEs within the ring-fenced bank so any impairment of their financial position, for example because their deposits are caught up in the wind down, would reverberate into the customer base of the ring-fenced bank.

1.15 Realistically, it would seem that the likely resolution options for both portions of the bank include bail-in, so avoiding putting taxpayer monies at risk and forcing private investors to take responsibility for the failure. Both banks would then need to be restructured—it is difficult to envisage a scenario where a bank has failed and this is not required—but the eventual outcomes could be radically different. The ring-fenced bank may largely resume operations whilst the non-ring fenced bank could be subject to transfers of its viable activities to another entity and the solvent wind-down of the remainder. But in this scenario, it would seem that we have not increased the resolution options—just put them into different buckets. This is an expensive solution to achieve this differentiation.

1.16 Contemporaneous with the work of the ICB we note the considerable body of work being undertaken on recovery and resolution under the guidance of the Financial Stability Board (FSB). The Bank of England (BoE) and the Financial Services Authority in the UK (FSA) have been at the forefront of this. Within this work, there appears to be an approach which recognises the impossibility of trying to achieve a full solution and full separation over a weekend. Instead, the required in-depth analysis of businesses and extensive preparation of resolution planning will provide a much wider range of options for the separation of banking operations into their constituent parts as part of a business restructuring once the firm has been put onto a firmer financial footing. The product of this work is a definition of a much broader range of critical economic functions within the UK's resolution regime, acknowledging the need for continuity in a wide range of banking functions, beyond the sub-set concentrated upon by the ICB.

1.17 We would conclude, therefore, that while ring-fencing adds clarity to different parts of the banking model and makes explicit the risks being borne by creditors to each portion, it has less practical impact on the “sorting out” of failed banks: it is financial bail-in which provides the solvency support to allow for a more considered restructuring of the firms at the necessary granular level using the information from the resolution planning process rather than the structural separation of activities.

1.18 *Curbing Risk Taking:* A key objective of the reform proposals is that by removing the implicit government support from an organisation which is too big or too complex to fail, funding providers are forced to embrace the riskiness of the business they are supporting. On top of this, reforms should place an effective curb on the instinct of bankers to take risks where the gain is private but the loss is public. We support all steps to achieve these objectives but argue the objectives are not achieved by ring-fencing but by:

- (a) the introduction of private sector bail-in, covering a wide range of creditors, including preferably the deposit guarantee scheme—so that these stakeholders have a strong incentive to curtail risks since, in the main, they have fixed rewards; and
- (b) reforms to remuneration policies which have ensured that risk-takers are clearly identified within any firm and that their incentives for excess risk are curtailed through deferred payments, payments in shares and clawback arrangements.

Q2. Do any of the recommendations of the Independent Commission on Banking (ICB), which the draft Bill seeks to implement, need revision as a consequence of developments since the ICB's report?

1.19 Although the Final Report from the ICB was published in September 2011, the Issues Paper on which it was based was published in September 2010 and much of the evidence which it considered was focused on periods before this. During 2011–12, there has been considerable progress in a number of areas.

1.20 *Structural Regulation:* Both the US and the European Union have considered structural reform to address questions of financial stability through (a) the Volcker Rule within the Dodd-Frank Act and (b) the Report of the Liikanen High Level Expert Group respectively. Given this broadening of interest by the authorities in structural reform, there is considerable merit in ensuring that this is undertaken on a globally consistent basis to reduce the risks of regulatory arbitrage, particularly given that many of the affected businesses are quite geographically mobile. In addition there is a need to ensure that the industry is not burdened with duplicative costs from similar but not identical requirements which will increase unnecessarily the costs of intermediation borne by the real economy.

1.21 *EU Recovery and Resolution Directive:* The European Commission has published a draft Recovery and Resolution Directive which sets out, *inter alia*, clear goals for loss-absorbency which would apply to all firms across the European Union. UK proposals for loss-absorbency may need to be modified to fit with this regime, in particular:

- (a) the proposals that loss-absorbency requirements are determined on a firm specific basis taking account of a series of criteria set out in the draft Directive (Article 39)—this has the effect of avoiding the cliff and trigger effects which come from the creation of a “hard minimum”, which HM Treasury indicated it was seeking to avoid in its White Paper of June 2012 (Para 3.30); and
- (b) depositor preference is not permitted under the European Commission proposals which also include scope for a deposit guarantee scheme (which in the UK would be the Financial Services Compensation Scheme) to be bailed-in—this is discussed further in our response to Question 21 below.

1.22 *EU Capital Requirements Directive 4 (CRD4)*: In addition to incorporating the proposals for the implementation of Basel 3 within the European Union, CRD4 also incorporates further provisions on remuneration and incentives which are relevant to the ICB’s considerations given the focus on “curbing incentives for excessive risk taking”.

1.23 *Capital Requirements for Trading Activities*: There has also been a significant change in the structure and nature of trading activities with the transfer of OTC derivative trading to central clearing counterparties (CCPs), the collateral requirements with these CCPs and the requirements for much higher margin requirements for trades which are not centrally cleared. These developments have significantly reduced the risk of trading operations to universal banks.

1.24 *FSB and Other Developments on Resolution*: In the period since the ICB’s work, there have been considerable developments by the FSB in its work on international resolution, including recognition of different approaches to the resolution of a Globally Systemically Important Bank (G-SIB) depending on the structure and nature of its operations—this is discussed further in our response to Question 3 below. As mentioned above, thinking has also advanced on the timetable for resolution, as set out in a speech by Andrew Gracie, Director, Special Resolution Unit, Bank of England on 17 September 2012. This indicates that resolution is not contemplated over a single weekend but over a much longer series of phases which makes the need for *ex ante* separation of universal banks less obvious.

Q3. Do the powers in the draft Bill and the Government’s stated intentions for their use give effect to the ICB’s recommendations? Are any deviations justified?

1.25 The Draft Bill and HM Government’s stated intentions do give effect to the broad thrust of the ICB’s recommendations through enabling HM Treasury with the requisite powers to implement the policy underlying the Bill through secondary legislation. This recognises that adjustments will always be required as high level policy making is applied in detail. This has also necessitated a modest number of deviations and developments from the original recommendations in the Final Report of the ICB. We have commented on some which are particularly relevant below.

1.26 *Group Primary Loss Absorbing Capacity*: The proposals on the application of PLAC requirements to Groups have been modified to recognise the diversity of Group structures and the associated differences applicable in resolution regimes, a point also now acknowledged by the FSB. There is now agreement that, *prima facie*, it would be inappropriate for PLAC requirements to be applied across an entire Group (such as HSBC) which operates through separately capitalised and funded banks, which would be resolved locally under what the FSB refers to as the “multiple-entry” approach. The original requirement would have forced such groups to migrate towards a “single-entry” or “top-down” model for resolution which would have placed much more responsibility and risk on the home country (i.e. the UK). HM Government has indicated that it does not wish to take on the task of resolving overseas operations of a UK-headquartered Group which pose no threat to the financial stability of the UK; the revisions from the original ICB report are therefore appropriate.

1.27 *Resolvability Buffer*: The Final Report of the ICB suggested that an additional 3% loss absorbency buffer could be added by supervisors if they had concerns about the resolvability of any firm. We concur with the view from HM Government that this power is unnecessary to make explicit given the other powers with similar impact which supervisors hold with respect to both resolvability and capital.

1.28 *Leverage Ratio*: The ICB recommended that the leverage ratio for the ring-fenced bank should be increased from 3.0% to 4.06% in line with its proposed increase of the minimum capital ratio from 7% to 10% for the largest ring-fenced banks. HM Government has proposed to restore this to the international standard of 3.0%. We support the decisions of HM Government and note that:

- (a) when the proposed increased capital requirements for G-SIBs were announced by the Basel Committee and FSB, they did not recommend any changes to the leverage requirements; and
- (b) the original leverage ratio of 3% devised by the Basel Committee was intended to apply across all banks including universal banks. Therefore it was a blended rate recognising that banks hold low risk liquidity pools and mortgages as well as higher risk-weighted corporate and wholesale banking assets. Applying that blended rate to retail ring-fenced banks, with their concentration of lending to lower risk mortgages and with larger tranches of liquid assets, would in and of itself constitute a more onerous standard. To go beyond this would mean that the leverage ratio would become a binding capital restriction rather than the backstop measure which the Basel Committee originally intended.

1.29 *De Minimis*: HM Government has decided to introduce a *de minimis* level for the implementation of ring-fencing. Whilst we agree that this is prudent, we disagree with the level at which this has been set—this is discussed further in our response to Question 13 below.

Q4. What should be the timetable for implementation of these measures, and should it be set out more clearly?

1.30 HM Government has set out a timetable for the implementation of primary legislation (i.e. by the end of 2013) with the intention that secondary legislation should be in place by May 2015. This timetable seems broadly appropriate although, as we note elsewhere, it is important that HM Government gives due and careful consideration to developments in both Europe and the US to ensure that there is a globally consistent approach to structural reform and regulatory arbitrages do not develop. Depending on progress elsewhere, this may require a modification of that timetable.

1.31 In terms of capital requirements, the ICB Final Report recommended that its proposals should be implemented in line with the timetable for the introduction of higher capital requirements under Basel 3 over a period to 1 January 2019. We concur with this timetable but would note that the British banks affected by the ICB proposals are already operating at capital levels which are above the “glide-path” for achieving Basel 3 compliance. This is, in part, due to the pressure being placed upon them by the Interim Financial Policy Committee, supervisors and market commentators. We note that this acceleration may be having detrimental effects on the ability of some banks to provide incremental credit support to the real economy, although recent Government initiatives such as the Funding for Lending Scheme and guidance from the FSA have sought to ease these pressures.

1.32 In terms of the timing requirements for separation to create the ring-fenced bank, HM Government has indicated that this should occur as soon after 1 January 2019 as is practicable. We recognise that it is important that this step must occur within a reasonable timeframe and be undertaken in a measured manner. Through the process of creating the ring-fenced banks, the major banks in the UK will be transferring the systems and operations resources and capabilities which support their most vulnerable customers (as identified by the ICB) to new entities to be established for this purpose. A huge communication exercise will be required to make customers aware of what is happening to their banking arrangements. They must also be given an opportunity to make choices where these are required and the legal process will need to be undertaken within an agreed protocol designed to avoid disputes and exposure to avoidable claims for compensation. The operational systems and processes to be established will have to be planned and properly implemented and tested thoroughly so that customers will not be affected by any break in service. New boards and governance structures will need to be put in place for the split banks. Much of this can be done in advance and in parallel but it will take care, time and proper planning, all of which is to be done during a period of expected economic fragility in Europe.

1.33 Given that the secondary legislation necessary to enable banks to make clear decisions will not be finalised before early 2015, it is difficult to envisage that the structural reform could be completed by 1 January 2019 and it may be some time thereafter depending on how quickly the secondary legislation can be published and rules around it promulgated. The final timetable will ultimately depend upon operational decisions which are made about how the switchover is to be accomplished and we believe it would be dangerous to be too prescriptive at this stage.

Q5. The draft Bill proposes continuity objectives on the PRA and FCA. Are these appropriate and compatible with their other objectives?

1.34 We believe that the continuity objectives which have been set out for the PRA and FCA are consistent with their overall objectives and the goals that they have been pursuing with the development of enhanced recovery and resolution plans.

BANKING STANDARDS AND COMPETITION

Q6. What will be the impact of the proposed changes in the draft Bill on banking standards in the UK more widely?

1.35 We are unconvinced that the proposed changes in the draft Bill will have any direct impact on banking standards more widely. We do not see either a strong linkage between standards in banking and the degree of mixing of retail and wholesale banking, nor that separation in and of itself changes the behaviour of individuals within the two pieces; this is one aspect of a much more complex issue on which we have commented to the Commission in our submission of 24 August 2012. However we believe the clarification of the different roles of the ring-fenced bank and its non ring-fenced affiliate, delivered through structural reform, may help public understanding of the industry. The intensified scrutiny of banks by debt and other creditors because of the bail-in regime should, however, put pressure on banks to ensure bail-in is a remote risk.

Q7. What will be the impact of the separation of retail and wholesale banking on the culture prevailing within each?

1.36 The HSBC Group operates on the basis of a common culture operating across its global business in both retail and wholesale banking. The principles underlying that culture were approved by the Board of HSBC Holdings plc and there has been a strong process, led by the Group CEO, ensuring that everybody in the firm understands and abides by these principles. As a result, we do not believe that there will be a change in culture as a result of the separation. We are working to have the same culture in parts of the Group outside the UK that will not be subject to ring-fencing so if we thought that structural change was necessary to achieve the right culture we would be making such changes in all our markets.

Q8. What will be the impact of the ring-fence on competition, both in retail and investment banking, and in other areas of financial services?

1.37 Retail financial services in the UK are already highly competitive and there is no reason to believe that ring-fencing will improve this level of competition; indeed there is a danger that the onerous capital and other requirements will act as a barrier to the development of substantial “challenger” banks, or these firms will avoid activities subject to the ring fence to avoid the additional costs of separation, thereby further concentrating the market.

1.38 Ring-fencing of wholesale banks will by design make them much smaller institutions with more volatile cashflows and, as a result, lower credit ratings. This will increase the level of capital which wholesale banks need to hold in order to be able to attract funding and raise the cost of such funding when that is available. In the global marketplace in which wholesale banking operates, if it is not possible for wholesale banks headquartered in the UK to attract the necessary incremental capital because they offer returns to investors which are below those available elsewhere, in particular from universal banks still perceived to have implicit government backing, then activities will migrate over time to these banks. It is not realistic to seek to assume it would be possible to charge customers materially above the rate offered by the competition to compensate.

1.39 Ultimately, therefore, we see a risk of a long term decline in UK-domiciled wholesale banking and a rising dependency amongst UK corporates and other institutions (such as pension funds) on overseas universal banks for their more sophisticated requirements. This could leave The City of London more vulnerable to external competition than it is today. HM Government will need to continue to monitor carefully the overall competitive position of The City within the international banking system and, more importantly, the impact of structural reform on companies based in the UK who depend on the City today for their funding and risk management needs.

DELEGATED POWERS AND ACCOUNTABILITY

Q9. The draft Bill grants a large number of delegated powers to the Government. Are the principles under which delegated powers are to be exercised sufficiently clear?

1.40 Following the Final Report of the ICB, there have been a series of interactions between the public, the banks and HM Treasury on the proposed implementation of the recommendations. These have led to some necessary adjustments as detailed issues around implementation have become clearer—these are discussed in more detail under Question 3 above. This process is, however, ongoing and will indeed continue throughout the implementation of the ring-fence. We appreciate, therefore, that it is not possible for all of the developments to be reflected in the primary legislation but we do believe that the principles are clear.

1.41 We note, however, that the objectives which HM Treasury must consider before making orders in respect of additional Core Activities, Core Services and Excluded Activities are very broad and the impact of any order could be significant for a bank. As a result, the principles and procedures under which these delegated powers are exercised will be important. For example, the definition of Core Activities and Core Services covers the entire operation of accepting deposits, making payments and providing overdrafts, not just limiting this to individuals and SMEs as recommended by the ICB. This is a crucial distinction for the banks since the reality of implementation of the ring-fence is that banks increasingly operate with a focus on customer segments, rather than products as seen by the ICB. If a bank defines the scope of its ring-fence bank separation largely on a customer basis to comply with the prevailing rules, and then orders from HM Treasury amend that, this could well result in the transfer of customers into (or potentially out of) the ring-fenced bank; a complex, time-consuming and potentially risky process and one very frustrating for customers.

1.42 We note that the scope of the delegated authorities in respect of both Excluded Activities and Prohibitions is also broad and we believe this illustrates the difficulties of giving effect to structural regulation within a country's banking system. It is recognition that, in a modern financial environment, it is exceptionally difficult to create absolute rules to separate different activities into distinct banks. The result is the need for regulatory and supervisory intervention to maintain the integrity of the separation. But this defeats one of the purposes of structural regulation—to remove some of the discretion from supervisors as existing powers have been shown not to have been exercised effectively before the last financial crisis.

Q10. Does the scope of the delegated powers in the draft Bill represent an appropriate balance between flexibility for the Government to respond to changing conditions and accountability to Parliament and the public?

1.43 We believe this is achieved. There is a continuing need for flexibility, subject to consultation and scrutiny—see our response to Question 11 below.

Q11. Is there sufficient clarity about the Government's intended use of delegated powers, both to enable public understanding and to enable affected banks to prepare for the proposed changes?

1.44 The primary legislation is high level but is a necessary first step in the implementation of these proposed banking reforms. We are confident that further details which will be provided in secondary legislation about how HM Government intends to use the delegated powers will give the public a clear understanding of the measures proposed and allow affected banks to prepare appropriately for proposed changes.

1.45 As discussed above, there is the need for continued flexibility for further measures to be introduced. However, at present, we do not understand the process by which such orders will be determined and implemented including (a) consultation with banking supervisors, the affected banks, their customers and other relevant bodies as well as scope for appropriate Parliamentary oversight of significant developments; and (b) the timetable for complying with such orders. We believe that this is an area where further discussion is required.

Q12. The draft Bill provides for review of the ring-fencing rules by the PRA every five years. Does the proposed review mechanism provide sufficient accountability?

1.46 The provisions in the draft Bill on the PRA review do not give any details as to the scope and objectives of proposed review; we assume that these will be set out in secondary legislation and/or agreed with HM Treasury when the review is initiated. We assume that if HM Treasury is to lay the report before Parliament, it will be subject to scrutiny on that report both by MPs directly and through appropriate committees such as the Treasury Select Committee and that representatives of the PRA could also be called to answer questions. If this is the case, there would seem to be opportunity for sufficient scrutiny and accountability if Parliament chooses to exercise it. The five year review period seems appropriate in general, although we would suggest that the first review might usefully be done after two or three years in case early remediation steps are required.

THE RING-FENCE

Q13. Is the power to be able to exempt certain categories of deposit-taking firms from having to establish a ring-fenced bank appropriate, and on what basis should the conditions for exemption be set?

1.47 At present, we understand that HM Government intends that the ring-fencing requirements will not apply to firms where the deposits which would otherwise need to be held within a ring-fenced bank (i.e. from individuals who are not High Net Worth Individuals or smaller SMEs) would be less than £25 billion.

1.48 We believe that it is appropriate for there to be a *de minimis* level at which firms are not required to introduce a ring fence. We are, however, unconvinced that the threshold of £25 billion of mandated deposits which has been proposed by HM Government is appropriate or sufficient on its own. Recent crises in the UK and elsewhere have demonstrated that even smaller deposit-holding firms have been shown to be systemically important, in part because of the risk of contagion to similar firms, as in the case of the savings and loans companies in the US, the former building societies in the UK and the cajas in Spain. This contagion effect will be exacerbated if the firm has a concentration of deposits in any market sector, either by geography or customer type. Careful consideration, therefore, needs to be paid to the regulation and resilience of these firms at this level.

1.49 Although the threshold is intended to be based upon a ceiling of £25 billion of mandated deposits, an exempted firm could hold deposits in excess of this, for example from middle market corporates or from individuals in excess of the personal free and investable asset threshold. Grossing-up the balance sheet for this effect would mean that these could be sizeable operations in the context of the UK economy not subject to ring-fencing rules and capital requirements. There may be communication challenges in explaining to consumers and small firms the differential protection they would receive in these smaller institutions.

1.50 By putting personal and SME deposits into a ring-fenced bank, the Government has effectively created an ancillary deposit support scheme, mandating higher capital levels and creating the option of a bail-in restructuring which should in most circumstances leave all deposit holders (not just those insured or preferred) unaffected by the failure of the bank. This also creates the potential problem that all deposit holders may want to benefit—and, more importantly, may expect to benefit—from this kind of protection.

1.51 There might then be a case where a firm is outside the scope of ring-fencing due to its modest deposit base, but remains a material risk to (part of) the economy and financial system due to activities on the asset side of its balance sheet. In these circumstances, there could be considerable moral pressure on the Government to ensure that the depositors in such firms were, in some sense, protected, when the scope of the Financial Services Compensation Scheme would not cover all of the depositors. This could be a considerable gap for the

Government to bridge and would suggest that either the deposit threshold should be set lower or that a threshold should be similarly defined with respect to total balance sheet size.

Q14. Is the range of core and excluded activities defined in the draft Bill appropriate and sufficiently broad? Are the Government's stated intentions for using powers to define further core and excluded activities appropriate?

1.52 *Core Activities:* As discussed above, the definition of Core Activities and Core Services currently covers the entire operation of accepting deposits, making payments and providing overdrafts, not necessarily limiting this to individuals and SMEs as recommended by the ICB, unless the additional activities and services are carried on in circumstances specified by order made by HM Treasury. It will be important that Core Activities is quickly defined so that banks can apply this definition effectively to their own customer bases when designing the necessary separation.

1.53 *Excluded Activities:* At present, HM Government has only defined the regulated activity of dealing in investments as principal as an excluded activity, a small sub-set of the activities envisaged by the ICB and in subsequent consultations. We understand that most excluded activities will be addressed in the secondary legislation. We hope that this will give HM Government an opportunity to (a) develop more detailed definitions of excluded activities so that banks can make firmer plans for separation, and (b) consider developments on structural separation in the European Union and US so that requirements and definitions can be, so far as is possible, harmonised and conformed to facilitate the smooth operation of the global financial system.

Q15. Which categories, if any, of customer should be permitted to deposit with a non ring-fenced bank?

1.54 The current proposal from HM Government is that insured personal depositors (excluding High Net Worth Individuals) and SMEs should be required to place their deposits with a ring-fenced bank; others including High Net Worth Individuals can become direct customers of the non-ring fenced bank if they so choose or can be customers of the ring-fenced bank. Overall, we concur with this position. At some point, customers must be considered eligible to choose how to invest their savings and accept the risks of decisions regarding the firm with which they choose to transact.

1.55 The level of personal deposit insurance has already established this threshold of responsibility for individuals. It is right that HM Government has extended this to the smaller companies and we believe that this criteria should be set at the lower end of the size range proposed, namely turnover of £6.5 million per year.

Q16. The Government is considering whether to allow ring-fenced banks to offer simple derivatives to their customers. Should they be allowed to? If so, what safeguards would be necessary?

1.56 We believe that it is important, from both a risk management perspective and customer service perspective, that ring-fenced banks should be able to offer simple derivatives to their customers. It is important to recognise that where a bank offers basic financial products such as fixed rate mortgages or loans or simple principal guaranteed investments, it is effectively providing a derivative, albeit built into the terms of the loan or other service. Indeed, they are already part and parcel of routine activity and most customers simply see the product they choose to take rather than unbundling the elements that went into its construction. There would in our view be customer push back if routine products were not available because there is an embedded derivative in the product construction. Allowing these to be sold separately and clearly identified will help ensure that customers, banks and supervisors are all fully aware of the risks which are being underwritten and can check that appropriate risk management is in place for the bank as a whole.

1.57 The customers of the ring-fenced bank can include larger corporates with much more sophisticated risk management needs than SMEs. If ring-fenced banks were not permitted to offer derivatives, it would force these businesses to choose between either (a) undertaking the entire transaction with a non-ring fenced bank, or (b) splitting the transaction so that the vanilla element (say, the loan) was with the ring-fenced bank and the hedge (say, a fixed interest or exchange rate) was obtained from a non-ring fenced bank. For the customer, this could mean that a loan made affordable by fixing interest or FX rates may not remain so because of having to deal with two counterparties with incremental operational complexity

1.58 HM Government has proposed that the only derivatives which can be offered would be standardised contracts for interest rates and FX. Since the customers of the ring-fenced bank can include larger corporates and given the scenario outlined above, we do believe that these restrictions are less efficient than they might be. Not all risk hedges will be capable of being put in place using standardised derivatives contracts and scope, within limits, should be created for non-standardised transactions, under standardised ISDA documentation and with collateral posted.

1.59 If the ring-fenced bank is to provide effective risk management products, it is critical that products can be tailored to mitigate client specific risk profiles. The proposed definition of "standardised" products may be overly restrictive to deliver this result. Instead, we believe that the focus should be on ensuring that the market for these contracts should be liquid and that these should be documented under standard ISDA agreements. In some cases, contracts could comprise two or more standardised products but it is not clear if this approach would be acceptable.

1.60 Having proposed that the ring-fenced banks should be able to offer derivatives to its customers, we recognise that it is important that there are safeguards in place to ensure that this power is not abused and that there is not an undue build-up of risk within the ring-fenced bank. We believe there should be two levels of safeguards: (a) a purpose test and (b) a limit on overall derivative exposure.

1.61 *Purpose Test:* The current Building Society Act sets out a “purpose test” which, with suitable modifications, could be applied to the ring-fence bank to prevent speculative activity. Attention is focused on transactions directly linked only to loans but some customers do not borrow money, instead making investments from their cash resources and these customers still want to manage their risks. In order to address this, a revised definition might limit the derivative risks which can be taken on by a ring-fenced bank to those where:

- (a) the derivative is directly linked to reducing risks arising from the provision of credit, holding of deposits or making and receiving of payments; or
- (b) the customer is a user, producer or consumer of the hedged asset (or a near equivalent, if the specific asset is not available), in appropriate quantities.

1.62 *Limit on Overall Derivative Exposures:* One of the safeguards that HM Government has proposed in the White Paper of June 2012 is that the residual market exposure from such derivatives should be capped at a percentage of capital which is as operationally close to zero as possible. This is unrealistic. Eliminating all market risk could potentially be prohibitively expensive since there will always be residual exposures, for example, on timing as expected (and actual) durations of thousands of underlying loans (such as mortgages) will not match the corresponding market-side hedge. We recognise that the residual market exposure for ring-fenced banks should be less than in the current universal bank and suggest that it would need to fall within a pre-defined risk framework which is subject to regulatory approval and periodic monitoring. The capital associated with any pre-defined risk framework would be agreed within Basel 2 Pillar 2 for each bank.

Q17. Are the proposed corporate governance arrangements between the ring-fenced bank and the wider group sufficient to ensure the independence of the ring-fenced bank? Are these arrangements compatible with directors’ duties and principles of accountability?

1.63 We recognise that having created a separate ring-fenced bank, it will need its own board and that body will also have a degree of independence; HSBC operates on this basis with its separate legal entities around the world and separate independent boards. HSBC has already installed an independent Chairman in its UK bank. It is also essential, however, that the ring-fenced bank remains clearly a part of the HSBC Group, adhering to the Group Standards which have been established.

1.64 It is intended that directors will have an additional duty to maintain the integrity of ring-fence alongside their other duties. Whilst it is feasible for directors to be required to manage a number of different objectives, this does make their role increasingly complicated and means that maintaining a high standard of directors will be essential. There will also need to be a clear regulatory definition of what is meant by the “integrity of the ring-fence”.

1.65 We support the position of HM Government on a separate committee for Risk—this is the practice with the majority of our locally incorporated entities in any event. We are unconvinced on the question of a Nominations Committee given that there will be an independent Chairman, but we would be happy to put this in place if required. We also believe that while the ring-fenced bank has input to and oversight of remuneration for its employees it is also important that the remuneration policy is closely linked to the Group, given that:

- (a) a considerable portion of the remuneration for directors and senior management will be in the form of shares in HSBC Holdings plc, and these must be issued on a common basis across the Group; and
- (b) senior management within the ring-fenced bank will often have served, or expect to serve in other parts of the HSBC Group, and the remuneration policies need to be consistent so that postings to the ring-fenced bank are not unduly penalised or favoured.

Q18. How appropriate are the proposed restrictions on exposures and operational dependencies between the ring-fenced bank and the rest of the group? Will these result in a sufficient degree of independence and resilience?

1.66 We understand that the proposed restrictions on exposures and operational dependencies between the ring-fenced bank and the rest of the group are to be designed to ensure that the ring-fenced bank can continue to operate despite the failure of other banks within the Group. These are the principles on which HSBC is developing its approach to the resolution of the Group and we believe that these will provide a sufficient degree of independence and resilience.

1.67 It will, however, be important that the UK authorities are not super-equivalent in requiring additional separation of exposures and services for ring-fenced banks beyond internationally agreed standards. This would set a precedent for national ring-fencing of finances and operations and prejudice the ability of UK-based banks to operate internationally on a competitive basis and so gain the benefits of economies of scale and best practice in global operations. We believe the continuity of services can be adequately protected in other ways.

Q19. Will it be possible to effectively monitor and police the ring-fence, given the degree of regulatory discretion the draft Bill proposes?

1.68 The monitoring of the ring-fence by supervisors should be aligned to the continuing analysis of resolution plans in the UK which require an annual update of the status of each of the Critical Economic Functions within the UK bank. These processes are still under development but, on this basis, we anticipate that the ring-fence can be effectively monitored.

1.69 In terms of the level of regulatory discretion, it will be important that the supervisors are clear in how their discretion is being exercised both across the industry and as applied to individual firms, and sufficiently far in advance of the implementation date so that firms are able to move efficiently to comply.

Q20. How effective will the provisions on corporate governance for ring-fenced banks be in promoting a wider improvement of standards? Should other measures also be considered?

1.70 We do not believe that the provisions on corporate governance for ring-fenced banks will promote improved standards within the HSBC Group as, in the main, these are standards to which we already operate. The sharper focus on directors' responsibilities will however reinforce the standards expected of directors. We do not believe that other measures are required.

DEPOSITOR PREFERENCE

Q21. Is the proposal to prefer insured deposits in the event of a bank insolvency justified? Is there a case for broadening the scope of deposits which benefit from this protection?

1.71 There is a strong case for insured depositor preference in the event of bank insolvency; however this would create a subordination of other creditors beyond that which exists today and care would need to be taken to understand the impact of this on funding markets. Depositor preference is also inconsistent with the scope for deposit guarantee scheme bail-in included in the European Commission's proposed Recovery and Resolution Directive and we believe there should be consistency around a single position.

1.72 There is also a case in terms of public policy to broaden the scope of deposits covered. We would not advocate extending this beyond personal deposits but it seems iniquitous to (a) punish, for example less sophisticated savers who do not open multiple accounts, all within the protection limits or (b) catch transitory monies from, for example, a house sale, a pension lump sum, insurance recoveries or life policy receipts that default into a bank account. Such monies should be protected as a matter of public policy in our view.

1.73 We will write separately on this subject as it is complex and we are still finalising our position.

CAPITAL LEVELS

Q22. Does the draft Bill adequately implement the ICB's recommendations on loss absorbency requirements?

1.74 As discussed in our response to Q3 above, HM Government's proposals for loss-absorbency differ from the final recommendations in a number of respects and we believe that those variations are justified.

Q23. The draft Bill gives the Government power to direct the way in which the regulators can implement loss-absorbency requirements. How appropriate and well-designed is this power?

1.75 The power is sufficiently broad to allow considerable scope and flexibility for HM Treasury to meet its overriding objectives of protecting core activities and its continuity objective.

1.76 The approach to applying the loss-absorbency requirements has important ramifications for HM Government as identified in the White Paper in June 2012. In relation to the application of PLAC across an entire Group it stated:

"if the UK authorities were to impose such requirements, it may risk creating a perception that the UK holds or retains responsibility for providing bail-out financial support for such overseas operations." [para 3.26]

1.77 Given these potential implications, it is justifiable that HM Government remains able to direct the overall policy framework for loss absorbency requirements. It is also important that there is full transparency as to how this power is exercised and there should be clarity around how changes in approach might be flagged and consulted upon.

Q24. Is the Government's stated intention for the design of loss-absorbency requirements workable? Will it provide a sufficiently well-capitalised banking system? In particular, how justified is the intention to allow an exemption for assets held in overseas operations?

1.78 Increasing the loss-absorbency of the UK banking system will be achieved through the proposals set out by HM Government but this is being done simply by shifting the burden of loss absorption to society, *ex ante*, through the savings and pensions market rather than *ex post* through taxation. The key success of the regulatory reforms will be in avoiding future systemically significant losses or mitigating the impact of tail risk

events rather than allocating such losses in a different way; society still bears the burden of whatever losses occur. The role of debt providers will change under the bail-in regime: their responsibilities to monitor those to whom they have provided long term funding will increase, fiduciary risk and accountabilities will have to be revisited and consideration given to whether the incentive structures within the fixed income investor community are aligned with the objectives of the draft Bill.

1.79 In summary, we believe there will as a consequence of all of this be additional costs and some contraction in the aggregate supply of credit. This flows through to higher costs for customers whose financing is intermediated by the formal banking sector, particularly SMEs who have less opportunity to seek alternative forms of finance. We therefore expect there to be a modest contraction in funding provided through the banking sector as the level of credit supply adjusts to available funding. One way of mitigating the burden of bail-in on debt providers would be to consider the option of bail-in of the deposit guarantee scheme (as an alternative to depositor preference) for expanding the overall loss-absorbency of the banking sector by spreading the burden more widely.

1.80 In respect of the proposed exemption for overseas operations we support the qualified exemption for assets held in overseas operations; see the response to Question 3 above.

Q25. Is the Government justified in its decision not to implement the ICB recommendation for a higher leverage ratio than is required by Basel III?

1.81 Yes—see the response to Question 3 above.

RESOLVABILITY

Q26. Will the UK authorities have the necessary tools and powers (as a result of this legislation and other initiatives) to be able to resolve a large failing ring-fenced or non-ring fenced bank, while maintaining financial stability and minimising the risk to public funds?

1.82 Since the introduction of the Special Resolution Regime, the UK authorities have had the ability to resolve a large failing firm through options such as the creation of a bridge bank or the bail-in of creditors. These powers are constantly being refined and added to as international debate in this area advances and it is likely that the UK powers will also be amended in the coming years, but the essential elements within the UK are already in place. Progress on handling cross border resolution is less well advanced although the principles have been set out. In summary, the tools are in place to handle a domestic failing bank but not yet in place globally for the failure of a large internationally active bank.

1.83 For the avoidance of doubt, however, we should be clear that in the event that a large bank fails, this will not occur without significant pressure on financial stability. As it restructures, the affected bank would undoubtedly reduce its provision of credit to the UK economy and the overall lack of confidence may well affect other firms' appetite for lending at pre-crisis levels. Funders and investors will pause to scrutinise the cause of failure, reducing appetite to the sector while the market assesses whether the failure is idiosyncratic or systemic. Other banks may well be forced or choose to take risk off and raise liquidity levels because of demands from both equity and debt investors who will be keen to see that (a) there has been no contagion between the failed bank and the rest of the industry and (b) that other banks are not operating on a similar business model and risk appetite to the failed firm. We have seen a number of examples where a series of smaller banks have all failed in succession, despite being separate institutions, for these very reasons. In essence the sector is substantially correlated in terms of risk profile, so until it is established that the failing bank has a particular problem not shared by others, the whole sector will be under intense scrutiny. This can be seen in recent months where the JPMorgan "London whale" incident hardly caused a ripple as it was seen to be institution specific, whereas the Spanish property weakness within the cajas cast a shadow across the whole sector.

1.84 Furthermore, since it is likely that markets will be unwilling to provide wholesale funding to restructured banks until confidence and transparency are restored fully, we anticipate that the UK authorities will need to provide significant amounts of special liquidity to the UK banking system; taxpayer monies should however not be at risk from this given the bail-in recapitalisation of the banks and the use of collateral for such facilities.

Q27. What is your assessment of the Government's preferred design of "bail-in" powers needed to improve bank resolution? How likely is it that the Recovery and Resolution Directive will deliver effective bail-in powers?

1.85 See the response to Question 3 above.

1.86 The Recovery and Resolution Directive ("RRD") is still subject to amendments from both the European Parliament and the European Council (representing the Member States). As a result, we have yet to see the final terms but the RRD as drafted has been described as consistent with the Key Attributes of an Effective Resolution as set out by the Financial Stability Board. Provided that these Key Attributes are retained, we believe firmly that the directive will deliver effective bail-in powers for application across the European Union.

IMPACT ASSESSMENT

Q28. *Is the impact assessment of the costs and benefits credible and balanced?*

1.87 The Impact Assessment accompanying the draft Bill is the development of a series of impact assessments undertaken in the UK and overseas to support banking reform which have become progressively more stylised in terms of presenting the case to support banking reform. It is difficult to comment in reality as the base case is set against the unacceptable cost of a future crisis so almost any cost can be justified. What is not attempted is to distinguish the benefits delivered by this draft Bill which are incremental to all those delivered from the EU/Basel/FSB reforms and from the regulatory regime change underway in the UK. What is clear is that all the benefits do not accrue from the UK's distinctive ring-fencing approach. We also offer below some more detailed comments.

1.88 *Costs:* The impact assessment attached to the draft Bill notes that there is a potential capital requirement from pension funds when universal banks are split and the joint and several liability which is currently available is no longer applied. This cost is ignored in the cost benefit calculation but we have not seen developments from HM Government which give us confidence that this can be resolved without either (a) a considerable capital injection or (b) a material compromise in the effectiveness of the ring-fence. The current proposal would entail delaying revoking the joint and several liability until 2025. We do not believe that this will be effective in reducing the effects as any schedule of payments agreed with the Trustees will be an immediate capital deduction from capital under current FSA and proposed EU rules. Additionally, the full protection of the ring-fence is not achieved until this joint and several liability is removed and this is not recognised in the analysis.

1.89 HM Government also assumes that the additional capital requirements necessary to enable banks to comply with the ring-fencing regime will be available through a range of options. Given the lower returns which the market is discounting in UK retail and wholesale banking and the opportunities for investors to invest in other jurisdictions and sectors, we do not believe that this assumption is valid.

1.90 *Benefits:* HM Government has set out a case which justifies the private and public costs of ring-fencing because it will materially reduce the probability of a future financial crisis and the impact of that crisis if it should occur. However, it is not clear how ring-fencing achieves this:

- (a) *Reducing the Probability of a Crisis:* This would seem to be driven by two assertions independent of structural reform (a) the higher loss absorbency which has been required would delay the point at which resolution would be required and therefore give time to implement recovery options, and (b) changes in incentives to take risks driven by the introduction of private sector bail-in and the changes to remuneration structure will deliver better governance and behaviour (see Question 1 above).
- (b) *Reducing the Impact of a Crisis:* The major GDP effects from a financial crisis arise from the withdrawal of credit as banks restructure their operations and adjust to new funding and capital constraints. There is no reason to believe that these adjustments would not be as severe within two banks as within a single universal bank—indeed, they may be more severe because of difficulties in attracting replacement funding and capital to firms with more narrowly defined business models.

1.91 In summary any cost-benefit analysis is subjective, particularly when set against the cost of an unacceptable systemic event, but it would be helpful if there was a better argued case for the incremental benefits of ring-fencing (as opposed to taking account also of all the other regulatory developments) so that incurring the clear and certain costs can be justified, based on a greater probability that true benefits will be achieved.

Q29. *Might there be any other unintended consequences which have not been considered?*

1.92 Undoubtedly; we anticipate that there will be a myriad of unforeseen developments and consequences as all the stakeholders in the banking system (banks, customers, equity and debt investors) get to grips with the very profound changes which are being proposed. One clear risk is the complexity in explaining the changes to customers and their reaction.

INTERNATIONAL ISSUES

Q30. *What will be the impact of the proposals on the international competitiveness of UK banks?*

1.93 Concerns around international competitiveness relate primarily to the non-ring fenced banks or “wholesale banks” which will result from ring-fencing. In providing services to the international corporates operating both in the UK and other jurisdictions, these banks will continue to compete with other wholesale banks aiming to serve the same customer base, most of whom will not be subject to the UK's ring-fence requirements. This will include many international banks operating in The City of London, only some of whom may be affected by similar proposals to those proposed by HM Government (see response on the Liikanen Report below). However, many other banks will not be subject to these restrictions, particularly banks from the United States (which will instead be subject to the Volcker Rule) and from emerging markets such as China, India and Brazil.

1.94 UK wholesale banks will operate with a number of disadvantages compared to their foreign rivals. The first will be capital requirements which we anticipate that UK wholesale banks will be required to hold in order to be able to continue in operation. Without the broad base of funding which is available to a universal bank, wholesale banks will need to obtain all of their funding from wholesale markets. This will need a proper blend of short, medium and long term funding in order to satisfy the requirements of the net stable funding ratio which is incorporated in the Basel 3 Accord. This will create two main disadvantages: (a) we anticipate that any wholesale bank will need to hold higher capital ratios, and (b) UK wholesale banks will lose the benefit of the lower cost of funding which comes from the universal banking model and a much broader mix of funding. Of course, the benefit if investors see a lower risk profile arising from the ring fencing arrangements may offset the higher capital requirements. Indeed it will be interesting to observe market reaction to the distinctive business and structural models that will emerge post regulatory reform. Capital will flow to the preferred model.

Q31. Are the proposals consistent with existing and forthcoming international and EU regulatory initiatives, for example the recent Liikanen Report? To what extent are they likely to be superseded or generate conflicts?

1.95 The proposals set out in the recent Liikanen report would appear to have many of the same characteristics as the ICB's recommendations although they approach the issue of ring-fencing or separation from two different angles:

- (a) the ICB proposes the ring-fencing of a small number of essential services which need to be protected; and
- (b) the Liikanen Group proposes that a small number of potentially higher risk activities should be separated from the rest of the bank.

1.96 In general, we believe that the UK should work towards having a single proposal, applicable as widely as possible where separation is considered. However, whilst these approaches are not incompatible, there are a number of areas of potential conflict:

- (a) Whilst the UK regime has been specifically targeted at UK banks and will not apply to entities incorporated outside of the UK, it is not clear whether the Liikanen proposals are intended to apply on an EEA basis or a fully consolidated basis as well as at EEA subsidiary level. It is not clear if this would imply extra-territorial application covering, for example, the non-EU incorporated subsidiaries of an EU-headquartered group. This would add further complexity to decisions around the optimal location for the headquarters of an international banking group.
- (b) The proposal for a clearly identified layer of bail-inable debt differs from the proposal from the European Commission for a wide bail-in regime (including the potential bail-in of deposit guarantee schemes).
- (c) Under the ICB proposals, a universal bank could be split into a narrowly defined ring-fenced bank incorporating just those customers and activities required within the ring-fence and a wider non-ring fenced bank with a correspondingly broader product and customer range. This may be preferred by some banks because of the scale and rating which would be applied to the larger non-ring fenced bank, but it is not clear that this flexibility would be available under the Liikanen proposals; the wider non-ring fenced bank available under UK proposals might still fall within the rules relating to the allowable proportion of trading assets, necessitating a further split or a redrawing of the boundaries for the scope of the ring-fenced bank.

1.97 We note, however, that the Liikanen proposals have not been officially adopted by the European Commission and/or the European Union and are subject to consultation. Furthermore, they are significantly less advanced than the UK proposals in terms of detail and further issues may emerge as that detail is filled in.

1.98 At least two other important sets of proposals will also emerge over the coming months:

- (a) Proposals from France for some form of separation within its local banks. HSBC has a locally incorporated subsidiary in France.
- (b) Revised proposals from the US for the implementation of structural separation under the Dodd-Frank Act (the Volcker and swaps push-out rules).

OTHER

Q32. What other matters should the Commission take into account?

1.99 We have no further matters to add at this time.

5 November 2012

Written evidence from Intellect

1.0 EXECUTIVE SUMMARY

1.1 In this response to the Parliamentary Commission on Banking Standards call for written evidence on the Banking Reform Bill, Intellect, the technology trade association for the UK, highlights an important consideration which should be considered alongside the existing provisions of the Bill—the underpinning infrastructure.

1.2 The operational reality is that many banks have overly complex infrastructures that are no longer “fit for purpose”, and as a result threaten to undermine the objectives of the draft Bill and any future regulatory or business change by;

- Preventing banks from knowing their own operations across their disparate businesses and accurately assessing what and where their losses are, whether they can be absorbed, and therefore what constitutes as excessive risk;
- Preventing regulators from assessing the true exposures of individual banks, the wider financial system, and therefore inhibiting their ability to make precise and timely market interventions to reduce the impact of failing banks;
- Causing business and regulatory change to take unnecessarily long periods of time to implement;
- Perpetuating a high cost of implementing regulatory change, fuelling banks’ resistance to reform;
- Increasing the operational risk of implementation large scale businesses change, such as the ring-fence set out in the draft Bill.

1.3 Intellect therefore proposes that the Bill should empower regulators to set a minimum infrastructure standard—to ensure that banks’ infrastructure is fit for purpose and are able to better support the proposed reforms, wider financial stability, and reduce the cost and risk associated with the implementation of all future regulatory reform. The Bill is an ideal vehicle to establish these standards as its provisions already imply significant structural changes for banks that will have to be implemented.

2. TAKING THE TECHNOLOGICAL REALITY INTO ACCOUNT

2.1 Intellect recognises the importance of a healthy financial sector as a catalyst for economic growth, and therefore welcomes the reform of the financial sector as a government priority. Reform of the UK’s financial sector is important in order to uphold financial stability, avoid a repeat of the events which led to the 2008 banking crisis, and enable better tools to deal with such events in their wake. It is an opportunity to ensure that the UK’s financial system returns to its original primary function of serving its customers and the economy, rather than providing short term dividends to investors.

2.2 It is important, however, that in doing this the technological reality of the financial system is taken into account at an early stage of policy development. It is the technological reality of the system which provides the foundations that the UK’s financial services industry is built upon. Failing to fully take this into account fails to account for the full context within which the financial system operates—rendering policy blind to the system’s full capabilities and weaknesses. This risks restricting the scope of policy considerations for financial reform, as well as poorly thought out implementation and operation strategies—with the danger of adding further complexity to an already complex myriad of systems (see paragraph 3.2 & 3.3).

2.3 Intellect therefore believes it is essential that the technological reality of the financial system receives appropriate consideration at primary stage of the legislative process.

3. THE TECHNOLOGICAL REALITY: A COMPLEX INFRASTRUCTURE, UNFIT FOR PURPOSE

3.1 It is an operational reality that the financial system is underpinned by overly complex infrastructure that is no longer “fit for purpose”. By “financial infrastructure” we refer to the “plumbing” that allows data—the lifeblood of the financial system—to flow within and between financial institutions. In reality, financial infrastructure refers to a complex myriad of systems, networks, applications servers, data bases, physical storage system, and end-user computing systems and devices.

3.2 As the independent analysts JWG Group reported in March 2012; “Decades of ad hoc technology investment, combined with merger and acquisition activity has left [many financial institutions] with disconnected silos of information and duplicative processes”. It is estimated that 90% of the technology budgets of North American and European financial institutions is spent on managing and maintaining legacy systems, leaving little more than 10% for innovation and programme development⁶⁹.

3.3 Today’s legacy systems and processes consist of multiple layers of technology platforms that, as banks and the technology available to them have evolved over the past 20 to 30 years, have been built on top of each other to facilitate changes and new requirements. These legacy systems are at the heart of established financial institutions’ operations, are business critical, interdependent upon other elements of a bank’s IT infrastructure and are often running 24 hours a day. Adding new elements or removing them from these systems is a complex and expensive process that will impact upon a multitude of different aspects of the banks’ systems. It is not

⁶⁹ P3. “FS infrastructure: ready for G20 Reform?”, JWG, March 2012.

unusual for integration testing to account for 50% of the cost of implementing new systems. Banks are therefore unable to clearly differentiate layers of operation and system functionality, rendering the introduction of additional change increasingly complex and costly to implement.

3.4 These complex, entwined systems often exist in support of business silos. This inhibits the ability of banks to have a holistic real time view of their own operations and financial exposures. In turn, it makes it impossible for regulators to build a macro view of the financial system as a whole that allows them to identify and mitigate systemic risks.

3.5 The legacy of underinvestment is an infrastructure that is inefficient, siloed, overly complex and an obstacle for cost effective business changes. These factors combined are at the heart of many of the failures we have seen in recent years in the financial system.

4. TIMESCALE

4.1 As outlined in paragraph 3.3, making changes to the operations of banks' legacy systems is a complex and expensive process that impacts upon the day-to-day operations of a bank. Any such change holds operational risk (see paragraph 6.2.2) and therefore can take a significant time to implement if no unintended disruption is to be caused. It is important that this is taken into account when mandating large scale operational changes—such as a retail banking ring-fence.

4.2 Intellect has noted that there are three proposed operational models for implementing a ring-fence, from the ICB Recommendations and government White Paper.

- (a) The ring-fenced bank accesses the operational infrastructure used by the rest of the group, but at an arm's length bases.
- (b) The ring-fenced bank and the rest of the group both independently access a detached subsidiary for their operational infrastructure (operational subsidiarisation)
- (c) The ring-fenced bank buy's and operates its own independent infrastructure.

4.3 Each of the three proposed operational models demands a different strategy and implementation timeline. However what connects them all is that, whichever option is chosen, banks will face a significant challenge to implement them as a result of their overly complex infrastructure. HM Treasury should understand that one of the largest obstacles to the implementation of effective and timely reform is this infrastructure

4.4 It is important that a decision is made on which operational model should be implemented as soon as possible, and the demands of this model are clearly and carefully communicated. To minimise operational risk, banks need to start planning their implementation strategy at the earliest possible opportunity. Delayed decision making will either result in missed deadlines or rushed implementation and increased operational risk.

5. SETTING MINIMUM INFRASTRUCTURE STANDARDS AS A FOUNDATION FOR REFORM

5.1 As set out in the draft Bill's policy document, the main objectives of the proposed reforms are to:

- (a) Make banks better able to absorb losses;
- (b) Make it easier and less costly to resolve banks that still get into trouble, and;
- (c) Curb incentives for excessive risk.

5.2 Intellect recognises the value of achieving these objectives in promoting a stable financial system, able to serve its customers and the economy. However, Intellect believes that one of the most significant reasons that many banks currently fail to meet objectives a) and b) is the result of their complex financial infrastructure which fails to allow banks to sufficiently "know their own businesses".

5.3 The complex and siloed nature of established banks' infrastructure (a result of years of mergers and acquisitions and "bolted-on" updates to "always on" business critical systems), prevents banks from achieving an accurate picture of the whole of their operations and exposures—limiting the ability of banks to make informed strategic decisions. Banks do not fully know their operations enough to recognise, with a great degree of certainty, what and where their losses are. As a result, they cannot accurately know whether they are able to absorb specific losses and therefore whether they are taking excessive risks.

5.4 The affect of entwined, complex financial infrastructure limits the efficient flow of data within and between institutions. This means regulators can currently have little confidence in their ability to receive data in suitable time frames and with any great confidence that it accurately reflects the exposures and positions of each financial firm, and therefore the financial system as a whole. This means that when banks do get into trouble, or are likely to do so, regulators struggle to assess the true exposures of individual financial institutions and therefore the financial system as a whole, and will be unable to make precise and timely market interventions to reduce the wider impact of a bank's failure.

5.5 Critical to ensuring that infrastructure at institutional level (and therefore also at a macro level) is fit for purpose and supportive of the draft Bill's three core objectives, is a commitment from individual institutions to address their underpinning infrastructure. Complex legacy systems inhibit the flow of data throughout the financial sector preventing banks from sufficiently "knowing their businesses" and regulators from successfully

monitoring and intervening to promote stability. As voluntary renewal has so far been resisted, there is a strong argument for the regulatory authorities to set minimum standards for banks' systems (as part of wider minimum standards for infrastructure)—to minimise unnecessary complexity, potential downtime and the risks posed by future updates to these systems. The work being undertaken by the Monetary Authority of Singapore in setting guidelines for technology risk management provides an example of how this could be undertaken.

5.6 By setting minimum standards for financial infrastructure, a sufficient foundation could be laid to support and promote the draft Bill's three core objectives.

6. REDUCING THE COST AND RISK OF IMPLEMENTING REFORM

6.1.0 *Cost of implementing reform*

6.1.1 Minimum infrastructure standards would also serve as a foundation for wider, ongoing reform of the financial system

6.1.2 Resistance from banks to complex business change often stems in part from the impact that such changes will have upon the bank's increasingly complex core systems; the resource that will have to be applied to achieve compliance; and the potential disruption that there will be to everyday banking activities.

6.1.3 If there is opportunity to reduce this cost in the future, there is a strong argument for banks to factor this into what are already significant change programmes to implement ongoing reforms. For instance, significant "unbundling" of systems will have to take place in order to implement a retail banking ring fence where both investment and retail banking operations must be, to all intents and purposes, structurally separate.

6.1.4 The proportion of the cost of implementing business change (be it regulatory or commercially driven), that is attributable to integrating new functionality into these existing systems is extremely high at approximately 70% (according to Intellect's members). By addressing the complexity of the systems that underpin a bank's operations now, the cost of (and level of resistance to) ongoing reform will be significantly reduced, freeing up additional budget to innovate, improve services and deliver greater value to customers and their businesses.

6.1.5 The Bill is an excellent opportunity to address the underlying problems facing the financial system—not just the symptoms. If the Bill is to succeed in fulfilling the three objectives above, there needs to be a focus on ensuring that this underpinning infrastructure ceases to be an obstacle to change, but instead becomes a foundation upon which the ongoing reform and evolution of the financial system can be based.

6.2.0 *Reducing operational risk*

6.2.1 The scale of change set out in the Bill poses significant operational risks to banks during the implementation phase.

6.2.2 Operational risk, generally defined as the risk of loss due to failures of people, processes, systems and external events, is a perpetual threat to banks as a result of the constant need to update systems and processes. As more updates are "bolted on" to systems, their complexity grows and with it, so does the risk associated with further future updates.

6.2.3 In a recent speech to the Exchequer Club in the U.S., Thomas J Curry, Comptroller of the Currency, (US Treasury Department) stated that "Operational risk is heightened when these systems and procedures are most complex. Given the complexity of today's banking markets and the sophistication of technology that underpins it, it is no surprise that the OCC [Office of the Comptroller of the Currency] deems operational risk to be high and increasing."⁷⁰

6.2.4 The cost attached to implementing changes to existing infrastructure—especially core legacy systems—stems from this risk to the continued provision of services that any mistakes or systems failures as a result of these updates pose.

6.2.5 The effects of systems failure have been no more visible to the public than in recent months with the issues surrounding RBS batch payments processing. While the exact causes of this are not yet publically known, the disruption of services to customers has been widespread and plain to see. Across all banks the more complex their systems become—as a result of "bolt-on" updates to existing infrastructure and systems—the greater the operational risk.

6.2.6 The draft Bill's flexible approach to expanding "core" and "excluded" activities, runs the risk of being treated by Banks as yet another "bolt-on" compliance solution, further adding to the complexity of the system and increasing operational risk. Setting a minimum standard for banks' underpinning technology infrastructure—and by doing so reducing its complexity—will not only support the draft Bill's three core objectives (see 4.0) but would also reduce the operational risk posed by implementation of the provisions of the draft bill and crucially, all future regulatory and commercially driven business change.

⁷⁰ Remarks by Thomas J. Curry Comptroller of the Currency Before the Exchequer Club; 16 May 2012.

7. CONCLUSION

7.1 Intellect believes that in reforming the financial system, policies should be evaluated against the operational realities of the financial system and against a long term objective of reducing the complexity of the system—in order to ensure the effectiveness of reforms and ensure future financial stability.

7.2 The current reform of the financial system provides a once-in-a-generation opportunity to tackle the underlying fallibilities that the financial crisis has exposed. Specifically this is an underlying problem of banks' overly complex infrastructure which is no longer “fit for purpose” and inhibits both the reform and the evolution of the system so that it can better serve customers and the wider economy. Intellect believes that setting minimum infrastructure standards for banks—as has been addressed by the Monetary Authority of Singapore—is necessary to support the Bill's objectives and the future stability of the financial system.

ABOUT INTELLECT

Intellect is the UK trade association for the IT, telecoms and electronics industries; industries that generate around 10% of UK GDP and 15% of UK trade. Our Members include blue-chip multinationals as well as early stage technology companies and play a crucial role in virtually every aspect of our lives. Intellect articulates a cohesive voice for these industries across all market sectors, and is a vital source of knowledge and expertise on all aspects of the technology industry.

Alongside the technology industry's considerable footprint in the UK, Intellect also enables many other industries to operate efficiently in today's economy including:

- financial services;
- creative industries;
- retail;
- transport and logistics;
- manufacturing;
- defence and aerospace;
- pharmaceuticals.

We are a trusted partner for Government, both in terms of policy development and policy implementation across numerous sectors. We look to ensure that all relevant engagement of policymakers and regulators with industry is both easy and as valuable as possible in order that the technology industry may play the fundamental role it merits in the success of UK plc.

Intellect's Financial Services Programme brings together over 180 suppliers of information systems, services and consultancy to the banking and insurance sectors.

Many of Intellect's members are heavily involved in providing the fundamentally important technology platforms upon which the UK's financial services industry is built. For example, these Members help facilitate the 5.7 billion automated payments that are made through the banking system on an annual basis. Similarly, the 40 million online bank accounts that are registered in the UK will not function without the technological capability that our members design and supply.

The relationship between the financial services industry and the technology sector is one of fundamental importance. As the Office for Fair Trading has recently stated, “IT systems are the backbone of retail banking activities and are essential to the safety and resilience of financial systems”. Technology not only plays a critical role in the functioning of the full spectrum of financial services, it is a hugely important factor in ensuring that the individual institutions within it can operate more responsibly and remain competitive in the global marketplace. The right technology can help depress costs, reduce risk and increase the confidence of lenders and investors, all of which are of paramount importance in the current economic environment. Applied inappropriately or to the wrong ends and it can contribute to systemic risk, lead to reduced inward investment and ultimately have a detrimental effect on the economy.

Consequently, if the UK's banking sector is to be reformed to meet the challenges posed in recent years and provide the backdrop to economic recovery, policy not only needs to reflect what technology can facilitate today, but what it will enable in the future. Reforms will only be effective and durable if they take into account how it will be implemented and how the application of technology can be complementary. For an industry like financial services that relies so heavily upon technology, it is essential that regulatory authorities are equipped with a full understanding of it.

For further information on the case for financial infrastructure renewal, please see the Intellect paper, “Biting the bullet—why now is the time to rebuild the foundations of the financial system”.

<http://www.intellectuk.org/publications/intellect-reports/8563>

5 November 2012

Written evidence from Legal & General

OVERALL SUMMARY:

We welcome the Government's efforts through The Financial Services (Banking Reform) Bill (hereafter referred to as "The Bill") to deliver greater stability in the UK retail banking sector and understand the rationale behind the proposals that have been put forward to implement the recommendations of the ICB.

We agree with the Government's aim of ensuring a vibrant and competitive financial services market for all participants, recognising the distinct nature and contribution that the bank and building society sectors bring to retail banking in the UK.

However, as currently framed, the overall package of proposals could have a significant impact beyond the central policy objective of strengthening the prudential soundness of retail deposit-takers and reducing any perceived implicit Government guarantee with associated costs to taxpayers.

We are concerned that The Bill is an Enabling Act, with the majority of the detailed policy coming later through Secondary Legislation, regulatory rules and/or guidance. This makes it difficult to assess the totality of the proposed measures at this stage. It is important that stakeholders should be given the opportunity to comment on the detailed implementation measures for these proposals. We believe Parliamentary scrutiny of all parts of these proposals, whether through further legislation or regulatory requirements must be a prerequisite. Confirmation from Government that a full process of consultation and scrutiny of all measures will occur would provide important comfort to market participants, including investors in banks.

Some aspects of the proposals could have a negative impact on growth, investment and choice. We strongly welcome the Government's decision to review its initial stance of prohibiting ring-fenced organisations transacting with insurance companies. However, the broad terms in which the proposals have been expressed suggest that they could significantly reduce the range of counterparties or asset types available to firms for financial management purposes. The resultant concentration of available counterparties could materially increase the risks and costs of funding for retail banks. We are concerned that the Government should take care to avoid placing unnecessary restrictions on activities where it is clear that they are unlikely to give rise to material systemic risks, are intrinsic to the mainstream activities of the ring-fenced entities themselves, and are important for the delivery of broader policy objectives including facilitating saving and prudent management of individual and household finances.

Banks and Building Societies provide millions consumers with essential access to a range of services and product solutions to their financial needs, including their saving, protection and investment needs. Insurers like L&G work in partnership with the proposed ring-fenced institutions to provide consumers with these services. The original Government White Paper was ambiguous as to whether they would continue to allow this. Given there is no material balance sheet exposure to ring-fenced institutions it is our assumption that our partnerships will not be impacted, but we require clarity. Failure to allow this important channel for customers to receive the products and services they need would have a detrimental impact on the UK economy and the ability of individuals to manage their finances, protecting their families and securing their financial futures.

We are disappointed that the Government is looking to provide itself the power to ask the FCA/PRA to levy financial services companies and their customers for UK membership of, or participation in, international organisations without explaining in detail what these costs will be.

RESPONSE TO SPECIFIC QUESTIONS

Q4. What should be the timetable for implementation of these measures, and should it be set out more clearly?

1. The Government has stated that the measures will come into force by 2019, with primary and secondary legislation completed by the end of this Parliament in May 2015. We would like to see a more detailed timetable published by the Government, including when they anticipate regulators being asked to create any specific rules or guidance. This is to allow financial services firms to effectively prepare for the proposed changes, and ensure sufficient time to review and comment on draft legislation/regulation to provide effective input to these proposals.

Q5. The draft Bill proposes continuity objectives on the PRA and FCA. Are these appropriate and compatible with their other objectives?

2. We agree with the Government's objective of trying to protect the provision of essential banking services. However, the PRA and FCA Continuity Objectives (sections 1EA and 2BA of The Bill), when combined with the very limited services and activities that ring-fenced institutions can undertake (in effect sections 142A-E of The Bill) is concerning. This is compounded by the fact the secondary legislation has yet to be tabled, making it difficult to establish the true impact that this Bill, or these specific regulatory objectives, will have.

3. As HM Treasury has stated "With a few very important exceptions, the majority of the detail of the policy will be set out in secondary legislation and regulatory rules. For example, the draft Bill introduces the concepts

of “core activities” and “excluded activities” but currently only provides for one instance of each type of activity (respectively accepting deposits and dealing in investments as principal).⁷¹

4. Without appropriate safeguards in this Bill, or knowing the content of the secondary legislation, there is a risk that these new objectives could create a regulatory environment where ring-fenced institutions have unintended restrictions placed upon them which could impact their ability to undertake activities that are beneficial to the UK. At the extreme, as currently drafted in this Bill, ring-fenced institutions could not provide, for example, mortgages, credit cards, retail savings and investments, protection products etc. Although we do not believe this is the Government’s intention, clarity on this is required given the legislative process being adopted.

5. Additionally, in terms of objectives, we believe that both the FCA and the PRA should be given the same requirement as the FPC to support the wider economic policy of the Government; ie to ensure that regulation delivers its remit within the framework of promoting, for example, jobs and growth.

Q9. The draft Bill grants a large number of delegated powers to the Government. Are the principles under which delegated powers are to be exercised sufficiently clear?

Q10. Does the scope of the delegated powers in the draft Bill represent an appropriate balance between flexibility for the Government to respond to changing conditions and accountability to Parliament and the public?

Q11. Is there sufficient clarity about the Government’s intended use of delegated powers, both to enable public understanding and to enable affected banks to prepare for the proposed changes?

Combined response to these three questions:

6. We have already set out much of our thinking in answer to question 5 and in our overall summary. Given the very significant changes being proposed, we are concerned that The Bill is an Enabling Act, with the majority of the detailed policy coming later through Secondary Legislation, regulatory rules and/or guidance. This makes it difficult to assess the totality of the proposed measures at this stage. This is compounded by Clause 12 (Transitional provisions and savings) appearing potentially to give Government the power to amend any enactment as a result of or included in this Bill.

7. There is also some ambiguity about the Government’s intended use of some of the powers as a result of them using enabling legislation with the detail in secondary legislation. As an example, the Government is using the Bill to provide HM Treasury with the power to direct the FCA/PRA to levy financial services companies and their customers for UK membership of, or participation in, international organisations. However, the Government has stated that “*The detail of the organisations which are relevant to this power, and the detail of what expenses can be recovered, will be set out in secondary legislation*”.⁷²

8. Given that the Government is asking for customers of financial services firms to bear these costs, we do not think it is appropriate for financial services firms and their customers to be asked to fund public policy without full explanation of the anticipated costs. In the interest of transparency, the Government should publish its estimates to help all stakeholders, including Parliament, understand the full implications of these provisions.

Q11. The draft Bill provides for review of the ring-fencing rules by the PRA every five years. Does the proposed review mechanism provide sufficient accountability?

9. We agree that it is important for there to be a regular review of these proposals. However we note that negative unintended consequences of poor primary or secondary legislation in terms of reduced investment in ring-fenced banks or reduced provision of financial products for individual savers, would be felt quickly, and could be difficult or impossible to correct after five years. We would reiterate therefore the importance of proper accountability, consultation and detailed scrutiny ahead of the process being implemented. Specifically on the five-yearly review, and given the broad nature of the proposed amendments, which also create requirements on the FCA and the Bank of England, we think that the Government should lead the review of the impact of ring-fencing rules with input from the regulatory bodies. We also suggest this report should also have to be laid before Parliament, including the Treasury Select Committee, to ensure effective scrutiny of the new laws.

Q14. Is the range of core and excluded activities defined in the draft Bill appropriate and sufficiently broad? Are the Government’s stated intentions for using powers to define further core and excluded activities appropriate?

10. Only those activities which impact on the Government’s central aim of making deposit-takers more resilient to financial shocks should be considered when determining whether or not an activity should be prohibited. We are concerned that the proposals could unnecessarily prohibit or restrict the following:

— The ability of ring-fenced institutions to sell and/or distribute retail investment and savings products.

⁷¹ HM Treasury, *Sound Banking: delivering reform*, October 2012; paragraph 2.5, page 6.

⁷² HM Treasury, *Sound Banking: delivering reform*, October 2012; paragraph 2.62, page 16.

- The ability for Insurers and ring-fenced institutions to work in partnership to provide important retail products to consumers.
- Consumers’ access to advice, especially in the post- Retail Distribution Review (RDR) marketplace.
- The delivery of the Government’s Simple Financial Products initiative.

11. As we have already outlined in previous answers, our primary concern stems from the lack of reassurance provided by this Bill at present, owing to much of the detail being expected only to become known through secondary legislation.

12. As background, the manufacturing and distribution partnerships that we enter into with ring-fenced institutions will have no material adverse impact on their resolvability. These partnerships may involve one or more of: the co-manufacture of retail products; the provision of advisers employed by us to provide advice and guidance to the bank or building societies’ customers; or the distribution of our products through their own customer-facing staff. These arrangements allow banks and building society partners to leverage our expertise in the savings, investment and protection markets to provide a strong proposition to retail customers. Indeed, it can reduce consumers risk exposure through diversification.

13. If it were the Government’s intention to prohibit such activity (which we assume cannot be the case) it would have a substantial impact on the profitability and invisibility of the institutions Government are seeking to reform; it would remove employment from the economy and by reducing consumers’ access to financial products would make them more vulnerable to the variety of financial shocks and challenges that they will face during their lives.

14. The bancassurance model is a key route to market for millions of customers across the UK to access financial services products and advice to meet their savings and protection needs. Last year, 23% of our customers came to us via the 20 partnerships we have with banks and building societies. Across the market, almost one in 10 UK customers used this channel to meet their financial needs. We believe this route will become increasingly important following implementation of the Retail Distribution Review (RDR) next year which will reform the advice market.

15. Furthermore, as the Sergeant Review of Simple Financial Products (to which we provided support) has highlighted, bancassurers are viewed as potentially key distributors of simple financial products, as they represent a key “shop-window” for consumers—particularly first-time consumers—seeking access to products or advice on their core financial needs. Should the Government create any prohibition in the area of protection and saving, we believe the success and coherence of the Government’s strategy in this area could be significantly undermined.

16. We understand the Government’s desire to take a more precautionary approach in identifying the activities that ring-fenced institutions should be allowed to engage in; but given there is no downside risk involved in many of those that would be captured in the restrictions initially proposed, we strongly believe this Bill needs to consider these issue again in more detail in order to give a clearer, more risk-focused indication of the intent of the legislation.

Q16. The Government is considering whether to allow ring-fenced banks to offer simple derivatives to their customers. Should they be allowed to? If so, what safeguards would be necessary?

17. Our response to Q14 is also pertinent to this question. We are pleased that the Government has developed its thinking since it published its White Paper. We had been very concerned the Government may have been concerned about retail structured deposits. Given the change in language adopted by the Government in its “Sound banking: delivering reform” paper, it would appear they have accurately recognised that structured deposits have the same risk profile as any other form of fixed term deposit account offered by a retail deposit taker.

18. However, we remain concerned that the Government has not sufficiently articulated what it means when it asks in “Sound banking: delivering reform”, “whether ring-fence banks should be able to offer simple derivatives to their customers”. As a result it is difficult to assess the impact of their intentions. Until we are able to understand this, it is also difficult to set out what safeguards would be necessary.

19. We would be extremely concerned if the Government wanted to prohibit ring-fenced institutions from offering products which used derivatives for efficient portfolio management and the financial management of risks. To do so would preclude consumers from accessing a substantial range of important products. For example, a fixed rate mortgage, a fixed rate deposit account, a stakeholder pension, multiple types of investment based product. As it would run directly counter to policy objectives as we understand them, we are assuming that it is not the Government’s intention to prohibit such products.

20. We therefore suggest that further detailed work is undertaken to understand the precise concerns the Government has and to provide detailed input to inform what might or might not be included within this definition as part of any detailed secondary legislation. Given the Government’s intended legislative approach this would not in anyway undermine this Bill, and would in fact add to the credibility of the overall approach by removing ambiguity.

Q21. *Is the proposal to prefer insured deposits in the event of a bank insolvency justified? Is there a case for broadening the scope of deposits which benefit from this protection?*

21. We agree with the Government's view not to extend depositor preference beyond insured deposits to other categories such as non-EEA deposits, bank pension funds, local authorities or charities. We think it is important to provide reassurance to customers that their deposits are protected up to the FSCS limit. However we agree with the Government that the case has not been adequately made for widening the scope further. This is especially so given that the more senior unsecured creditors that are created alongside FSCS deposits, the less attractive the ring-fenced bank becomes to other investors (creditors).

Q31. *Are the proposals consistent with existing and forthcoming international and EU regulatory initiatives, for example the recent Liikanen Report? To what extent are they likely to be superseded or generate conflicts?*

22. We recognise that the Government is likely to be much better placed to understand and influence the potential changes to the EU banking sector and we therefore welcome the update they provided alongside this Bill. However, it is clear that the EU legislative process often means that the initial proposals are modified, sometimes substantially, prior to being enacted. As a result, we think it is almost unavoidable for there to be overlap, under-lap and conflicts between the UK and EU initiatives in this area.

23. We believe that the UK Government will need to remain fully engaged with the EU banking developments, and should proactively look to ensure that it mitigates the cost and risks associated with any potential conflict given the substantial costs associated with both the UK and EU proposals.

ADDITIONAL POINTS NOT COVERED IN THE ABOVE QUESTIONS

Prohibited Institutions

24. We set out in our overall summary that we strongly welcome the Government's decision to review its initial stance of prohibiting ring-fenced organisations transacting with insurance companies. However, we are concerned that even though the Government has not reached a view on this, it is continuing with this legislation that could enable them to enforce such a prohibition, only proposing to act at the secondary legislation stage.

25. Focusing specifically on insurance companies, it is worth noting that during the credit crisis, no UK listed insurer required government assistance or failed to meet obligations to policyholders. Indeed they were liquidity providers to the market and hence contributed to stability.

26. Even the largest insurance companies, so long as they are conducting insurance business, are moreover not "systemic" in the same way as banks. Insurance companies, when they fail, do so via a period of more protracted run-off as products are more illiquid and policyholders cannot therefore participate in a "run on the company" of the sort seen for example at Northern Rock. The exception is where insurance companies conduct non-insurance business (eg AIG). Shadow banking, or certain types of riskier non-insurance business conducted by insurers could in our view be justifiably prohibited.

27. It should moreover be noted that a well-established prudential regime, administered by the FSA, already exists for insurance companies, and is likely to be strengthened further by Solvency II. These arrangements, which have worked well, are designed specifically to protect retail customers. It would seem odd that the White Paper effectively proposes that, while consumers' exposures to insurance companies are adequately covered by these rules, insurers are effectively deemed too risky for the ring-fenced banks.

28. More broadly, we had originally proposed to the Government an alternative, more risk based approach. The June 2012 White Paper had originally said: "The Government proposes that the type of institution that ring-fenced banks should be restricted in their dealings with should include:

- non-ring-fenced banks, or banks that engage in otherwise prohibited activities;
- investment firms;
- funds and fund management companies; and
- insurance companies."

29. We believe this approach is inconsistent with the White Paper's description (paragraph 2.32) of the characteristics of "risky" institutions. A much more appropriate approach would be to focus on the types of transaction conducted between ring fenced banks and other financial institutions—and particularly the exposures these create for the ring fenced entities—rather than the descriptions of the institutions concerned.

30. We are also concerned that the definitions of funds should not inadvertently capture entities such as pension funds, which could generally be characterised as low-risk institutions (and are limited by the nature of their own regulation as to how and why they can make investments and incur economic/market exposures) and, in the case of DB schemes at least, need to be able to access a range of counterparties in order to transact derivatives for legitimate, risk-hedging activities relating to their long-term (liability-driven) investment strategies. Furthermore, any application of a prohibition or restriction to "fund management companies" should take account of the nature of investment management activity in the UK whereby investment managers are usually acting as agent for underlying investors. Under any approach which does choose to focus on the

institution with whom the ring-fenced bank transacts, it should be ensured that the principal underlying client, and not the manager firm is assessed.

31. A more appropriate approach would therefore be to permit or prevent types of transaction between ring-fenced and other financial institutions based on the degree of risk involved to the ring fenced bank, rather than imposing a blanket rule based on type of institution. Under this approach, only those transactions or relationships creating a genuine risk exposure for the ring-fenced bank would be forbidden. Where no such exposure is created, no restrictions should apply.

32. There is more scope to tackle this issue via quantitative limits, which vary according to the level of balance sheet exposure for the ring fenced bank, the credit rating of the counterparty and the transaction type. Where no exposure is created (eg distribution arrangements via ring fenced banks) there should be no restriction.

2 November 2012

Written evidence from Standard Chartered Bank

The responses below set out Standard Chartered's response to the call for evidence on the pre-legislative scrutiny of the Banking Reform Bill. Since it is unlikely we will need to create an ICB ring-fence we have focused our responses on the Primary Loss Absorbency Capacity ("PLAC") questions but have provided some comments on ring-fencing to the extent we think this would be helpful.

2. Do any of the recommendations of the Independent Commission on Banking (ICB), which the draft Bill seeks to implement, need revision as a consequence of developments since the ICB's report?

There is considerable uncertainty about how the Liikanen recommendations will be implemented. The scope of the ring-fence and the extra-territorial application are key issues on which there is currently a lack of clarity. Until these issues are clear it will be difficult to understand the interplay with the ICB regime, therefore, although we appreciate the need to make steady progress on the ICB legislation, the interaction with Liikanen will be key.

4. What should be the timetable for implementation of these measures, and should it be set out more clearly?

The timelines for implementing ICB and any of the recommendations from Liikanen need to be aligned because they will represent such significant structural change that bank funding models will need time to adjust to avoid a negative economic impact. It will also be important to understand the linkages and possible conflicts between the two regimes and how they will interact with Capital Requirements Directive IV ("CRD IV") and Capital Requirements Regulation ("CRR") plus the Recovery and Resolution Directive ("RRD").

DELEGATED POWERS AND ACCOUNTABILITY

10. Does the scope of the delegated powers in the draft Bill represent an appropriate balance between flexibility for the Government to respond to changing conditions and accountability to Parliament and the public?

Yes. Given the uncertainty of the current EU legislative landscape it is necessary for the UK authorities to have a degree of flexibility so legislation can be implemented in a coherent way. The publication of Liikanen adds considerable uncertainty about how the ICB and Liikanen regimes will interact. This will also be partly driven by interactions with other EU legislation already in train including the RRD, CRD IV and CRR.

11. Is there sufficient clarity about the Government's intended use of delegated powers, both to enable public understanding and to enable affected banks to prepare for the proposed changes?

This will partly depend on the implementation timetable for Liikanen and what the final conclusions are from the European Commission. We appreciate the need for quick implementation but this has to be done in such a way to ensure the smooth creation of the new regimes.

12. The draft Bill provides for review of the ring-fencing rules by the PRA every five years. Does the proposed review mechanism provide sufficient accountability?

Yes. The focus of the review should be on the impact of the ring-fence on the financing needs of businesses and consumers. Given the possibility of EU legislation with the implementation of the Liikanen recommendations, it will also be helpful to ensure similar provisions are included with EU legislation and the UK effectively feeds into any EU process.

THE RING-FENCE

13. *Is the power to be able to exempt certain categories of deposit-taking firms from having to establish a ring-fenced bank appropriate, and on what basis should the conditions for exemption be set?*

Yes. The *de minimis* approach provides for a proportionate regime based on the impact that the failure of an institution may have on financial stability. Setting the *de minimis* requirement at a lower level may act as a barrier to entry given the increased costs of creating a retail ring-fence. This is a crucial example of striking the right balance between financial stability and creating an effective competitive landscape.

15. *Which categories, if any, of customer should be permitted to deposit with a non ring-fenced bank?*

Using a *de minimis* approach will help to ensure the ring-fence regime is proportionate and that it does not prevent market entry which is key for ensuring a competitive landscape. We also agree with HMT that there should be an exemption for high net worth individuals because their needs will be different to those of high street customers.

16. *The Government is considering whether to allow ring-fenced banks to offer simple derivatives to their customers. Should they be allowed to? If so, what safeguards would be necessary?*

Standard Chartered is unlikely to be required to create a retail ring-fence because of the small amount of mandated deposits we hold. However, we believe that there are benefits for small and medium businesses being able to access risk management products from within the ring-fence. These are essential services that are particularly important for medium-sized corporates seeking to enter export markets. We appreciate the concerns that have been raised by the misselling of Interest Rate Swaps but conduct and financial stability issues need to be considered separately. Regardless of whether derivatives are in or out of the ring-fence there will be the need for an effective conduct regime to be developed for the sale of these products. However, if SMEs are unable to access derivatives their ability to effectively manage their foreign currency and interest rate risk will be limited.

18. *How appropriate are the proposed restrictions on exposures and operational dependencies between the ring-fenced bank and the rest of the group? Will these result in a sufficient degree of independence and resilience?*

ICB (and possibly Liikanen) will lead to fundamental shifts in the way in which banks fund themselves and the relationship between different parts of the bank. They will pose significant challenges and could inadvertently lead to a greater reliance on wholesale funding, which seems a perverse outcome. The requirements for a third party relationship between the ring-fenced and non-ring-fenced bank is likely to increase the costs of funding for banks and will ultimately be borne by clients and customers. We also think policymakers need to consider why adopting a third party approach is appropriate given that a bank will have a much greater understanding of the risks inherent in activities it has generated, as opposed to third party banks. These arrangements are likely to make it more difficult for banks to comply with the liquidity requirements set out in Basel III or indeed the Financial Service Authority's current liquidity regime. As with our view on structural reform generally, we have concerns that these extra intra-group requirements will actually make banking groups more brittle and unable to deal with relatively minor funding problems. We believe that such issues would be better dealt with through effective Recovery and Resolution Plans ("RRPs") and challenging oversight by supervisors.

DEPOSITOR PREFERENCE

21. *Is the proposal to prefer insured deposits in the event of a bank insolvency justified? Is there a case for broadening the scope of deposits which benefit from this protection?*

No. The effect of the policy really is only to push the Financial Services Compensation Scheme ("FSCS") further up the insolvency hierarchy. There will be no difference for depositors that hold deposits with a failed bank. Therefore, all of those with deposits up to £85,000 and eligible for protection under the FSCS, will continue to have their deposits protected. We do not believe there is a compelling case for increasing the scope of depositor preference and note that any further increase could increase the costs of funding, which would in turn increase the costs of borrowing. It will also make a bank's deposit base increasingly fragile as customers will no longer make a conscious decision about the quality of a bank with which they place their money. Since we only have limited protected deposits in the UK, the policy does not have a material impact on our funding costs.

CAPITAL LEVELS

22. *Does the draft Bill adequately implement the ICB's recommendations on loss absorbency requirements?*

Yes. The draft Bill is consistent with the recommendations of the ICB on loss absorbency. The Bill is relatively clear on the qualifying instruments that would be made loss absorbing, although the key issue here will be the shape of the regime that is developed with the implementation of the RRD and the decisions on

the implementation of the Liikanen recommendations. Much will also depend on the methodology used in setting PLAC.

23. The draft Bill gives the Government power to direct the way in which the regulators can implement loss-absorbency requirements. How appropriate and well-designed is this power?

We support the creation of RRP and the use of bail-in, however both need to be developed in a manner that ensures the most effective and proportionate resolution of failed banks. We would stress that regulators should have discretion to set the level of PLAC and its composition from the perspective of the risk profile of the individual entity rather than against a uniform, one-size-fits-all, approach. The quality and effectiveness of an individual institution's RRP should influence the level and composition of loss absorbency.

24. Is the Government's stated intention for the design of loss-absorbency requirements workable?

Yes, but it depends significantly on developments outside the UK. There are substantial mechanical issues to work through as the concept of bail-in regime is a material shift from the established creditor hierarchies applied to the non-financial sector with which markets have grown accustomed. It will take investors some time to understand these differences and a sustained period of education will be needed. Some institutional investors will be precluded from investing in senior debt made eligible for bail-in as their constitutions preclude them from either holding equities completely, or only up to a relatively low cap because of investment mandates. This might expose pension funds to reinvestment risk indirectly. Policymakers should consider a statutory approach for handling these issues.

Markets will need to adjust their pricing parameters to accommodate the bail-in regime and this will rightly increase cost differentials between different banks based on the risks they take. Policy is developing quickly on bail-in and it is not clear all the factors have yet been thought through but it will be essential to consider these as the market changes. For example, there will be some complex pricing movements between equity and senior debt as a bank travels closer to the point of non-viability. There may even be some unintended arbitrage opportunities that would attract investors whose interests are not aligned with the wider interests of financial stability.

We strongly urge the government to adopt a statutory regime for the application of bail-in covering all existing senior unsecured debt in issue irrespective of residual maturity. We believe this provides a good foundation for a global regime. The regime developed with the RRD also needs to reflect these options. This is important for a number of reasons:

- Maintaining consistency with the likely evolution of bank capital under CRD IV and Capital Requirements Regulation.
- Carving out senior debt with less than one year to maturity creates an unnecessary distortion to the market. Perversely it will encourage the issuance of short-term debt at the expense of more stable long-term funding which is precisely opposite to the thrust of much of Basel III.
- A statutory regime that embraces all debt in issue avoids the “first issue peril” where the initial issue would carry the entire loss absorbency and would also infer that the rest of the senior debt could not effectively absorb losses. This would create major market disruption given the sporadic access some banks have recently had to unsecured new issuance funding and the dependence that has emerged on official programmes such as the LTRO.

In designing a bail-in and recovery regime it is also clear that short-term liquidity support may be required to ensure effective resolution. This should not come at the expense of the Exchequer. There could be some advantages to the Bank of England giving consideration to a new, broader definition of eligible collateral to be used specifically in the context of liquidity support for resolution planning strategies based around bail-in. This issue has to be given greater consideration but we believe it will be necessary as part of a more holistic approach to resolution.

—In particular, how justified is the intention to allow an exemption for assets held in overseas operations?

The original intent of ICB appeared to be the protection of the UK economy from material disruption caused by the failure of a systemically important entity. Applying that intent *does* justify the carve out in respect of the calculation of PLAC and therefore we agree with the position set out by HM Treasury in the White Paper. However, there are instances where the application of the exemption renders the orderly wind-down of an international bank's operations in resolution potentially unworkable. For instance where the exemption has an impact on the UK's reputation or the ability of the home regulator/resolution authority to discharge its obligations to provide a coordinated resolution of a troubled bank. Our view is that the exemption should be available for application by the resolution authority on a discretionary basis where these issues are addressed.

25. Is the Government justified in its decision not to implement the ICB recommendation for a higher leverage ratio than is required by Basel III?

Yes, we support the idea of a back stop leverage ratio but agree with the approach adopted by HMT. We do not believe that being super-equivalent on this point would be appropriate.

RESOLVABILITY

26. *Will the UK authorities have the necessary tools and powers (as a result of this legislation and other initiatives) to be able to resolve a large failing ring-fenced or non-ring-fenced bank, while maintaining financial stability and minimising the risk to public funds?*

Yes, the provisions in the legislation supplement those already available to the authorities in the Banking Act 2009 and those being developed with the RRD. However, it will be essential to ensure effective international co-operation on the development of recovery and resolution regimes. Cooperation between regulators in home and host countries will be an essential step to ensuring these regimes are effective. It is not yet clear how this will work across borders, especially beyond the EU, however we support moves to a global statutory bail-in regime applied to all debt in issuance.

27. *What is your assessment of the Government's preferred design of "bail-in" powers needed to improve bank resolution? How likely is it that the Recovery and Resolution Directive will deliver effective bail-in powers?*

Bail-in should only be at the point of resolution and with a statutory regime without carve outs for minimum maturities. Other options could have a negative impact on the stability of institutions. Regulators are best placed to set the levels of PLAC required by banks and this should reflect the quality and effectiveness of an institution's RRP as well as their pre-existing levels of resilience in both capital and liquidity terms.

INTERNATIONAL ISSUES

31. *Are the proposals consistent with existing and forthcoming international and EU regulatory initiatives, for example the recent Liikanen Report? To what extent are they likely to be superseded or generate conflicts?*

Liikanen appears to be biased towards a contractual regime for bail-in which we do not believe is workable. We remain concerned about the lack of clarity around the purpose and creation of resolution funds and the impact of capital agreements. There is considerable uncertainty about the scope of the Liikanen regime and this will not become clear until the European Commission publishes more details on the scope of the regime.

OTHER

32. *What other matters should the Commission take into account?*

We support the creation of bail-in regimes, however in developing and regulating the regimes policymakers will need to consider the systemic impact the triggering of bail-in might have in a crisis. Losses will be absorbed within the system as a whole and most probably by a combination of institutional and retail investors who may not be in a strong position to absorb them. Regulators will need to be alert to these risks and consider, for instance, the impact a bail-in could have on investment returns for pension funds. However, whilst obviously multiple bail-ins could have second order impacts on market stability, they would, managed well between coordinating regulators, be a less destabilising phenomenon than many of the alternatives.

5 November 2012

Written evidence from Virgin Money

SUMMARY

1. We agree that an enabling Bill, with delegated powers to the Treasury and to the PRA to make the detailed rules, represents a sensible approach, since it will allow flexibility to respond to changing circumstances, to the wish or need to achieve alignment with EC Directives, and to any need to respond to unintended consequences or attempts by some banks to "get round the rules". However, given the large number of powers that are delegated, we suggest that a date might be set by which the rules should be determined, to remove uncertainty for banks and their customers. To achieve a balance between delegation of powers and accountability to Parliament, we suggest that an initial review of the rules might be carried out after the rules are determined but before they are implemented, that subsequent reviews might be carried out more frequently than every five years, and that the reviews might be carried out by a body that was not involved in setting the rules.

2. We believe that the ICB's proposals for unsecured debt that can be bailed-in and for depositor preference will reduce future risk to tax-payers and should increase market discipline on banks, and that the proposals for ring-fencing should make resolution easier, although we anticipate that, in conditions that are already stressed, the authorities may for good reasons be reluctant to force banks into the formal process of resolution, required for them to access capital that can be bailed in, if it can be avoided. We agree with the conclusion of the impact assessment that ring-fencing and depositor preference are better than the "do nothing" option, but we regret that the ICB's reports and the impact assessment do not contain comparative analyses of the costs and benefits associated with alternative options, such as the approach taken in the Dodd Frank Act or recommended in the Liikanen Report, or full separation of retail banking and investment banking, and so it is not possible to

give an informed response to the Commission's question about whether the measures in the draft Bill are the most efficient and effective means of delivering the objectives.

3. We suggest that further consideration should be given to some matters covered in the draft Bill, including whether the continuity objective for the FCA will weaken its competition objective (see the first section of the draft Bill, headed "Objectives of Financial Conduct Authority"), whether the independence of a ring-fenced bank from other members of its group is consistent with subsidiarisation (see section 142H of the draft Bill), whether ring-fenced banks should in some circumstances be allowed to undertake activities that are excluded (see paragraph 2.25 of the policy overview), and whether breaches of the ring-fencing rules should be result in banks being fined but not in individuals being sanctioned (see section 142G of the draft Bill).

4. We do not believe that the measures in the draft Bill will in themselves necessarily lead to a material improvement in banking standards and cultures in banking. The ICB was asked to come up with recommendations to improve financial stability and competition, and Sir John Vickers made it clear that the ICB would not consider matters such as bonuses and governance. We therefore anticipate that the Parliamentary Commission on Banking Standards, seeking to improve banking standards as well as financial stability and competition, and taking account of the further evidence presented to it, may make recommendations which, if accepted, may require some amendments to the draft Bill and/or to the delegated powers in it.

OBJECTIVES AND GENERAL APPROACH

1. *Does the draft Bill successfully give effect to the objectives set out in paragraph 1.3 of Sound banking: delivering reform and is it the most efficient and effective means of delivering those objectives?*

5. The draft Bill gives effect to the ICB's recommendations to improve financial stability through ring-fencing, depositor preference and a framework for implementing PLAC requirements. In addition, paragraph 2.3 in the policy overview confirms that the bail-in tool will be progressed through the proposed RRD, the equity ring-fence buffer through CRD IV and CRR, and the resolution buffer through CRD IV variable Pillar 2 requirements: these all seem to be consistent with the existing approach to banking regulation.

6. The draft Bill does not give effect to the ICB's recommendations to improve competition, because they will be progressed through alternative means. Paragraph 2.3 confirms that the Government supports the creation of a strong challenger bank from the LBG divestment required by the EC, and that it supports the ICB's recommendations on PCA switching, with quarterly meetings to hold the industry to account on its September 2013 deadline for the current account redirection service, and on transparency, which the OFT and PRA will implement.

7. Although the ICB's recommendations to improve competition did not include payments reform, paragraphs 2.66 and 2.67 confirm the Government's intention to improve competition in payments, note the recent consultation on setting the strategy for UK payments, and state that, although there are no clauses on Payments Council reform in the draft Bill, clauses will be included in the Bill when it is introduced in Parliament early next year.

8. It is not clear whether the measures in the draft Bill represent the most efficient and effective means of delivering the objectives. While we agree with the conclusion of the impact assessment that ring-fencing and depositor preference are better than the "do nothing" option, we regret that the ICB's reports and the impact assessment do not contain comparative analyses of the costs and benefits associated with alternative options, such as the approach taken in the Dodd Frank Act or recommended in the Liikanen Report, or full separation on retail banking and investment banking.

2. *Do any of the recommendations of the Independent Commission on Banking (ICB), which the draft Bill seeks to implement, need revision as a consequence of developments since the ICB's report?*

9. Since the ICB's report, one set of developments has related to the ongoing eurozone crisis and to reduced forecasts for economic growth. While these developments strengthen the case for ring-fencing, depositor preference and PLAC requirements, to protect tax-payers, there does not seem to be any need to revise the ICB recommendations that are reflected in the draft Bill because of them.

10. Since the ICB's report, another set of developments has related to LIBOR manipulation and derivatives mis-selling, and to the establishment of the Parliamentary Commission on Banking Standards. It seems unlikely that recommendations made by the Parliamentary Commission will imply the need for any revision to the ICB's recommendations on depositor preference and PLAC requirements. However, in relation to ring-fencing, it seems possible that the further evidence presented to the Parliamentary Commission, including by Paul Volcker and Erkki Liikanen, might lead it to take a different view from the ICB on the location of the ring-fence and/or on the extent of separation between retail banking and investment banking, to improve banking standards as well as to improve financial stability.

3. Do the powers in the draft Bill and the Government's stated intentions for their use give effect to the ICB's recommendations? Are any deviations justified?

11. Our understanding is that the Government intends to implement in full the recommendations made by the ICB, through either primary legislation or secondary legislation, or through alternative means. We see no intention to water down, or deviate from, the ICB's recommendations. Paragraphs 2.63 to 2.67 of the policy overview state that, in addition to the ICB's recommendations, the Bill will cover Payments Council reform and FSCS governance reform.

4. What should be the timetable for implementation of these measures, and should it be set out more clearly?

12. We recognise that the deadline of 2019 for full implementation of the ICB's recommendations to improve financial stability is still some years ahead, but we believe that it is sensible to allow large banks enough time to make the arrangements that will be necessary for ring-fencing, and to align the changes in capital requirements with the implementation of Basel III. Banks already have much higher capital ratios than they did in 2008, and effective recovery and resolution plans should now be in place: it seems undesirable to impose in the short term any additional measures which might limit banks' ability to lend and to support economic growth.

13. However, it would be helpful to set a much shorter deadline by which the detailed matters which are not specified in the draft Bill, particularly about the location of the ring-fence and the height of the ring-fence, are made clear, at least to the level of detail that the Basel III regulations are already known, to remove uncertainty for banks and their customers.

14. We see no reason to delay the ICB's recommendations to improve competition. We support the September 2013 deadline for the introduction of the current account redirection service, and believe that a similar deadline should be set for the introduction of measures to improve transparency (including transparency about interest forgone on current accounts), as finalised by the OFT and the PRA.

5. The draft Bill proposes continuity objectives on the PRA and FCA. Are these appropriate and compatible with their other objectives?

15. We support the intention that there should be continuing provision of essential banking services. However, we are concerned that adding the continuity objective to the objectives of the PRA and of the FCA could have the unintended consequence of tilting the balance further in favour of financial stability at the expense of competition.

16. It is understandable that greater priority was given to financial stability than to competition around the time of the banking crisis of 2008, but we have commented in our submissions to the OFT, Treasury Committee and the ICB on the potential reduction in competition arising from the further consolidation that took place in this period, most notably by allowing the acquisition of HBOS by Lloyds TSB to go ahead despite the OFT's reservations.

17. There seems to be a possibility that the words in the draft Bill that the FCA's objective to promote "effective competition in the interests of consumers, but [...] only so far as this is compatible with [...] acting in a way which advances the continuity objective" could have been used to justify the acquisition of HBOS by Lloyds TSB despite the possible lessening in competition about which the OFT expressed reservations, and that it could be used in future in similar circumstance and with similar effects.

18. Since the banking crisis of 2008, various measures have been introduced to support financial stability, including higher minimum equity capital ratios and more conservative bases for calculating RWAs, and the need for banks to have effective recovery and resolution plans. Financial stability will be enhanced further by the implementation of the ICB's recommendations for ring-fencing, depositor preference and PLAC requirements.

19. The ICB's objective was to come up with recommendations to improve financial stability, while continuity was a concept used by the ICB to determine which banking services could only be provided by ring-fenced banks: we are not sure that continuity should replace or augment financial stability as the objective. We suggest that consideration should be given to the possible reduction in competition that might arise from the FCA's duty to promote effective competition being limited by its duty to advance the continuity objective.

BANKING STANDARDS AND COMPETITION

6. What will be the impact of the proposed changes in the draft Bill on banking standards in the UK more widely?

20. It is not clear that the proposed changes in the draft Bill will in themselves have any impact on banking standards in the UK. They were not intended to do so. The objective set for the ICB was to come up with recommendations to improve financial stability and competition, and the ICB took the view that matters such as bonuses and behaviour were not in its remit. At a hearing of the Treasury Committee, on 24 May 2011, Sir John Vickers said, "I think there is a very important set of public policy issues around remuneration, around

bonuses and around governance. I think those issues are very relevant to our remit, but I think they are not within our remit and I think there is a danger for us as a Commission of spreading too wide and too thin.”

21. To the extent that the proposed changes, including the separation of retail banking and investment banking, have an impact on standards in ring-fenced banks, we believe that it should be positive rather than negative. However, PPI and derivatives mis-selling have, unfortunately, shown that it can not be assumed that retail banks will automatically maintain high standards just because they do not engage in investment banking activities.

22. A possible negative impact of ring-fencing on banking standards is that it could lead to some banks trying to find ways to “get round the rules”. In our submission to the Parliamentary Commission on Banking Standards, we suggested that “manipulation” of regulatory capital requirements should be liable to sanctions, and we suggest that the same should apply to “manipulation” of the ring-fencing rules.

7. What will be the impact of the separation of retail and wholesale banking on the culture prevailing within each?

23. It is not clear that the separation of retail and wholesale banking, as currently proposed, will have a significant impact on the culture prevailing within each. The measures in the draft Bill are intended to improve financial stability rather than to enhance internal cultures. However, to the extent that the separation has an impact on internal cultures, we think that it should be positive rather than negative.

24. Although it is not clear where the ring-fence boundary will lie, and how much flexibility there will be, our assumption has been that large banks would opt to include a broad range of customer-facing activities for personal and business customers in the ring-fenced bank. In this case, the separation would be between a “retail bank” an “investment bank”, as defined by Sir John Vickers in his speech at the LSE on 22 January 2011, when he introduced the concept of subsidiarisation. As well as supporting financial stability and the continuing provision of essential banking services, this separation would be sensible in terms of cultures, since it would make a separation between activities that are customer-facing and focus on credit risk, and activities that involve trading and focus on market risk.

25. In our submission to the Parliamentary Commission on Banking Standards, we commented on differences between retail banking and investment banking, including that trading activities can easily lead to fundamental conflicts of interest between making profit for the bank (and bonuses for employees) and supporting its customers. Andrew Haldane has recently suggested that a benefit of full structural separation of investment banking and commercial banking is that it would “better ensure that the distinct cultures of retail and investment banking were not cross-contaminated”.

26. Our experience suggests that employees are, in general, more able to identify with homogeneous cultures in distinct subsidiaries than with heterogeneous cultures across large diversified businesses. In this case, the establishment of ring-fenced banks should help to restore a culture in which employees focus on serving their customers, although it may in itself not be sufficient to do so.

27. Outside the ring-fenced bank, separation and transparency may discourage some of the activities which have been described as “casino banking” or as “socially useless activities”, but which have generated large bonuses.

8. What will be the impact of the ring-fence on competition, both in retail and investment banking, and in other areas of financial services?

28. We believe that the introduction of the ring-fence should enhance competition in retail banking, to some extent, as well as improve financial stability.

29. Our experience is that retail banking has been seen as less interesting than investment banking, within universal banks. Associated with the introduction of the ring-fence, the establishment of a ring-fenced subsidiary with dedicated governance and separate reporting should lead to greater focus on retail banking and on its performance.

30. However, the positive impact on competition in retail banking should not be overstated, given that, in the UK, retail banking is dominated by an effective oligopoly of five large banks which have a greater interest in defending their established positions than in acting as challenger banks. For example, were any one of them to compete by reducing its prices for both new and existing business, the lost income on existing business would almost certainly be greater than the additional income on new business.

DELEGATED POWERS AND ACCOUNTABILITY

9. The draft Bill grants a large number of delegated powers to the Government. Are the principles under which delegated powers are to be exercised sufficiently clear?

31. The draft Bill is clear about what powers are to be delegated to the Treasury, and how they are to be exercised, in matters relating to ring-fencing (exemptions for building societies and other classes of institution, core activities, excluded activities and the imposition of prohibitions) and relating to loss-absorbency

requirements and amending legislation relating to groups. The explanatory notes, although not part of the draft Bill, are helpful in confirming what the clauses in the draft Bill mean.

32. In one important area, the draft Bill is not so clear. Paragraph 2.25 of the policy overview states that, “There may be circumstances in which it may be necessary or desirable to permit a ring-fenced bank to undertake an excluded activity. So the draft Bill gives the Treasury power to make secondary legislation providing for exceptions to the excluded activity.” This seems to be a particularly important matter, since it could open up a loophole through which some banks might find ways to “get round the rules”. But the draft Bill, and the explanatory notes, do not give examples of what might be permitted, or what restrictions might be placed on allowing ring-fenced banks to undertake excluded activities.

33. The powers given to the Treasury under Section 142F, including powers to confer powers on themselves or on a regulator, seem sensible, to provide flexibility for future developments which can not be anticipated at the outset. But again, consideration might be given to restrictions on such delegated powers.

34. Section 142H gives powers to make ring-fencing rules, including for “requiring the disclosure to the appropriate regulator of information relating to transactions between the ring-fenced body and other members of the group”. We suggest that it would be helpful, in supporting the independence of the ring-fenced bank, if wider powers were given for rules to be made for the minimum regulatory and financial disclosures to be made by ring-fenced banks, to their regulator and in public disclosures. We think that requirements for comprehensive public disclosures would encourage the ring-fenced bank to think of itself as an independent subsidiary rather than a division.

10. Does the scope of the delegated powers in the draft Bill represent an appropriate balance between flexibility for the Government to respond to changing conditions and accountability to Parliament and the public?

35. We agree that an enabling Bill, with delegated powers to the Treasury and to the PRA to make the detailed rules, represents a sensible approach, since it will allow flexibility to respond to changing circumstances, to the wish or need to achieve alignment with EC Directives, and to any need to respond to unintended consequences or attempts by some banks to “get round the rules”.

36. However, given the large number of powers that are delegated, we suggest that, to achieve a balance between delegation of powers and accountability to Parliament, an initial review of the rules might be carried out after the rules are determined but before they are implemented, and that subsequent reviews might be carried out more frequently than every five years.

11. Is there sufficient clarity about the Government’s intended use of delegated powers, both to enable public understanding and to enable affected banks to prepare for the proposed changes?

37. An important issue for customers of banks, and for banks themselves, is that many important details are not clear at this stage. For example, for smaller banks which might qualify for the *de minimis* exemption, it is important to know exactly how the *de minimis* threshold will be determined and at what level it will be set. For retail banks, it is important to know exactly where the location of the ring-fence will lie, so that they can decide whether or not to continue any existing activities that will be outside the ring-fence. For universal banks that will have activities inside the ring-fence and outside the ring-fence, it is important to know where the ring-fence will lie, so that they can explain the ring-fencing rules to their personal and business customers.

38. We therefore suggest that a deadline should be set for the details to be determined, and, possibly, reviewed and reported on through the Treasury to Parliament, so that banks and their customers can understand the implications for them, and make appropriate arrangements.

12. The draft Bill provides for review of the ring-fencing rules by the PRA every five years. Does the proposed review mechanism provide sufficient accountability?

39. We support the concept of a periodic review of the ring-fencing rules, with a report to the Treasury and through it to Parliament.

40. While we have no objection to the reviews being carried out by the PRA, there is a case for the reviews to be carried out by a body other than a body that was involved in setting the rules. If not by the PRA, the reviews could be carried out either by the Treasury Committee and/or by an independent body with appropriate credentials.

41. Given the extent of the detailed matters that are delegated in the draft Bill, we suggest that there could be merit in an initial review after the rules are determined but before they are implemented, to confirm both that the rules are appropriate and that the review process is effective. Also, we suggest that the periodic reviews should be carried out more frequently than every five years, at least initially, so that any shortcomings in the rules, or unintended consequences of them, or attempts by banks to “get round the rules” can come to light and be addressed more quickly.

THE RING-FENCE

13. *Is the power to be able to exempt certain categories of deposit-taking firms from having to establish a ring-fenced bank appropriate, and on what basis should the conditions for exemption be set?*

42. We support the proposed exemptions for certain deposit takers.

43. In our submissions to the OFT, Treasury Committee and ICB, we have expressed concern about limited competition in retail banking, caused partly by its domination by an effective oligopoly of five large banks, leading to high concentration and limited diversity. The view has been put forward that the large banks should be broken up to create new challenger banks. Although we think that this would in theory be good for competition, we are not sure that this is practical, given the difficulties experienced by RBS in separating the branches which it had agreed to sell to Santander, and by Lloyds in finding a buyer for its divestment. We therefore believe that it is important to reduce barriers to entry and expansion.

44. In this context, a *de minimis* exemption from ring-fenced requirements, as proposed in the Banking Reform White Paper, seems sensible—provided that the exemption does not inhibit the ability of smaller banks that are not ring-fenced to secure funding at competitive rates. Given that retail deposits form the only product that will certainly be among the products that can only be provided by ring-fenced banks, we believe that it is appropriate for the *de minimis* threshold to be set in terms of retail deposits. We note the proposal in the White Paper that the threshold should be set at £25 billion of retail deposits. As an indication of scale, the retail deposits of Virgin Money (including those of the acquired business Northern Rock) were £16.7 billion at 31 December 2011.

45. We agree with the proposal that building societies should be exempted from the ring-fence requirements, and dealt with by amendments to the Building Societies Act. Building societies offer important sources of diversity and competition in retail banking. It seems desirable that building societies should maintain their distinct identity under the Building Societies Act.

14. *Is the range of core and excluded activities defined in the draft Bill appropriate and sufficiently broad? Are the Government's stated intentions for using powers to define further core and excluded activities appropriate?*

46. It seems uncontroversial that retail deposits should be inside the ring-fence, and that proprietary trading should be outside the ring-fence. However, these reflect the ends of a spectrum, and it may be difficult to make rules with definitions which indicate whether some other banking activities are core or excluded, or permitted. As a result, the rules could become complicated, as has happened in framing the Dodd Frank Act, despite the apparent simplicity of the Volcker Rule. Voluminous and complex rules could, as in prudential regulation, reinforce a “tick-box compliance” mindset which the Government and the FSA are trying to change to a more judgemental approach, and could lead to some banks finding ways to “get round the rules”.

47. The ICB set out a framework for categories of activities that must be inside the ring-fence or must be outside the ring-fence, or that can be either inside or outside, and it seems reasonable for the draft Bill to give delegated powers to the Treasury to finalise the definition of each category. However, it would be helpful to have, within a reasonable period, determination of the details, to remove uncertainty for banks and their customers.

48. Paragraph 2.25 of the policy overview states that, “There may be circumstances in which it may be necessary or desirable to permit a ring-fenced bank to undertake an excluded activity.” While this sounds sensibly pragmatic, it may be difficult to define such circumstances in a way that avoids the possibility of creating a significant loophole. Experience suggests that loopholes, once opened, can be used in unexpected ways, and can become larger over time.

49. Clause 142G comments on the sanctions that will be applied to ring-fenced banks that carry on excluded activities or contravene prohibitions. The explanatory note states that, “Under subsection (1) a ring-fenced body which has done this is treated as having contravened a requirement imposed on that body by the regulator under FSMA. It will in consequence be liable to the disciplinary measures and penalties which the regulators may impose under Part 14 of FSMA. However, under subsection (2), the ring-fenced body will not have committed a criminal offence solely by reason of the contravention, and transactions entered into contrary to a prohibition remain valid.”

50. This raises an important issue, in the context of recent cases where some bankers have been deemed to have exercised poor judgement but not to have broken any laws, and in the context of improving banking standards, as to whether corporate fines are having an adequately positive impact on behaviour, or whether individuals should be liable to professional and criminal sanctions, through processes that are fair and transparent.

15. *Which categories, if any, of customer should be permitted to deposit with a non ring-fenced bank?*

51. We support the proposal that high net worth individuals and large companies should if they wish be allowed to place deposits with a bank that is not ring-fenced.

52. However, definitions of the levels of thresholds, in terms of income or assets, are not easy, as is indicated in the summary of responses to the Banking Reform White Paper, where it is reported that different banks have different views on the appropriate levels of the thresholds. This is likely to reflect the fact that different banks segment their personal and business customers in different ways.

53. For business customers, paragraph 2.20 of the policy overview suggests a threshold of £6.5 million annual turnover, which seems reasonable. Turnover figures have the advantage of being readily available for business customers, and, according to the summary of responses, the level of £6.5 million is preferred to the £25.9 million figure which is used in some analyses. For high net worth customers, the suggested threshold of £250,000 free and investable assets, suggested in paragraph 2.21, does seem quite low, as some respondents have observed, and it is not clear how banks will know the free and investable assets of such customers.

54. We support the proposal that the thresholds should be determined in secondary legislation, after further consultation. We suggest that consideration should also be given as to how, and how often, the thresholds will be updated.

16. The Government is considering whether to allow ring-fenced banks to offer simple derivatives to their customers. Should they be allowed to? If so, what safeguards would be necessary?

55. We agree with the proposal that ring-fenced banks should be allowed to offer simple derivatives to their customers. Many customers use derivatives in a responsible manner to reduce foreign exchange and other risks in their businesses, and will find it convenient to get a broad risk management service from their ring-fenced bank, as they get from their bank at present.

56. However, if the distribution of derivatives to their customers by ring-fenced banks is allowed, we suggest that it should be subject to restrictions such as the following:

- The derivatives should be distributed on an agency or brokerage basis. Ring-fenced banks should not be allowed to engage in proprietary trading of derivatives (or of other securities).
- The distribution of derivatives should be subject to a code of conduct, with sanctions for breaching the code, to limit the risk of mis-selling derivatives.
- The derivatives should be limited to simple derivatives that are centrally cleared.

57. The definition of “simple” derivatives may not be easy. Clearly CDOs are complex, while interest rate swaps are simple. In determining the category of derivatives to be permitted, we suggest that consideration be given to Article 132 of the Solvency II Directive. This article says that insurance companies “shall only invest in assets whose risks the undertaking concerned can properly identify, measure, monitor, manage, control and report”.

58. We support the proposal, in paragraph 2.26 of the policy overview, that ring-fenced banks should be allowed to use derivatives to manage their liquidity, interest rate and credit risks.

17. Are the proposed corporate governance arrangements between the ring-fenced bank and the wider group sufficient to ensure the independence of the ring-fenced bank? Are these arrangements compatible with directors’ duties and principles of accountability?

18. How appropriate are the proposed restrictions on exposures and operational dependencies between the ring-fenced bank and the rest of the group? Will these result in a sufficient degree of independence and resilience?

59. The draft Bill’s requirements that a ring-fenced bank acts independently of other members of its group and that it operates on an arms-length basis with other members of its group, and the limitations on the ring-fenced bank’s shares or voting powers in other companies and on payments to other members of its group, address key issues which should support the independence of the ring-fenced bank, as far as a fully-owned subsidiary can be independent of its parent, especially when the parent has to answer to external shareholders on its behalf.

60. However, we are not sure that the independence of the ring-fenced banking subsidiary is in practice really possible. As implied by the question about directors’ duties and responsibilities, the board of a fully-owned subsidiary normally reports to its parent group board as its shareholder, and responds to the views of its parent group board.

61. Also, we are not sure that the independence of the ring-fenced banking subsidiary was really intended. The draft Bill’s requirements ensure that the ring-fenced bank could easily be separated and continue to operate, and is protected from problems in other parts of its group. Independence sounds more consistent with full separation of retail banking and investment banking than with subsidiarisation.

19. Will it be possible to effectively monitor and police the ring-fence, given the degree of regulatory discretion the draft Bill proposes?

62. While it would be helpful to get more detailed information within a reasonable period about the matters which are delegated in the draft Bill to the Treasury (for the location of the ring-fence) and to the PRA (for

the height of the ring-fence), we believe that the degree of regulatory discretion proposed in the draft Bill will support effective monitoring and policing, because it will allow flexibility to respond to any attempts by banks to “get round the rules”.

63. We are optimistic that the recommendations of the Parliamentary Commission on Banking Standards will lead to a significant improvement in banking standards. However, banks have a track record of “getting round the rules”. For example:

- The Basel Committee has found evidence of banks moving assets from their trading book to their banking book, or vice versa, to achieve less onerous capital requirements.
- Over the last year, the Bank of England has commented on “RWA optimisation” by some banks, to reduce their regulatory capital requirements.

In this case, the possibility exists that ring-fencing, while improving financial stability, and enhancing competition in retail banking to some extent, might result in some banks finding ways to “get round the rules”, particularly if the rules are or become extensive and complex. The flexibility allowed by the degree of regulatory discretion in the draft Bill would enable the Treasury and the PRA to address any such outcomes, while adhering to the principles set out in the draft Bill.

20. *How effective will the provisions on corporate governance for ring-fenced banks be in promoting a wider improvement of standards? Should other measures also be considered?*

64. It is not clear that the governance arrangements for ring-fenced banks will in themselves necessarily lead to a wider improvement in banking standards, and we believe that other measures should be considered. Other measures to improve banking standards might include the professionalisation of banking, with training and CPD, a professional code of conduct and sanctions for breaches of the code, some regulatory parameters for bonuses and total remuneration (at least in ring-fenced banks), supported by shareholder oversight, and requirements for disclosure of information about bonus schemes and bonus payments. It might also be sensible to ask the OFT and the FCA to examine cross-subsidies between, and within, retail banking products, including current accounts, since they can lead to mis-selling, as with PPI. These and related measures to improve banking standards were discussed in our submission to the Parliamentary Commission.

DEPOSITOR PREFERENCE

21. *Is the proposal to prefer insured deposits in the event of a bank insolvency justified? Is there a case for broadening the scope of deposits which benefit from this protection?*

65. We support the concept of depositor preference. This will reduce risk to tax-payers, and, along with unsecured debt that can be bailed in, should enhance market discipline on banks.

66. We believe that depositor preference should be limited to insured deposits, whose owners have no incentive to apply market discipline.

67. Assuming that depositor preference is introduced, and that it is limited to insured deposits, we consider it important that:

- there is a clear rule that consumers can understand. This supports the proposed link with the limit on insured deposits, and suggests that the scope of depositor preference should not be extended to other categories of deposits.
- the implications of depositor preference are explained clearly to retail depositors, to avoid the possible perception, based on what happened in the banking crisis of 2008, that all retail deposits are implicitly guaranteed by the Government, if not by the FSCS, and to allow retail depositors to make appropriate arrangements to mitigate potential losses on non-insured deposits, if they wish to do so. One straightforward way to achieve this would be to encourage banks to offer clearly-labelled accounts, one type for insured deposits, with a limit of £85,000, and another type for deposits that are not insured, with no limit.

CAPITAL LEVELS

22. *Does the draft Bill adequately implement the ICB's recommendations on loss absorbency requirements?*

23. *The draft Bill gives the Government power to direct the way in which the regulators can implement loss-absorbency requirements. How appropriate and well-designed is this power?*

68. Paragraphs 2.54 to 2.58 in the policy overview confirms that the Government intends to implement the ICB's recommendations that:

- there should be a PLAC, and that it should be set at 17% of RWAs.
- long-term unsecured debt should be capable of being bailed in, in the event of resolution.

However, neither section 142J nor the corresponding paragraph in the explanatory notes mention the terms primary loss-absorbing capacity or bail-in.

69. We understand the intention that the draft Bill should not be too prescriptive, and that it should delegate powers, in this case to the Treasury, to set PLAC requirements.

70. However, contrary to what might have been expected, unsecured debt holders did not suffer losses in the banking crisis of 2008, because injections of equity capital were made before banks failed—although, had such injections not been made, the equity capital of the relevant banks would not have been sufficient to absorb the losses that arose. Even in more recent banking problems, such as Bankia, equity holders have lost much of their capital, and injections of equity capital have been made, but unsecured debt holders have not suffered losses.

71. It seems that unsecured debt holders are reluctant to accept that they will suffer losses in such situations in future, even though it is expected to be part of European recovery and resolution plans. So we suggest that there is a case for the draft Bill making explicit mention of primary-loss absorbing capacity requirements, including, as well as equity capital, some category of unsecured debt that can be bailed-in. Also, given the relative losses suffered by equity investors, debt holders and tax-payers in banks that were failing, and given the likely and understandable reluctance of the authorities to force banks into resolution in conditions that are already stressed, there is a case for the draft Bill making it clear that a failing bank can not receive an injection of equity capital from tax-payers unless or until the relevant debt has been bailed in.

24. Is the Government's stated intention for the design of loss-absorbency requirements workable? Will it provide a sufficiently well-capitalised banking system? In particular, how justified is the intention to allow an exemption for assets held in overseas operations?

72. We support the ICB's recommendation that there should be a PLAC, including some unsecured debt that can be bailed-in as well as equity capital. And, on the basis of the losses suffered by banks over the years around the banking crisis of 2008, we believe that the level of 17% of RWAs that was recommended by the ICB seems adequate.

73. With hindsight, it is clear that banks' minimum equity capital ratios were too low ahead of the banking crisis of 2008. Looking to the future, while it is very undesirable that tax-payers should have to make further equity capital injections in banks, it is also undesirable that banks' minimum equity capital ratios should be set at a level that overly restricts banks' ability to lend and to support economic growth. Minimum equity capital ratios are already much higher under the Basel requirements, and the bases prescribed for calculating RWAs are now more conservative. The availability of unsecured debt that can be bailed in will provide access to additional equity capital if it is required, but will enable banks to hold levels of equity capital that are not excessive.

74. We support the proposed exemption from PLAC requirements for some assets held in overseas operations. We accept that the extension of PLAC requirements to non-EEA operations might cause some banks with large non-EEA operations to reconsider their domicile, and we think that the proposed exemption is sensible and reasonable, provided that the ring-fencing arrangements are such that losses on non-EEA operations cannot deplete the PLAC of ring-fenced banks in the UK.

25. Is the Government justified in its decision not to implement the ICB recommendation for a higher leverage ratio than is required by Basel III?

75. The Basel III regulations propose a minimum leverage ratio of 3% for all banks. There is merit in consistency with this in the UK, to avoid introducing a difference which could lead to regulatory arbitrage between areas. However, there was also merit in the ICB's recommendation that minimum leverage ratios should be higher for large banks, in a manner that is consistent with the higher capital ratios that will be required for large banks. Different approaches to setting capital and leverage ratios could lead to a new sort of regulatory arbitrage, between the two ratios.

76. The Swedish Financial Markets Committee suggested that the introduction of a leverage ratio might have the unintended consequence of restricting the growth of the banks with the lowest risk, and might have the undesirable consequence of encouraging them to engage in greater volumes of securitisation. The potentially perverse impact of a minimum leverage ratio on banks with low-risk assets such as prime mortgages was recognised by the ICB, and in paragraph 3.21 of the Government response to the Independent Commission on Banking. We are concerned that the imposition of a single minimum capital ratio for all banks might have unintended and undesirable consequences for retail banks such as Virgin Money which have low-risk assets such as prime mortgages.

77. The ability to make sound judgments about this matter is constrained by lack of publicly-available information about banks' leverage ratios. UK banks have not normally disclosed their leverage ratios. And, if they had, they might have been subject to "leverage ratio optimisation" along the lines of the "RWA optimisation" about which the Bank of England has expressed concern.

78. We therefore agree with the Bank of England's proposal that UK banks should disclose their leverage ratios from a date earlier than that required under the Basel regulations. We suggest that the draft Bill should give delegated power to the PRA, with input from the FPC, to determine the minimum leverage ratio, and that,

within such power, the option should be left open to set different minimum leverage ratios for different categories of banks rather than to set a uniform minimum leverage ratio for all banks.

26. Will the UK authorities have the necessary tools and powers (as a result of this legislation and other initiatives) to be able to resolve a large failing ring-fenced or non-ring-fenced bank, while maintaining financial stability and minimising the risk to public funds?

79. We think that the powers and tools will be adequate, as a result of a combination of the measures that have already been taken to improve financial stability, since the banking crisis of 2008, and the measures in the draft Bill:

- The possibility of bank failures has already been reduced by requirements for much higher minimum equity capital ratios and capital buffers, and for more conservative bases for the calculation of RWAs.
- Further protection to tax-payers will be given by the ability of the authorities to bail-in long term unsecured debt in the event of resolution.
- The ability of the authorities to resolve failing banks has been enhanced by the Special Resolution Regime and the requirement that banks have effective plans for recovery and resolution.
- Practical aspects of resolution will be easier as a result of ring-fencing and the separation of retail banking and investment banking.

80. As a result of these developments, the failure of a large ring-fenced bank is less likely, but, should such an event occur, it seems that the UK authorities will have adequate tools and powers to resolve it, and to continue the provision of vital banking services, while maintaining financial stability and minimising the risk to public funds.

81. For a large failing non-ring-fenced bank, the best answer might be to allow it to fail, through the resolution process, with systemic risk reduced by the developments listed above. However, it remains to be seen whether the authorities, in the UK or elsewhere, will be willing to allow such an outcome, in what would probably be severely stressed conditions, given what followed the failure of Lehman Brothers in 2008.

27. What is your assessment of the Government's preferred design of "bail-in" powers needed to improve bank resolution? How likely is it that the Recovery and Resolution Directive will deliver effective bail-in powers?

82. We support the concept that long-term unsecured debt should be capable of being bailed-in, because it will enable banks to access additional equity capital if required to do so in a crisis, when the issuance of new equity capital would be difficult, but it will not require banks to hold so much equity capital as to restrict their ability to lend and to support economic growth.

83. To protect the buyers of the unsecured debt that can be bailed-in, and to limit the increase in the rate paid to holders of the unsecured debt because of the possibility that it might be bailed-in, it seems likely that the terms of the debt will have to specify that bail-in will only be possible in the event of resolution.

84. However, this means that the authorities will have to put the bank into resolution for it to be able to access the additional equity capital. In such a situation, where conditions are likely to be already stressed, the authorities, in the UK or elsewhere, may for good reasons be reluctant to force a potentially failing bank into resolution, and the possibility exists that they might instead put pressure on holders of the unsecured debt to accept a voluntary bail-in or write-down, as happened to holders of Greek government debt. A voluntary approach may in some circumstances be better than the formal process of resolution, but, to protect tax-payers, we suggest that a failing bank should not be able to receive an injection of equity capital from tax-payers unless or until the relevant debt has been bailed in.

30. What will be the impact of the proposals on the international competitiveness of UK banks?

85. When the ICB's proposals were first mooted, and were expected to include subsidiarisation and ring-fencing and a capital surcharge for large ring-fenced banks, there appeared to be some concern that, although they would improve financial stability, they might reduce the ability of UK banks to compete effectively with their international peers. However, parallel developments in the UK and Europe, discussed at hearings of the Parliamentary Commission with Paul Volcker and Erkki Liikanen, confirm that the US and Europe have similar objectives, even if they are seeking to achieve them in different ways and at different speeds.

86. Also, responding to a question about whether less stringently regulated financial centres would benefit, Paul Volcker observed that London and New York were the only two markets with capability, size and knowledge. This suggests that it would not currently be easy for banks to move activities to other areas, although of course things may change in future.

31. *Are the proposals consistent with existing and forthcoming international and EU regulatory initiatives, for example the recent Liikanen Report? To what extent are they likely to be superseded or generate conflicts?*

87. There is a case for focusing on what is appropriate for the UK, even if it leads to some conflict, because of the importance of banking to the UK and the importance of London as a leading financial centre. There is also a case for consistency with the approach being taken internationally, in which context it is reassuring that paragraph 2.4 of the policy overview states that, “These [the recommendations of the High-Level Expert Group chaired by Erkki Liikanen] include strong support for a bail-in tool and a requirement for the structural separation of banks’ trading activities from retail deposit-taking. [...] The Group’s proposal for ring-fencing of trading activities from deposit-taking has many similarities with the recommendations of the ICB, and the Group has noted that the Government’s plans for ring-fencing of UK banks are compatible with the Liikanen recommendations.”

88. We suggest that the delegated powers in the draft Bill should be sufficiently widely drawn to allow for the possible requirement or wish to achieve greater alignment with the approach being taken in Europe, or in the US, and to allow for the possibility that the Parliamentary Commission, in seeking to improve banking standards as well as financial stability and competition, and taking account of the further evidence presented to it, including by Paul Volcker and Erkki Liikanen, might take a different view from the ICB on the location of the ring-fence and/or the extent of separation between retail banking and investment banking.

2 November 2012

Written evidence from Which?

EXECUTIVE SUMMARY

Which? strongly supports the full and robust implementation of the Vickers proposals for ring-fencing retail banks. Essential retail banking services on which consumers and small businesses rely should not be put at risk by imprudent behaviour elsewhere in large banking groups. There is also an urgent need to limit the scope of the implicit taxpayer guarantee for large banking groups and the distortions to competition arising from this subsidy.

We welcome the Government’s stated intention of “comprehensive and far reaching reform”. However, the Draft Bill provides a significant amount of discretion to the Treasury and regulators to implement ring-fencing. This leads to the following concerns:

- The draft Bill only allows the Treasury to make an order prohibiting an activity in a ring-fenced bank if it is “necessary or expedient” to protect the continuity of the provision of “core services”.
- The precise boundary between technical and non-technical matters is not clear.
- The Government’s intentions for the consultation arrangements for secondary legislation is not clear.
- The lack of a proper, agreed process of parliamentary scrutiny for the secondary legislation.
- The lack of accountability for the PRA, which currently is only required to consult firms and banks on its proposals.
- The lack of a properly focused objective for the PRA to promote effective competition.

We have the following comments on the other issues raised by the draft Bill:

Large banks: Despite ring-fencing, resolution arrangements for the largest banks are still not credible. The scale of banks currently operating poses dangers for both stability and competition. An immediate referral to the Competition Commission is the best way to resolve this issue.

High-net worth individuals: The threshold above which individuals may opt-out of placing deposits in a ring-fenced bank should be substantially higher. We also recommend the introduction of an advice regime for deposits in non-ring-fenced banks and for non-ring-fenced banks to be required to use the term “fixed-interest securities” and “variable-interest securities” to avoid any possibility of confusion.

Financial product restrictions: There are significant risks in allowing ring-fenced banks to sell derivatives to their customers and a prohibition may be the simplest way of controlling these risks. They should be prohibited from selling their own subordinated or senior unsecured debt or that of a linked non-ring-fenced bank directly to their retail customers. This should include a prohibition on selling structured products or any derivatives based on any of those types of debt.

Governance: The directors of both the ring-fenced bank and the wider group will need to be given specific duties to preserve the integrity of the ring-fence. It should be made clear to the directors that they will automatically be subject to individual regulatory action if they fail to uphold this duty.

Leverage ratio: We disagree with the Government’s proposals not to apply a higher leverage ratio to large ring-fenced banks.

Depositor preference: We support depositor preference, although the Government is proposing to implement a narrower definition, only covering insured depositors. There also needs to be reform to the FSCS to make it easy to understand by providing protection for each brand and coverage for temporary high balances.

INTRODUCTION

1. Which? established and supported the Future of Banking Commission, chaired by Rt Hon David Davis MP. In addition to taking evidence from senior regulators, banking executives and academics, the Future of Banking Commission included the Which? big banking debate—an event attended by 300 members of the public and allowed consumers to make their own submissions on our website. The report was published on 13 June 2010 and made a series of recommendations for changes to the structure, regulation, governance and culture of the banking industry.⁷³

1. *Does the draft Bill successfully give effect to the objectives set out in paragraph 1.3 of Sound banking: delivering reform and is it the most efficient and effective means of delivering those objectives?*

2. No, the draft Bill does not sufficiently give effect to the objectives set out in paragraph 1.3. Which? strongly supports the principle of ring-fencing of essential retail banking services. However, the lack of detail in the draft Bill, together with the substantial delegation of authority to both the Government to set the detail in secondary legislation and the PRA to set the rules for ring-fencing means that the Bill alone will not ensure that the objectives will be achieved.

3. We welcome the Government commitment to introducing ring-fencing as part of the Banking Reform Bill. The broad nature of the draft Bill leaves the risk that the lobbying power of the major banks and the inevitable concessions during the Bill's Parliamentary passage may see it watered down before it is implemented. We highlight the following concerns about the PRA.

4. **Accountability and governance of the PRA:** The PRA will be responsible for making the rules governing ring-fencing. In this regard it is extremely worrying that the PRA only has a duty to consult banks and other firms when making rules. This empowers the PRA to only take the views of banks into account when formulating the rules.

5. **Lack of a properly focused competition objective for the PRA:** The PRA should be given a specific duty to promote effective competition in the interests of consumers. Appropriately, the PRA will have a general objective to promote “safety and soundness”. However, there is no mention of competition in its objectives even though it will be required to make decisions that will have an impact upon competition. This means that the PRA will not be required to consider the competition consequences of its decisions.

6. We agree with the Government regarding the need to curtail implicit government guarantees and their distorting effect on competition. However, the Government has not given the PRA an objective to promote effective competition or to limit the extent of the implicit government guarantee. To ensure that the PRA operates in line with Government policy we believe its objectives should be amended to give it a role in these two areas. In addition to being given a specific objective to promote effective competition the PRA should be required to report every year on the size of the potential implicit subsidy, the progress with implementing the ICB's recommendations and what progress has been made in reducing the implicit subsidy. It is also important to note that the PRA will have a role in activating the Special Resolution Regime. Currently, the objectives of the SRR contain no mention of the desirability of promoting competition.

7. The PRA will also have responsibility for issuing banking licences. Without a statutory obligation to consider competition, the PRA will not have an incentive to encourage new entrants to the market or reduce significant barriers to entry for new players. Challenger banks are vital to invigorating the market and improving conditions for consumers. For example, when Metro Bank launched, it promised to give current account holders their new debit card in branch when they opened their account. This forced other banks to reassess their own account opening procedures and compete against the service provided by the new challenger. This small example typifies the benefits that new entrants and effective competition can bring to consumers.

8. Challenger banks can invigorate the market and force existing players to compete for custom by introducing new products and services. This should create a more dynamic market in which good firms will grow. The FCA has an objective to promote effective competition. In the interests of regulatory synchronicity the PRA should be given an equivalent competition focus.

9. The Joint Committee that scrutinised the draft Bill recognised the importance of competition in decision making at the PRA:

“Competition within the financial sector is an important part of developing a stronger, more diverse system. The actions of the PRA have the potential to affect the costs of individual firms or of particular types of institution, and affect the barriers to entry and expansion in the market. While the need to protect and promote competition in the sector should not dictate the actions of the PRA, nor detract from the clear role of the OFT in this area, we believe it is a factor that ought to be considered in the course of PRA decision making.”

⁷³ The full report is available at <http://www.which.co.uk/documents/pdf/future-of-banking-commission-report-276591.pdf>

2. Do any of the recommendations of the Independent Commission on Banking (ICB), which the draft Bill seeks to implement, need revision as a consequence of developments since the ICB's report?

10. The ICB's recommendation surrounding the Lloyds divestiture should be reviewed as a consequence of developments since the ICB's report. Even after the existing sale of Lloyds branches to the Co-operative, Lloyds Banking group will still be left with a significant market share in current accounts, mortgages and savings. It is important to note that it has not achieved this large market share by offering customers good value products or by being efficiently run. Rather, it has achieved its dominant position through Government subsidies, bail-outs and a suspension of normal competition law. The scale of the largest banks now operating poses dangers for both stability and competition. It is clear that a bank such as Lloyds Banking Group, which is responsible for a significant amount of credit provision within the economy will not be allowed to fail and will never be subject to resolution.

11. The Competition Commission is the only body with the power to restructure major banking groups. An immediate referral to the Competition Commission would provide a clear process for doing so, with consequent benefits for both effective competition and financial stability.

3. Do the powers in the draft Bill and the Government's stated intentions for their use give effect to the ICB's recommendations? Are any deviations justified?

12. Please see our comments below.

4. What should be the timetable for implementation of these measures, and should it be set out more clearly?

13. The Government should set out a more detailed timetable for implementation of these measures during the process of Parliamentary scrutiny. Our preference would be for implementing the ring-fencing proposals earlier than 2019. Any delay increases the risks to the Government's AAA credit rating from the possibility of having to support the major UK banks. However, when considering the timetable of implementing the measures for enhancing capital requirements, the Government should give consideration to any short-term impact on the volume of lending in the economy.

5. The draft Bill proposes continuity objectives on the PRA and FCA. Are these appropriate and compatible with their other objectives?

14. We are slightly concerned by the lack of a definition of "continuity" in the legislation. The document itself defines continuity as the "uninterrupted provision of vital banking services".⁷⁴ This might be a better definition to use.

15. With regard to the PRA, we are concerned that the current recovery and resolution plans contain little information about how customers will be treated during the resolution process. It will be important that these aspects are considered by the PRA.

BANKING STANDARDS AND COMPETITION

6. What will be the impact of the proposed changes in the draft Bill on banking standards in the UK more widely?

16. The course of history suggests that financial crises will recur at regular intervals and that it is not helpful to completely eliminate the risk of failure (or to claim that a Government or regulator will eliminate the risk of failure in all circumstances). The current corporate structure of the UK banking system allows banks to take retail deposits and be an essential part of the payments system, while at the same time engaging in all manner of risky and speculative investment banking activities including proprietary trading.

17. This corporate structure helps to create banking institutions that are "too big to fail" and results in the Government (and ultimately taxpayers) guaranteeing that these banks will continue in business. The implicit (and in reality explicit) taxpayer guarantee encourages banking corporate structures which intertwine highly leveraged wholesale investment banking activities with retail deposits and the payment system. When these, large complex banks are at risk of failure, in the past the Government has had little choice but to extend support to the full spectrum of retail and investment banking activities. The result has been that the UK taxpayer has provided guarantees against losses by banks on loans they made to hedge funds based in the Cayman Islands and losses on trading of complex derivatives.

18. Subsidies will inevitably be greater for those banks with low professional standards. This makes banking unique from other sectors. In no other sectors that we examine do firms actively obtain a government subsidy for behaving badly. The corporate structure also results in taxpayers paying the costs of low banking standards as they end up owning a majority stake in poorly run banks with the lowest level of banking standards.

19. If the draft Bill reduces the level of subsidy and taxpayer support for banks with low levels of banking standards then should, in the longer term, improve the level of banking standards. However, this would require

⁷⁴ HM Treasury, Sound banking, Delivering reform, Para 2.9.

full and robust implementation of the ring-fence. It should also be noted that the timetable for implementation will mean that the draft Bill could take a significant amount of time to lead to improvements in standards.

7. What will be the impact of the separation of retail and wholesale banking on the culture prevailing within each?

20. Strong governance arrangements for ring-fenced will be necessary to achieve the following objectives:

- To prevent the extraction of value from the ring-fenced bank into the remainder of banking group.
- To protect the integrity of the ring-fence and ensure the continuity of essential banking services for consumers and SMEs.
- To ensure that the culture of the ring-fenced bank is separate and insulated from the investment banking culture in the other parts of the banking group.
- To impose a credible threat of failure on the non-ring-fenced bank.

21. Accomplishing these objectives will require the Board of the ring-fenced bank to be demonstrably independent of the wider banking group. The directors of both the ring-fenced bank and the wider group will need to be given specific duties to preserve the integrity of the ring-fence. It should be made clear to the directors that they will automatically be subject to individual regulatory action if they fail to uphold this duty.

22. The ring-fenced bank should also be required to maintain independent nominations, risk, audit and remuneration committees, with the chairs of those committees having no link to the rest of the banking group. To prevent undue influence on the incentive structures set in the ring-fenced bank, it is important that the remuneration committee of the ring-fenced bank does not contain any executives from the wider banking group.

8. What will be the impact of the ring-fence on competition, both in retail and investment banking, and in other areas of financial services?

23. If the implementation of the ring-fence makes it more likely that poorly-run banks will be allowed to fail then it should have a positive effect on competition, both in retail and investment banking. However, the positive impacts on competition may be mitigated by the lack of a clear objective for the PRA to promote effective competition.

DELEGATED POWERS AND ACCOUNTABILITY

9. The draft Bill grants a large number of delegated powers to the Government. Are the principles under which delegated powers are to be exercised sufficiently clear?

10. Does the scope of the delegated powers in the draft Bill represent an appropriate balance between flexibility for the Government to respond to changing conditions and accountability to Parliament and the public?

11. Is there sufficient clarity about the Government's intended use of delegated powers, both to enable public understanding and to enable affected banks to prepare for the proposed changes?

24. The Bill sets out that the Treasury will be responsible for setting the scope of the ring-fence (its "location") and the regulator responsible for determining its "height". However, the document also states that the "Treasury may confer powers upon the appropriate regulator to determine technical matters, according to the purposes set out in primary and secondary legislation". We would highlight the following points:

- The draft Bill only allows the Treasury to make an order prohibiting an activity in a ring-fenced bank if it is "necessary or expedient" to protect the continuity of the provision of "core services". It is not clear what burden of proof will be used by the Treasury. The draft Bill also allows the Treasury to make exceptions by stating "circumstances in which it may be necessary or desirable to permit a ring-fenced bank to undertake an excluded activity."
- The precise boundary between "technical" and "non-technical" matters is not clear.
- The Government's intentions for the consultation arrangements for secondary legislation is not clear.
- The lack of a proper, agreed process of parliamentary scrutiny for the secondary legislation.

25. When combined with the concerns about the lack of accountability for the PRA and the absence of a competition objective, it could lead to a concern that the ring-fencing requirements could be watered down.

12. The draft Bill provides for review of the ring-fencing rules by the PRA every five years. Does the proposed review mechanism provide sufficient accountability?

26. We do not believe that the proposed review mechanism provides sufficient accountability for the PRA. A time period of 5-years from when the first rules come into place is far too long before the PRA begins to assess the implementation of the policy. The proposed review mechanism should include the following:

- Before the first implementation of the ring-fencing rules, the PRA should be required to publish a full evaluation timetable for the ring-fencing rules. This should be consulted on with academics, consumer groups and the public in addition to firms and banks.

- This should include a full list of the desired outcomes and objectives the PRA is seeking to achieve with the implementation of its ring-fencing rules. It should also specify the short-term and long-term indicators which the PRA will use to assess whether its objectives and outcomes are achieved.
- The PRA should be required to measure and report annually on the extent of the implicit subsidy from the taxpayer guarantee, the extent to which it is distorting competition and what progress has been made in reducing the subsidy.
- Yearly progress updates should be published by the PRA with the report of these updates given to the Treasury and laid before Parliament.

THE RING-FENCE

13. *Is the power to be able to exempt certain categories of deposit-taking firms from having to establish a ring-fenced bank appropriate, and on what basis should the conditions for exemption be set?*

27. Any exemption from ring-fencing should not be open to abuse by banking groups by splitting their bank into smaller separate entities. Any threshold should be set by reference to the amount of deposits within the bank. On balance, £25 billion may be too high as it would allow banks of a significant size to benefit from the Government guarantee without a requirement for ring-fencing.

14. *Is the range of core and excluded activities defined in the draft Bill appropriate and sufficiently broad? Are the Government's stated intentions for using powers to define further core and excluded activities appropriate?*

Restrictions on selling retail investment products

28. There should be restrictions on the ability of ring-fenced banks to sell retail investment products. The Government should ensure that ring-fenced banks are unable to sell their own subordinated debt or senior unsecured debt or that of a non-ring-fenced bank from within the same group. We are concerned that banks such as Santander are using their retail arm to sell structured products such as this to their retail customers. In the past, Barclays has also sold a number of such products, including an account which was listed as an "Investment ISA" but was actually the senior unsecured debt of Barclays group.

29. Allowing ring-fenced banks to sell their own subordinated debt or that of a non-ring-fenced bank within the same group would lead to a significant conflict of interest. Banks would not be willing or able to ensure that such debt was priced appropriately and would be likely to mis-represent its nature to consumers and disguise the true risk the consumer was taking. It would also not be realistic to expect consumers buying this debt through retail branches to impose any effective market discipline on banks with riskier activities.

30. The sale of subordinated debt and structured products based on subordinated or senior unsecured debt to retail consumers could also pose a significant barrier to resolution. This could occur if the Government viewed itself as unwilling or unable to impose losses on ordinary retail consumers who had purchased this debt. It could also occur if imposing losses on consumers who had bought this debt would result in substantial legal claims against the bank due to the fact that the bank had failed to ensure that such investments were suitable for the consumer. Spanish consumer groups are currently dealing with the problem of thousands of retail consumers who were mis-sold risky preference shares by Spanish savings banks. The widespread retail holdings of these products have complicated attempts to place the Spanish banking system on a sustainable footing. If ring-fenced banks mis-sell a large amount of these products to retail customers then it is likely to pose a significant barrier to "bail-in" or resolution. Any attempt to impose losses on retail consumers will lead to the bank facing uncertain and potentially large legal liabilities.

31. In recent years a number of banks have sold inappropriate structured products through their retail branches. These have included:

32. Barclays five-year fixed income bond (with the option to invest in an ISA)—This was actually a Barclays corporate bond and exposed the consumer to credit risk of Barclays group. It was advertised as offering a "potentially higher return than most savings accounts".

33. Barclays Defined Returns Plans, which offered returns linked to the performance of the FTSE 100, but actually involved consumers accepting counterparty and credit risk from Barclays Group. These were described to our mystery shopping researchers as "no risk investments" where "your capital is 100% guaranteed"

34. Santander are offering products, including calling a product "Protected capital plus", when it is not subject to the FSCS. The Key Features documents for their structured products are potentially misleading as they include frequent references describing capital as "guaranteed" and describing the individual structured products as a "very low risk investment." We were also concerned that the so-called guarantee was provided by "Santander Guarantee Company" which was in fact dependent on Santander UK. In our mystery shopping, Santander staff described these products as offering "a guarantee on your investment so you can't lose a penny" and "Capital is guaranteed at 100%" and "they'll guarantee your money back".

35. It is also important that both ring-fenced and non-ring fenced banks are not able to sell any other financial product which purports to offer a guarantee of a consumer's capital but which are not covered by the FSCS.

Structured deposits

36. We are also concerned about poor value and misleading structured deposits sold by UK retail banks and building societies. In the short term, structured deposits should be brought within the scope of MIFID and we agree with the Government that extensive use of these products could expose banks to increased risks. There should be limits on the ability of ring-fenced banks to sell structured deposits.

15. *Which categories, if any, of customer should be permitted to deposit with a non ring-fenced bank?*

37. Which? believes that the threshold for high-net worth individuals should be as high as possible. We suggest a figure of at least £2 million net financial wealth (after deducting debt). We do not see any significant benefits to individual consumers from placing their deposits in a non-ring-fenced bank. These “deposits” in the non-ring-fenced bank would not be covered by the FSCS and would not be “preferred” as they would rank equally in line with wholesale creditors in any resolution. In our view, it is very unlikely that these individual depositors will be able to offer any meaningful form of market discipline on these non-ring-fenced banks, by demanding higher returns from riskier banks.

38. We are concerned that a measure of “free and investable assets” with a single bank may provide too much leeway for individuals to be inappropriately advised to use a non-ring-fenced bank. For example, under the Government’s current criteria an individual with a substantial amount of debt outstanding to another bank could meet the definition. By only assessing the level of free and investable assets with one bank, the Government is also ignoring a key recommendation of the ICB that such individuals should not be able to use a bank where even a temporary interruption would have a significant economic cost. Where a customer only has free and investable assets of £250,000 and places them all with a non-ring-fenced bank, any interruption of access to those assets or subjecting them to loss would have a significant economic impact on the individual consumer.

39. There is also the issue that the FSA handbook does not contain any specific provisions regarding the provision of advice to consumers around deposits. This would mean that non-ring-fenced banks would be free to recommend their deposits to any consumer who met the criteria, without assessing the customer’s attitude to risk or investment goals. If the Government decides to proceed with the high-net worth exemption it is imperative that an advice regime for deposits in non-ring-fenced banks is introduced. Finally, we question whether the term “deposit” is an appropriate term to use. There is significant scope for confusion if both non-ring-fenced and ring-fenced banks are allowed to operate from a single bank branch/website. We would prefer a term such as “fixed-interest securities” or “variable-interest securities” so that they are clearly differentiated from insured deposits held in ring-fenced banks.

16. *The Government is considering whether to allow ring-fenced banks to offer simple derivatives to their customers. Should they be allowed to? If so, what safeguards would be necessary?*

40. Ring-fenced banks will have a unique role in providing parts of the economy with credit. If they want to borrow money, consumers and small businesses typically have few alternatives to these banks.⁷⁵ It is important that these banks are not able to take advantage of this unique position by making the provision of a loan depend (or appear to depend) on the purchase of an ancillary product such as insurance or derivatives. This has three important impacts, firstly if ring-fenced banks are allowed to sell derivatives then they could be used to extract value from the ring-fenced bank to the wider group. Secondly, they could make the ring-fenced bank less stable if the money gained from selling the derivative is used to cross-subsidise riskier lending. Thirdly, there is the risk of derivatives being sold inappropriately leading to subsequent payments of redress which might destabilise the ring-fenced bank. These impacts were all caused by the mis-selling of Payment Protection Insurance.

41. Restrictions on ring-fenced banks selling derivatives would not prevent those banks from offering fixed-rate loans. However, they would prevent the bank from selling a consumer a variable rate loan and a separate linked derivative to fix their payments.

17. *Are the proposed corporate governance arrangements between the ring-fenced bank and the wider group sufficient to ensure the independence of the ring-fenced bank? Are these arrangements compatible with directors’ duties and principles of accountability?*

42. This will be impossible to determine until the relevant rules are consulted upon by the regulator. The current draft Bill contains a provision for the PRA to make rules including provision “about the corporate governance of the ring-fenced body with a view to securing as far as practicable its ability to act independently of other members of the group.”⁷⁶ The presence of the term “as far as practicable” will give the regulator a significant amount of discretion to water-down the requirements.

43. We believe that the demonstration of independence is best achieved by requiring the ring-fenced bank to make disclosures as if it were independently listed on the London Stock Exchange. We are concerned that

⁷⁵ Please see Para 58 of the Which? submission to the PCBS for further details about the special features of the market for banking services.

⁷⁶ Draft Financial Services (Banking Reform) Bill, page 8.

under any other proposal, the ring-fenced bank may not be required to disclose appropriate information as it might be part of a much larger banking group such that the information is not considered to have a significant effect on the overall share price of the banking group.

44. The ring-fenced bank should also be required to commission an independent audit of the integrity of the ring-fence and publish this in full alongside its annual report.

45. We are also concerned that in the run-up to the implementation of the ring-fence there may be a lack of clarity about where possible liabilities for legal or regulatory action will lie if they crystallise in the future. It is important that at the process of separation the banking group is unable to load potential future liabilities onto the ring-fenced bank, because of poor past conduct in the wider banking group.

18. *How appropriate are the proposed restrictions on exposures and operational dependencies between the ring-fenced bank and the rest of the group? Will these result in a sufficient degree of independence and resilience?*

46. We support strong restrictions on exposures and operational dependencies between the ring-fenced bank and the rest of the group. The Treasury has delegated the development of these rules to the regulator, which at this stage, makes it difficult to say that these will result in a sufficient degree of independence and resilience.

47. The assumption in the impact assessment that ring-fenced banks will be able to have an exposure to their group of up to 25% of their regulatory capital is unlikely to ensure a sufficient degree of resilience.

19. *Will it be possible to effectively monitor and police the ring-fence, given the degree of regulatory discretion the draft Bill proposes?*

48. The significant degree of regulatory discretion the draft Bill proposes, combined with the inherent complexity of the ring-fencing rules may make it difficult to monitor and police the ring-fence. The Commission should consider the evidence from Andy Haldane, Executive Director of the Bank of England, that complexity in regulation can raise questions about the robustness of the framework. We would also highlight that a complex framework suits those banks which are able to devote significant time and resources into lobbying for changes to the framework. It also makes it more difficult to monitor the performance of the regulator.

20. *How effective will the provisions on corporate governance for ring-fenced banks be in promoting a wider improvement of standards? Should other measures also be considered?*

49. The provisions on corporate governance within ring-fenced banks are, on their own, unlikely to promote a wider improvement of standards.

DEPOSITOR PREFERENCE

21. *Is the proposal to prefer insured deposits in the event of a bank insolvency justified? Is there a case for broadening the scope of deposits which benefit from this protection?*

50. We support reform to the bankruptcy procedures so that depositors become a higher ranked creditor than senior unsecured credit (depositor preference) and so that bondholders become exposed to the true credit risk of the bank that they are lending to. Retail depositors are not well placed to evaluate the credit risk of the bank in which they place their deposits. They are therefore not able to provide the proper incentives to encourage bank management to control risk. It is also important to note that the costs of the FSCS levies are ultimately paid for by bank depositors as a whole or taxpayers.

51. In the Irish banking crisis senior members of the Irish government attempted to reassure senior unsecured creditors by saying that they ranked equally with depositors and that they would not be subject to a write-down unless depositors were affected in a similar way.⁷⁷ This should be extremely worrying for the position of depositors in Irish banks. When the Irish Government introduced its so-called deposit “guarantee” we were clear that there was “no guarantee that the protection that has been offered by the governments in question will be forthcoming. It may be, for example, that the government cannot afford it or decides to exclude overseas savers. Consumers should not move their savings to any foreign country or bank on the strength of these guarantees.”⁷⁸

52. The Government’s chosen form of depositor preference covers only insured depositors and no depositors outside the scope and limits of the deposit insurance system. The uninsured amount of a deposit will be treated as an unsecured senior creditor claim. This approach could have the advantage of limiting the application of depositor preference to the level covered by the FSCS. However, it has the disadvantage of excluding retail depositors who hold levels above the limit from benefiting from depositor preference. This will reduce the willingness of the Government to impose losses on wholesale creditors and bondholders if they rank *pari passu* with deposits above the limit. It is also clear to us that there are many occasions during a person’s life when they need to hold deposits above the level set by the FSCS. These could include house purchase/sale, receiving

⁷⁷ Conference Call, October 2010, <http://www.zshare.net/audio/811167506d52d618/>

⁷⁸ Which? magazine, ‘Keep your money safe’, December 2008.

an insurance pay-out, inheritance or pension lump-sum. We believe that at such times, retail depositors are not well placed to impose market discipline on banks and the loss of a deposit would risk having a catastrophic effect on the individual.

53. We can see a benefit from including charities within the definition of preferred deposits.

54. We are opposed to giving any preference to banks' own pension funds. This would place the retirement benefits of senior executives at the same level as ordinary depositors.

Deposit insurance schemes

55. The events of the financial crisis have shown that the current system does not go far enough to protect consumers. Whilst steps are already being taken to tackle some of the weaknesses in the current system, Which? believes that these reforms need to go further in order to ensure that consumers retain confidence in the banking system. To ensure that this is the case the deposit insurance scheme needs to provide absolute clarity to consumers.

56. The UK retail ring-fencing proposed by the Government increases the need for the deposit insurance scheme to fulfil this objective. If this not the case then consumers may react to the failure of a non ring-fenced bank by withdrawing their deposits from the UK retail ring-fenced bank.

57. Research by the FSA⁷⁹ found that awareness of the UK scheme was very low, even after the collapse of Northern Rock, and almost nobody involved in the interviews or focus groups undertaken knew any details about how the scheme actually worked.

58. If the Deposit insurance scheme proceeds on the basis of coverage per licenced institution, a consumer who has several accounts with different brands covered under the same licence will only be compensated up to £85,000. We are concerned that consumers will not be able to understand the complexities that this approach introduces. Given the plethora of different brands it is extremely difficult for consumers to understand the corporate structure of a bank and determine whether their money is protected. For example, brands including Halifax, Bank of Scotland, Birmingham Midshires, Intelligent Finance, AA Savings and Saga are all covered by a single licence.

59. The lack of consumer understanding was confirmed in research carried out by the UK regulator, the Financial Services Authority, which showed consumers "identified the brands as being different entities, leading to an assumption that all separate brands would be treated separately for the purposes of compensation". The FSA research found that "The discovery that this separation might apply, but could not be taken for granted, was a shock that prompted considerable criticism of both the system and the banks which had a single authorisation across brands. This was seen as unfair at best and underhand at worst, a practice intended to benefit the banks at the expense of their customers." The FSCS awareness campaign was unsuccessful in improving awareness of the scheme because of the complex message it sought to present to consumers.

60. Which? believes that the Government should ensure that deposit protection should be on a per brand basis. We were pleased to see the European Parliament vote through an amendment to the Deposit Guarantee Scheme Directive which will allow national regulators to apply the protection limits to brands rather than institutions. We urge the Government to support this important amendment in Council as the UK and other Member States develop their response to the Parliament's position.

61. There will also need to be clearer warnings for consumers that exceed the deposit protection limit.

CAPITAL LEVELS

22. *Does the draft Bill adequately implement the ICB's recommendations on loss absorbency requirements?*

23. *The draft Bill gives the Government power to direct the way in which the regulators can implement loss-absorbency requirements. How appropriate and well-designed is this power?*

24. *Is the Government's stated intention for the design of loss-absorbency requirements workable? Will it provide a sufficiently well-capitalised banking system? In particular, how justified is the intention to allow an exemption for assets held in overseas operations?*

25. *Is the Government justified in its decision not to implement the ICB recommendation for a higher leverage ratio than is required by Basel III?*

62. We disagree with the Government's proposals to not apply a higher leverage ratio to large ring-fenced banks. This will allow large ring-fenced banks to run substantial and potentially excessive leverage. This poses a substantial risk that taxpayers will be forced to step in to provide them with guarantees in the event of their failure. Recovery and resolution plans can never be credibly used for large institutions as there would be too much of a damaging impact on the economy. For example, Lloyds Banking group⁸⁰ will never be subject to a Recovery and Resolution plan due to the amount of credit it provides to customers. These factors strengthen the argument for applying a higher leverage ratio to large ring-fenced banks.

⁷⁹ Consumer awareness of the Financial Services Compensation Scheme, FSA, January 2009.

⁸⁰ We note that this strengthens the arguments for further restructuring of Lloyds Banking Group.

63. More generally, we are sceptical that setting capital requirements with respect to risk-weighted assets will ever be effective. As noted by the ICB “the amount of capital that banks are required to hold is dependent on the way in which assets are risk-weighted. This produces an incentive for banks to try and exploit this by choosing the riskiest assets for a given risk-weight.” This aspect was also clearly illustrated in the run-up to the financial crisis with banks increasing their leverage in ways which did not show up in the conventional measures of risk-weighted assets and tier 1 capital.⁸¹ The risk of banks undertaking this sort of exploitation of the risk-weighting framework is increased if senior management are given incentives to maximise returns on risk-weighted assets.⁸²

64. More broadly, we are concerned that, in itself, designating a bank as “systemically important” is likely to significantly distort competition. It may provide an unreasonable degree of reassurance to market counterparties, other banks and retail and business customers that the bank will not be allowed to fail. Some consumers believe their deposits to be more at risk in new entrants than in conventional long-standing banks. This impact even extends to supposedly more sophisticated companies who are managing money on behalf of consumers. Hargreaves Landsdown states that when deciding which banks to use for the holding of client money it prefers “those which we believe the government would fully support in any further financial crisis.”⁸³

65. One approach may be to set the additional capital requirements for “systemically important” banks in a way which offset this competitive distortion with an objective to ensuring a level playing field between “systemically important” and “non-systemically important” banks.

RESOLVABILITY

26. *Will the UK authorities have the necessary tools and powers (as a result of this legislation and other initiatives) to be able to resolve a large failing ring-fenced or non-ring-fenced bank, while maintaining financial stability and minimising the risk to public funds?*

27. *What is your assessment of the Government’s preferred design of “bail-in” powers needed to improve bank resolution? How likely is it that the Recovery and Resolution Directive will deliver effective bail-in powers?*

66. The draft Bill does nothing to enhance the likelihood of the UK authorities placing a large failing institution into the resolution process. There appears to have been little consideration of the interaction between competition and stability and the risks posed to both by the overall size and market position of Lloyds banking group.

67. With regard to enhancing resolvability, the introduction of portable bank account numbers could provide the authorities with an important tool. Portable account numbers could enable the quick and easy transfer of accounts from a failing bank. This issue should be considered by Government and regulators by undertaking an independent cost-benefit analysis and technical study alongside other benefits such as enhancements to competition and administrative savings.

IMPACT ASSESSMENT

28. *Is the impact assessment of the costs and benefits credible and balanced?*

29. *Might there be any other unintended consequences which have not been considered?*

68. We are concerned that the word “consumers” in the impact assessment is used to represent retail consumers as well as small/large businesses and investment banking customers. This could lead to misunderstanding that all of the costs of the White Paper reforms will be passed on to UK retail consumers. This will not be the case as the majority of the costs will fall on customers of banks outside the ring-fence—mainly large corporations and other financial institutions. These sophisticated purchasers should be perfectly able to shop around and to reduce the extent to which they absorb any increase in costs. Furthermore, a significant proportion of the customers of non-ringfenced banks will be located outside the UK. The Government should amend the impact assessment to make these points clear.

INTERNATIONAL ISSUES

COMPATIBILITY WITH WTO RULES

69. Which? supports restrictions on ring-fenced banks’ activities outside the EEA. However, we are concerned that large banking groups may use the WTO rules to challenge this restriction. The Government should ensure that the proposed restrictions will not be caught by the WTO rules and also lobby for the rules to be changed.⁸⁴ To ensure that the UK is not challenged in the WTO, the Government should support Ecuador’s proposal for a review of the WTO’s financial services rules.

⁸¹ For a case study concerning the experience with RBS please see page 59 of the *Future of Banking Commission* report.

⁸² For example see http://files.the-group.net/library/barclays/annualreport2010/pdfs/barcar10_remuneration.pdf

⁸³ <http://www.hl.co.uk/investment-services/vantage-service/how-safe-is-your-investment>.

⁸⁴ WTO, General Agreement on Trade in Services, Article XXIX, Annex on Financial Services.

30. *What will be the impact of the proposals on the international competitiveness of UK banks?*

70. London's position as a financial centre needs to derive from its comparative advantage, skilled workforce and infrastructure and not because it is in receipt of implicit or explicit subsidy from the UK taxpayer. Our only hope of hosting a large international banking sector in the UK is to ensure that it does not rely on the taxpayer for support—otherwise we will have to shrink the overall size of the sector. Iceland and Ireland are illustrative of the significant dangers to the national fiscal position of encouraging a significantly over-sized financial sector which ultimately relies on extensive support from the taxpayer. The potential negative impacts on the economy and consumers are increased if banks are able to intertwine essential UK-based activity with international activity.

71. Furthermore, the best way to ensure the international competitiveness of the UK financial sector is to ensure that it faces the full rigour of a domestic and international market with a high level of competition. Any attempts to reduce the level of competition or using government subsidy to insulate certain banks within the UK sector from market discipline are as doomed to failure as policies which attempted to create national champions in other sectors such as the automotive industry or airlines.

31. *Are the proposals consistent with existing and forthcoming international and EU regulatory initiatives, for example the recent Liikanen Report? To what extent are they likely to be superseded or generate conflicts?*

72. With regard to the design of the UK retail ring-fence we would be concerned if UK retail banks could avoid measures to make UK retail banking more stable by transferring ownership to an entity elsewhere in the EEA and using the “branch” model to offer services to UK consumers.

31 October 2012

Written evidence from the Association of Corporate Treasurers

“SIMPLE” DERIVATIVES FOR RING-FENCED BANK CLIENTS

Several aspects of the subject may be important.

- Do smaller companies need access to a provider of non-complex financial derivatives including commodities?
- What should be included among non-complex derivatives?
- What restrictions or safeguards might apply?

CUSTOMER NEED

Need arises in mitigating some risks from companies basic business—in its costs and revenues—the actual exposures being very contingent on its own circumstances and those of the industry in which it operates. It can also arise from its financing.

- Foreign exchange: in revenues and costs or arising from the activity of competitors and, sometimes, from financing.
- Interest rates in financing contracts—including sales finance or leasing, not just borrowings.
- Commodity prices.

For a smaller number of firms—particularly those supplying the government sector or regulated utilities—general inflation hedging may be required. Few companies use credit derivatives.

The ICB's conclusion on derivatives was in prudential terms of reducing the risk to the bank from unrestricted derivative business and this can be justified in terms of the increased exposure of the bank to the other financial institutions from an unrestricted book. It is unlikely that material increased risk to the bank arises from transactions with its own corporate customers. This is for two reasons. Banks restrict derivative business with a corporate client as part of the overall corporate credit exposure management and non-financial firms show low correlation among themselves or relative to financial firms.

To be able to deal derivatives the bank will need to allocate a credit line for the company. A bank that gains a variety of business from the company may be willing to do this but for a small company seeking alternative banks willing to do the occasional transaction is difficult. Small companies will normally have a limited number of bank relationships.

Of course, if ring-fenced banks that deal with a customer routinely cannot provide derivatives, the firms would have no alternative but to turn to other providers—non-banks or non-ring-fenced banks, but this will not be easy. This should remain a possibility for companies but smaller companies should recognise the need for care here.

PROTECTION OF THE BANK

On prudential grounds we see no reason for further safeguards for ring-fenced banks from dealing with corporate clients and the consequential transactions in laying off with other financial firms any arising (net) positions of the bank.

However, on conduct grounds further safeguards may be appropriate. Mis-selling may give rise to financial and reputational costs that may begin to have repercussions on a bank's credit standing.

PROTECTION OF THE SMALLER CORPORATE CUSTOMER

Perhaps smaller customers (other than those especially qualified) may need explicit protection from mis-selling by the bank as well as reform to some banks' culture. Smaller customers run the risk of being charged exorbitant prices for financial services and products but this is no different from any other procurement decision. The onus is on the customer to seek alternative quotes and to negotiate on pricing.

The finance staff of smaller firms are, if qualified at all, often from an accounting background and with some experience in the operational aspects of smaller firm financing. Rarely will they have significant relevant experience or education in financial price risk management or in other financing contracts. They lack the conceptual frameworks against which to evaluate novel proposals. This may remain true to some extent even for companies with several hundred millions of turnover. Good external advice is often difficult for firms to buy-in. Understanding advice (bought in or from a well-intentioned bank) may be difficult. It is unlikely that other senior staff of the firm from other disciplines will have much ability or willingness to help.

So this raises the question of conduct requirements for banks dealing in this area.

Of course, the ICB proposed that ring-fenced banks might provide non-complex derivatives, simple derivatives.

What might be meant by simple derivatives?

First, outright forward contracts to buy or sell or for settlement of movements in prices (non-deliverable forwards, forward rate agreements, etc.) and similar clearly qualify.

For a broader picture, it is necessary to understand the nature of most corporate exposures. Most corporate exposures are of a contingent rather than outright nature. For example, an exporter selling in foreign currency may publish a price list annually and will be able to estimate its likely sales, but cannot be absolutely certain. Where an exposure is small, these contingencies may not be seen as material. But if the exposure is large in the context of the firm, the contingent exposure can be important. This may be seen starkly with a small auto-components supplier selling to continental European vehicle assemblers. Such contracts are usually placed for several years on a "call-off" contract basis. If the supply is not called off, no sale is ever made. If it is, the fixed price agreed at the outset applies: small firms have little leverage to require customers to carry the risk of price movements during the life of a contract. The supplier probably needs a currency option for this type of protection. Academic studies suggest that companies grossly under-hedge generally and use options far too little—usually because firms are unfamiliar with their use and perceive them as "expensive".

Straight forward options bought by the customer should be seen as included in "simple". There is an upfront cost to a bought option so this in itself will discourage companies that do not properly understand the product.

However, any option in a derivative that may be exercised *by the bank* should make it "complex". Smaller firms (and some larger ones too) usually lack the systems and expertise to manage financial price options granted to others. This also applies to "knock in" or "knock out" or so-called "low cost" options. It would not prevent a firm buying an option with an exercise price less favourable than the relevant price at the time of entering into the option—this just representing the firm saying it can cope with a small but not a large adverse fluctuation.

It may be argued that a further safeguard might be in the area of excessive length of hedge—e.g. where a bank insists that a borrower hedge interest rates on a five-year floating rate loan for 20 years without especial justification. The credit risk for the bank in a long hedge should make it reluctant to enter into such contracts for small firms unless the bank has an early termination option. But such an option would make it a complex derivative (see above) in any case.

We think generally that it would be unreasonable to require a bank to substitute its own judgement as to the appropriateness of the product for what ought rightly to be the judgement of the company. But a bank could be required to tell a company if it was asking for an unusually large (time or money) hedge and ask it to confirm that it really did want to proceed. In the investment field, the Markets in Financial Instruments Directive requires banks, for some clients, to consider appropriateness and suitability of what is being considered., but that might represent an extra burden for both bank and customer.

Of course a bank should have agreed with the company proper arrangements for verifying instructions from the company and exchange of confirmations and for supply of statements of outstanding positions etc. with the company.

More broadly, as part of their marketing to smaller firms and as a socially useful activity, banks can and do provide simple training matter to smaller clients using derivatives.

1 November 2012

Written evidence from HM Treasury

1. In the Commission's letter to the Chancellor, further information was requested on how the Treasury would use specific proposed powers set out in the draft Banking Reform Bill, and a summary of relevant European legislation.

2. First, this note sets out the Government's legislative approach and supplies further detail on those powers of which the Commission asked for more information. As requested, it then also sets out the proposed powers to amend primary legislation via statutory instrument in the Bill. Detail on how other ICB recommendations are to be implemented can be found at the end of this paper.

3. Annex A to this paper sets out the implementation vehicles for Independent Commission on Banking (ICB) recommendations. Annex B sets out detail on relevant EU legislation with regard to the draft Bill, as requested by the Commission.

THE LEGISLATIVE APPROACH TAKEN IN THE DRAFT BILL

4. The draft Financial Services (Banking Reform) Bill makes provision for a number of the recommendations made by the Independent Commission on Banking (ICB). These are:

- the ring-fencing of core⁸⁵ activities;
- a power for HM Treasury to make an order in relation to the debt component of Primary Loss Absorbing Capacity (PLAC), and;
- the introduction of depositor preference.

5. The provisions within the draft Bill are mostly in the form of enabling powers. The regulation of banking, like regulation of other forms of financial services and markets is very complex, and highly technical. Regulation operates against a background of markets for financial products which are continuously developing, sometimes very rapidly.

6. In order to give regulators the tools to respond effectively to innovation within the sector, the Treasury believes that the most appropriate way in which to deliver a ring-fence that is robust and remains so over time is to set out in primary legislation the objectives and principles of the ring-fence, and to define the principal activity which should be within the ring-fence (accepting deposits), and the principal excluded activity but to determine the precise details of the ring-fence via secondary legislation.

POWER TO EXEMPT SOME INSTITUTIONS FROM THE DEFINITION OF A RING-FENCED BODY (142A)

7. As set out in the white paper, the Government believes there is a case for an exemption from the requirements of ring-fencing for certain firms. These are firms where ring-fencing activities would likely make only a small difference to the possibility of resolving those firms without taxpayer support, or insulating those activities from financial shocks, but potentially have a large marginal cost relative to other firms, and so affect their ability to compete effectively. The Government believes that the most appropriate measure would be the size of deposits which qualify as core for the purposes of ring-fencing

8. The Government believes that a threshold set at £25 billion of core deposits (or 1.8% of GDP) is an appropriate pro-competitive threshold below which firms would not be required to ring-fence their deposits from individuals and SMEs.

9. The *Sound Banking* paper set out that this power is proposed in order to deliver this de minimis exemption for smaller banks. In addition, secondary legislation made under this power would set out:

- the final amount of core deposits which the Government thinks appropriate for the exemption;
- the way in which this is to be calculated (for example whether set as a nominal cash amount or as a proportion of GDP, and/or whether as a point-in-time figure or (more likely) an average level over a set period); and
- to establish the arrangements for banks that grow to be above the threshold level, requiring banks to have the ring-fence in place within a specified period of time after their core deposits exceed the minimum threshold. Flexibility over time is required in order to respond to changes in banking practice, and growth in the size of the deposit base.

⁸⁵ Referred to as "mandated" activities by the ICB.

POWER TO SPECIFY THE CIRCUMSTANCES IN WHICH ACCEPTING DEPOSITS IS NOT TO BE A CORE ACTIVITY (142B)

10. The ICB referred to mandated activities, by which they meant those that had to be within the retail ring-fence. In the draft Bill, mandated is referred to as “core” activities. The Government agreed in the white paper that the only specified core activity at this time is the accepting of deposits and so only this core activity is on the face of the Bill.

11. Like the ICB, the Government believes that core deposits should be ring-fenced when:

- A short term interruption of provision would have a significant impact on UK households and SMEs; and
- Capacity cannot easily be substituted in the short term.

12. The ICB recognised that for some depositors, these conditions would not necessarily be met. The Government agrees that such depositors should be well-placed to make alternative provision and so intends to use this power to:

- provide for deposits from larger companies to be held outside of ring-fenced banks if those customers wish; and
- set a level of net worth, beyond which individuals may choose whether or not to place deposits in ring-fenced banks or non-ring-fenced banks.

13. *This is not a requirement.* Both corporates and high-net worth individuals (HNWI) will be entitled to place their deposits inside the ring-fence should they wish. Indeed, in the case of HNWI the default will be that they are *inside* the fence; they will be required to self certify that they are cognisant of the risks and benefits, in a process similar to that for individual investors under the Markets in Financial Instruments Directive (MiFID).

14. The secondary legislation will specify the measure at which an individual is classified as a HNWI. The Government set out in the white paper it believes that it should be between £250,000 and £750,000 of free and investable assets with a single bank. Further policy work is required to determine the final amount, which will be a matter for secondary legislation. An order under this power will also specify how this level of wealth is measured as there is no commonly accepted definition of “free and investable” assets. The Government does not intend to include illiquid assets such as residential property in this definition. The Government proposed in the white paper that individuals should only qualify as HNWI if their free and investable assets exceed the threshold for a period of at least 12 months. This is the approach used in the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 with regard to defining a HNWI for the purposes of that Order.

15. An Order made under new section 142B will also set a threshold above which organisations should have the option (but not the obligation) to place their deposits outside the ring-fence. The white paper proposed to use the Companies Act definition of an SME as a basis for this threshold, using a threshold for annual company turnover between £6.5 million and £25.9 million. The Treasury is undertaking further analysis on the exact level, and the Order will specify the threshold. This includes:

- how it is to be measured (for example over what period, and how calibrated for organisations to whom the definition of “turnover” in the Companies Act may not apply); and
- the arrangements that should apply to organisations that either grow to be above the threshold (for example, requiring that banks wishing to invite such customers’ to move deposits outside the ring-fence provide them with full information about the proposed move, and obtain the customers’ written consent to any move), or
- arrangements for those organisations which sink beneath the *de minimis* (for example, requiring that banks notify customers that they are no longer eligible to deposit outside the ring-fence and take steps to move or close their accounts within a specified period of time).

POWER TO SPECIFY CIRCUMSTANCES IN WHICH DEALING IN INVESTMENTS AS PRINCIPAL IS NOT TO BE AN EXCLUDED ACTIVITY (142D(2))

16. Dealing in investments as principal (a regulated activity as per the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001) cannot be undertaken in the ring-fenced bank. This is as the ICB recommended, as they felt these activities impede resolution and directly increase the exposure of the ring-fenced bank to global financial markets. The Government agrees.

17. However, the ICB identified ancillary activities, which are those necessary for the purposes of managing balance sheet risks, liquidity management and raising funding in the course of providing core activities. It was their view that ring-fenced banks must be able to undertake risk management: the accepting of deposits and extending of loans is inherently risky, and ring-fenced banks need access to suitable instruments in order to manage this risk. It is the Government’s intention to ensure that ring-fenced banks can manage liquidity, interest rate risk, credit risk and other risks which may require them to hold derivative products or other assets on their own account.

18. The draft Bill does not refer explicitly to ancillary activities, but rather provides for this policy intent through the power in new section 142D(2) to set out circumstances under which excluded activities could be undertaken by the ring-fenced bank. An Order made under this power will specify the circumstances in which excluded activities are permitted, and conditions attached to this permission. The Treasury is continuing to work on these conditions. For example, the secondary legislation may permit the holding of certain instruments that are held for the express purpose of meeting regulatory requirements to maintain a buffer of liquid assets. The conditions under which such exemptions may be granted include, for example that all derivative contracts permitted must be centrally cleared and/or be subject to specific collateralisation requirements. Similar conditions are discussed in more detail in the white paper (pp 21–23).

POWER TO PROVIDE FOR ACTIVITIES, OTHER THAN DEALING IN INVESTMENTS AS PRINCIPAL, TO BE TREATED AS EXCLUDED ACTIVITIES AND TO CREATE EXCEPTIONS TO ANY NEW EXCLUDED ACTIVITY (142D(4))

19. The ICB recommended that banks should not be allowed to deal in investments as principal—for example originating, trading, lending or making markets in securities, including equity securities, debt securities, derivatives and asset-backed obligations—within the ring-fence. The Government agrees and has made this an excluded activity, set out on the face of the Bill. The power set out here makes provision for the Treasury to exclude further activities from being undertaken within the ring-fenced bank. This provision gives the Treasury flexibility to respond to innovation in the financial sector over time—this is in part future proofing.

20. Further policy work is being undertaken to comprise the activities HMT would wish to exclude in addition to the exclusion on the face of the Bill. The ICB recommended that the following be excluded:

- any service which would result in a trading book asset;
- any service which would result in a requirement to hold regulatory capital against market risk;
- the purchase or origination of derivatives or other contracts which would result in a requirement to hold regulatory capital against counterparty credit risk; and
- services relating to secondary markets including the purchase of loans or securities.

21. The ICB said that these restrictions would result in the following activities being excluded from ring-fenced entities:

- structuring, arranging or executing derivatives transactions, as agent or principal,
- investing in stock, corporate debt securities, convertible/exchangeable securities, convertible bonds, partnership interests, mutual funds, exchange traded funds etc.;
- originating, trading, lending or making markets in securities; and
- underwriting the sale of debt and equity securities, including private placements.

22. Many of these activities are captured under the regulated activity of trading in investments as principal. Where not, the Government will make additional exclusions to capture the intention of the ICB recommendations, and the activities described above.

23. Excluded activities need not be regulated activities.

POWER TO PROHIBIT RING-FENCED BANKS FROM ENTERING INTO SPECIFIED TRANSACTIONS, ESTABLISHING BRANCHES IN SPECIFIED COUNTRIES OR TERRITORIES, OR FROM INVESTING IN SPECIFIED COMPANIES (142E)

24. The ICB identified the interlinkages between different parts of the financial system as one of the key challenges to making banks resilient and resolvable. Consequently, they recommended that the ring-fence bank should be insulated more widely from the rest of the financial system. The Government agrees that the ring-fenced bank must be credibly and easily separable in a period of stress and able to demonstrate its operational independence at all times.

25. The proposed power here is intended for the Treasury to meet this policy commitment in three distinct ways.

26. Firstly, the ICB said that ring-fenced banks should be restricted in their dealings with financial institutions. The Government agrees that ring-fenced banks' exposures to financial institutions should be restricted. It proposes to achieve this through the power granted under 142E(1)(a). The Government believes that at a minimum, secondary legislation made under this power would restrict dealings with:

- non-ring-fenced banks, or banks that engage in otherwise prohibited activities;
- investment firms;
- funds and fund management companies; and
- insurance companies.

27. However, where the potential costs are more finely balanced against the benefits, prohibition may not be appropriate, for example with friendly societies and small mutual insurers.

28. Orders made under this power will specify the definition of “financial institution” for the purposes of this prohibition: the white paper proposed that the definition be cast in terms of activities set out in the Financial

Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO). An order under new section 142E(1)(a) could thus define a “financial institution” as any person who undertook any of a list of regulated activities, with exemptions for bodies such as friendly societies and small mutual insurers where appropriate.

29. Orders made under this power will also deal with circumstances where the prohibition does not apply, for example the facilitation of payments, which the ICB recommended be permitted as ring-fenced banks may be clearing banks for these types of firms.

30. The ICB noted that cross-border activities can pose a significant threat to resolvability. In order to reduce this threat, the Government proposes, through use of orders under 142E(1)(b) and 142E(1)(c), to ensure that ring-fenced banks should not carry out any banking activities through non-EEA subsidiaries or branches, where this would present risks to the resolution of ring-fenced banks. Where arrangements are in place that reduce such risks, such as mutual recognition of resolution decisions, a blanket prohibition would not be necessary. The Order is therefore likely to limit the ability of ring-fenced banks to have non-EEA subsidiaries or branches except in approved circumstances, and determine the way in which such subsidiaries or branches may be approved.

POWERS TO AMEND PRIMARY LEGISLATION VIA STATUTORY INSTRUMENT

31. The Commission asked about powers to amend primary legislation via statutory instrument in the draft Bill. The Government proposes two such powers.

32. The first is under Clause 4, S142K. This proposes that the Treasury “may by order make such amendments of the legislation as appear to them to be necessary or expedient for the purpose of ensuring that the carrying on of core activities by a ring-fenced body that is a member of a group is not adversely affected by things done or committed by other members of the group.”

33. The ICB identified circumstances under which a liability could be placed on a ring-fenced bank by action taken or not taken by the non-ring-fenced part of the bank. At the limit, this could be sufficiently severe to threaten the viability of the ring-fenced bank. The example given by the ICB was the existence of joint and several liability for VAT liabilities to which members of VAT groups are subject. There may be other cases where this applies, and the power assists with future proofing.

34. The second is Clause 6 on building societies. Having listened to the sector, the Government has agreed that in order to maintain the unique identity of building societies, they should be effectively ring-fenced through amendment to the Building Societies Act 1986, rather than this legislation. That Act already imposes restrictions on the activities which may be undertaken by building societies (in section 9A), preventing them, for example, from entering into transactions involving derivative investments except in specified circumstances. The Government proposes to align these restrictions with the provisions to be made in relation to excluded activities and prohibitions for ring-fenced banks.

ICB MEASURES NOT IN THE DRAFT BILL

35. Two sets of recommendations are not included in the draft Bill. The first set are those recommendations which the ICB noted would be delivered through non-legislative means:

- the Financial Services Authority (FSA) and the Bank of England are conducting reviews of the prudential and conduct requirements for new entrants to the banking sector. The reviews will reassess the prudential requirements of the new Prudential Regulation Authority (PRA) and the conduct requirements of the new Financial Conduct Authority (FCA) to ensure that they are proportionate and do not pose excessive barriers to entry or expansion for new entrants and prospective new entrants to the banking market. The conclusions of the reviews will be published when the FSA and the Bank of England set out the detail of the new supervisory models for the PRA and FCA. Where possible, the FSA and the Bank of England have committed to introduce these changes in advance of the new regulatory structure;
- the Government actively engaged with the European Commission and Lloyds Banking Group (LBG) to ensure that the divestment of part of LBG’s business resulted in as strong a challenger bank as possible. The forthcoming sale to the Co-op will deliver this;
- the Government has continued to hold the banking industry to account on its commitment to implement a new current account redirection service to enhance the process for individuals and small businesses who wish to switch their bank account to a new provider. To date, banks representing more than 97% of the current account market have committed to being ready to launch the seven day switching service in 2013. The service will be free to use and provide a guarantee that no customer will suffer any financial loss if any mistakes occur; and
- the FSA has committed to carry out a fundamental review, in early 2013, of how it can promote greater transparency in the way it and its regulated firms operate in order to better serve the interests of consumers.

36. The second set are those which are legislated for in other ways than through the Banking Reform Bill:

- the Government amended the Financial Services Bill, prior to introduction to Parliament on 27 January 2012, to recast the FCA's efficiency and choice operational objective as "promoting effective competition in the interests of consumers" (the exact wording recommended by the ICB) and also retained the competition duty for the FCA.
- A bail-in power will be delivered through the EU's Recovery and Resolution Directive (for more on which, please see the separate note on relevant EU regulation). As the task of resolving large cross-border banks is complex, it is important that the UK works with other countries to design a broadly consistent bail-in tool which can work in relation to the resolution of cross-border institutions. HMT is working with European partners to develop a credible and usable bail-in tool that meets the ICB's objectives as part of the RRD.
- The ICB recommended that banks should hold both extra capital and loss-absorbing debt—in combination referred to as "primary loss absorbing capacity (PLAC)". Following the ICB recommendation, the Government has agreed that large ring-fenced banks should be required to hold an equity capital buffer (3% of RWA) beyond the Basel III minimum standards (7% of RWA). The Basel III capital standards framework is to be implemented in Europe through the Capital Requirements Directive (CRD) IV and Capital Requirements Regulation (CRR)—the UK has secured agreement at the European Council level for member state discretion to set additional equity buffers of this size.

Annex A**ICB RECOMMENDATIONS AND IMPLEMENTATION VEHICLE**

<i>Structural reform</i>	
Ring-fencing of vital banking services	Banking Reform Bill
<i>Loss-Absorbency</i>	
Equity requirements	European Capital Requirements Directive 4/European Capital Requirements Regulation
Leverage ratio	European Capital Requirements Directive 4/European Capital Requirements Regulation
Primary loss absorbing capacity	European Recovery and Resolution Directive, where there is disgression implemented in the UK via the Banking Reform Bill
Bail-in power	European Recovery and Resolution Directive
Depositor preference	Banking Reform Bill
<i>Competition</i>	
Credible challenger from the Lloyds divestment	Sale of the divestment business "Verde" to Co-op Bank
Barriers to entry	FSA and Bank of England reviews which will be published before Christmas. Where possible, the FSA and the Bank will introduce changes in advance of the new regulatory structure.
Switching	Industry led. Banks representing more than 97% of the current account markate have committed to being ready to launch the seven day switching service in 2013.
Transparency	The FSA has committed to carry out a fundamental review in early 2013 of how it can promote greater transparency.
FCA competition duty	The Government amended the FS Bill prior to introduction so that the FCA now has an objective of "promoting effective competition in the interests of consumers", the exact language recommended by the ICB
Market investigation reference	The ICB recommended that this should be made in 2015, should the other recommendations listed here not be achieved.

Annex B**DRAFT BANKING REFORM BILL AND EU LAW***Capital Requirements Directive and Regulation*

1. The Commission issued proposals in July 2011 for the Capital Requirements Directive IV (CRD4) and a Capital Requirements Regulation (CRR)⁸⁶, which will replace the current Capital Requirements Directive⁸⁷ and transpose the Basel III rules into EU law. As the CRR is a regulation, its provisions will be directly applicable in all member states.⁸⁸ The proposals are still under negotiation, but a Council "General Approach" was agreed in May 2012.

⁸⁶ http://ec.europa.eu/internal_market/bank/regcapital/new_proposals_en.htm

⁸⁷ Directives 2006/48/EC and 2006/49/EC.

⁸⁸ The general "own funds" requirements are set out in Article 87.

Rules on capital

2. The CRR sets out the “Pillar 1” own funds requirements which banks must hold in respect of certain types of risk (credit, market, operational and settlement risk). “Own funds” means the sum of Tier 1 capital, which consists of Common Equity Tier 1 (“CET1”) and Additional Tier 1 capital and Tier 2 capital⁸⁹ and the requirement is to maintain a level of “own funds” equal to a total of at least 8% of risk-weighted assets (of which at least 4.5% must consist of CET1 capital)⁹⁰. Banks are required to comply with the own funds requirements on an individual basis and, in specified cases, on a consolidated basis⁹¹.

3. In addition to the Pillar 1 requirements, CRD4 will require banks to maintain a capital conservation buffer and a countercyclical capital buffer consisting of CET1 capital, which aim to ensure sufficient capital is built up to absorb losses in stressed periods.

4. As part of its agreed General Approach, the Council has included in CRD4 a discretionary power for member states to introduce a “Systemic Risk Buffer” requirement⁹², consisting of additional CET1 capital. Under this provision, member states would be free to introduce an additional buffer requirement of up to 3% for the banking sector as a whole, or a subset of that sector, to prevent or mitigate long term systemic or macro-prudential risks, as long as certain conditions are met. Member States may only introduce a buffer above 3%, with the Commission’s prior approval (on the basis of assessments which may be provided by the European Systemic Risk Board and European Banking Authority). Subject to this provision remaining in CRD4 as finally adopted, it is intended that the “systemic risk buffer” should be used to implement the ring-fence buffer.

Pillar 2 requirements.

5. In addition to the Pillar 1 requirements and additional buffer requirements described above, competent authorities continue to have power to impose additional capital requirements on banks on an individual basis, following a supervisory review, where there are concerns that a bank does not have sufficient own funds to cover the risks to which it is exposed, and the risks which it poses to the financial system⁹³.

6. The “Pillar 2” power to impose additional own funds requirements is limited in some ways:

- (a) the power is intended to be used to impose additional requirements on an individual basis, following an individual supervisory review (although there is some scope to apply the process to a number of banks with similar risk profiles⁹⁴);
- (b) additional own funds requirements cannot be imposed on a permanent basis;
- (c) the power can only be used if the relevant tests are met; and
- (d) the power only includes the ability to impose additional own funds requirements to the extent that the risks, or elements of risks, are not covered by the Regulation.

7. The PRA, as the UK competent authority, will be responsible for applying EU rules on capital requirements to all banks authorised in the UK (including banks classed as systemically important financial institutions), as their home-state regulator. It will be able to impose additional capital requirements on such banks following a supervisory review of the bank in accordance with the Pillar 2 rules.

Liquidity

8. The CRD4 contains a general requirement that banks must have robust policies to deal with liquidity risk⁹⁵. The CRR⁹⁶ provides for a uniform liquidity coverage requirement to be introduced in 2015 by the Commission, after an initial review period during which banks will be required to ensure they have appropriate liquidity coverage in accordance with national law. Banks will be required to comply with the liquidity provisions in the CRR on an individual basis⁹⁷. Under the Commission’s original proposals, competent authorities were required to waive this rule in relation to groups where certain conditions were met, but the Council has agreed in its General Approach that this waiver should be discretionary⁹⁸. It should therefore be possible for the regulator to apply liquidity rules to ring-fenced banks on an individual basis. The CRR also imposes certain reporting requirements in relation to liquid assets and banks are also required to report on the availability of stable funding, in relation to which the Commission is expected to bring forward proposals for uniform rules on a net stable funding requirement by 2018.

⁸⁹ Articles 24 to 47 determine what items may be included as Common Equity Tier 1, adjustments and deductions which must be made and available exemptions and alternatives. Articles 48–58 contain the relevant rules on Additional Tier 1 capital and Articles 59–68 cover Tier 2 capital.

⁹⁰ The required ratios for each type of capital are set out in Article 87 CRR.

⁹¹ See in particular, articles 5 and 10 CRR.

⁹² Article 124a and 124b of the Council General Approach text.

⁹³ See in particular Articles 92 and 100 CRD4.

⁹⁴ Article 95 of the original Commission proposal (Article 99a of the General Approach).

⁹⁵ Article 84 CRD4.

⁹⁶ Part 6—articles 401–417; and see also Parts 9 and 10 CRR containing relevant provisions on delegated acts and reviews.

⁹⁷ Article 5 CRR.

⁹⁸ Article 7 CRR.

Large exposure rules

9. A “large exposure” is defined as an exposure to a client or group of connected clients which is equal to or exceeds 10% of its “eligible capital” (CRR art 381). Under CRR “eligible capital” is the sum of tier 1 capital (including additional tier 1 capital) and tier 2 capital (see CRR art 4(23)). The basic rule is that a bank may not incur an exposure to a customer or group of connected clients which exceeds 25% of its “eligible capital” CRR Art 384 (after taking into account the effect of applicable credit risk mitigation). There are rules giving smaller firms some flexibility in relation to inter-bank exposures.

10. There is an exemption from the large exposure limit in (CRR art 389(1)) for exposures to counterparties listed in para 6 or 7 of article 108 CRR if they would be assigned a risk weight of 0% under the standardised approach. This includes other members of the same group if certain conditions are met (and subject to the approval of the regulator).

- (a) the counterparty is an institution or FHC (etc) subject to appropriate prudential standards;
- (b) the counterparty is included in the same consolidation as the bank or investment firm on a full basis;
- (c) the counterparty is subject to the same risk evaluation, measurement and control procedures as the bank or investment firm;
- (d) they are established in the same MS;
- (e) there is no current or foreseen material practical or legal impediment to the prompt transfer of own funds or repayment of liabilities from the counterparty to the bank.

11. But the regulator will have discretion as to whether to assign a 0% risk weight. If it does not, the exposure is treated as a third party exposure.

12. In addition, CRR art 389(2)(c) permits the regulator to exempt exposures to other members of the group fully or partially, where they are covered by supervision on a consolidated basis or equivalent standards enforce in third country.

13. The intention is that limits on intra-group exposures for ring-fenced banks should be treated as if the exposure was to a third party, rather than a member of the same group. The regulator has power to apply this principle under the rules on large exposures in CRR.

Disclosure

14. The CRR imposes various public disclosure requirements on banks (which include requirements to disclose information on risk management, own funds, capital requirements, exposure to counterparty credit risk, capital buffers, credit risk adjustments, ECAIs, exposure to market and other risks, and remuneration policies).⁹⁹ In addition, credit institutions are subject to requirements to report every large exposure they have to the regulator in accordance with Article 383. Additional or more frequent reporting requirements may be imposed by the regulator under Pillar 2.

RECOVERY AND RESOLUTION DIRECTIVE*(a) Bail-in*

15. The Recovery and Resolution Directive (RRD), as published, will make provision for a bail-in tool.¹⁰⁰ As currently drafted, it will require Member States to ensure that the resolution authorities (in the UK, primarily the Bank of England, though the Treasury also has some resolution powers) have powers to bail in¹⁰¹ institutions; and to ensure that institutions maintain a sufficient aggregate amount of own funds and eligible liabilities. The RRD will also determine what liabilities are to be subject to the bail-in tool; provide for a minimum requirement for such liabilities and set out rules for the implementation of the bail in tool (determining, for example, the hierarchy of such claims to be applied, and how liabilities arising from derivatives are to be treated).

16. Clause 142J of the Bill gives the Treasury power to set conditions on the regulator’s powers to require banks to issue debt instruments, or debt instruments of a particular type. This would enable the Treasury to ensure that UK banks (including those banks which are ring-fenced bodies) are required to issue debt instruments which are eligible for being bailed in. It will also enable the Treasury to ensure that the UK banks are required to issue a sufficient quantity of debt instruments to improve their loss absorbing capacity in line with the ICB recommendations. However, in exercising that power, the Treasury will need to comply with its obligations under the RRD, when that directive comes into force. It would not be possible, for example, for the Treasury to provide that the regulator could not require UK banks to issue the minimum eligible liabilities requirement set by the RRD.

⁹⁹ Part 8—articles 418–440.

¹⁰⁰ See Articles 37 to 50.

¹⁰¹ For example, powers to write down or convert debt instruments to shares; to reduce the principal amount of or outstanding amounts of eligible liabilities; or to cancel debt instruments or shares of an issued by an institution under resolution.

(b) *Depositor preference*

17. Article 99(2) of the RRD as initially proposed provided that “Member States shall ensure that, under the national law governing normal insolvency proceedings, the deposit guarantee schemes rank *pari passu* with unsecured non-preferred claims.” The effect of this provision would be to make it impossible to give effect to depositor preference in the way recommended by the ICB. Under the rules of the financial services compensation scheme (the FSCS) (which is the deposit guarantee scheme for the UK), depositors will assign all claims to their deposits to the FSCS (in some case the FSCS may be subrogated automatically to the depositors’ claims)¹⁰². When the FSCS is bringing a claim in insolvency, it benefits from any preference given to the depositor. This would be prohibited by Article 99.2. The government is seeking an amendment to the directive to remove this provision. In the event that this amendment is not accepted, it would be necessary to amend the Bill to remove clauses 7 and 8.

FREE MOVEMENT OF CAPITAL

18. Under Article 63 of the Treaty on the Functioning of the European Union, all restrictions on the movement of capital between member states and between member states and third countries shall be prohibited. Article 65 provides for exceptions to this principle in relation to measures taken by member states, *inter alia*, to prevent infringements of national law and regulations in the field of the prudential supervision of financial institutions, or measures which are justified on grounds of public policy or public security. Under paragraph 3 of Article 65, it is made clear that such measures may not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments.

12 November 2012

Written evidence from the Bank of England

RESOLUTION AND RING FENCING

Changes to the statutory regime for resolution

1. The key legislative changes relevant to bank resolution that will arise from the Government’s implementation of the recommendations of the Independent Commission on Banking are:

- ring fencing of banks providing core insured-deposit services, as provided for in the draft Banking Reform Bill;
- a requirement for extra loss-absorbing capacity, in the form of debt or equity, in both ring-fenced banks and at consolidated level for groups containing a ring-fenced bank, which will come via CRD4 implementation; and
- insured depositor preference.

2. Those reforms need to be seen in the wider context of other prospective developments in the resolution regime. Those changes stem from the Financial Stability Board’s *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Key Attributes), which was endorsed by G20 Leaders as an international standard in November 2011.¹⁰³ The Key Attributes set out, amongst other things, the essential elements of a resolution regime’s legal framework and powers, including for the resolution of global systemically important financial institutions (G-SIFIs). Broadly speaking, the US has already acquired the necessary powers through Dodd-Frank. In Europe, the Key Attributes are currently scheduled to be incorporated into law via the proposed Recovery and Resolution Directive (RRD).¹⁰⁴ Two elements of this wider regime are worth highlighting. First, resolution powers are to be extended to bank holding companies; that is already being effected in the UK via the Financial Services Bill. Second, the RRD powers include a “bail-in” resolution tool, under which, once the equity of a distressed bank was exhausted, the Resolution Authority could write down debt claims in order to cover expected losses and could convert part of the residual debt into equity to recapitalise the distressed firm (or a successor entity). The Government plans that that power will be incorporated into UK law as part of its implementation of the RRD; it sensibly waits until then because the RRD will remove some impediments to resolution arising currently from other EU directives.

Resolution strategies

3. The Financial Services Act 2010 requires banks to submit recovery and resolution plans to the FSA (the PRA in future), which has to consult the Bank’s resolution team and HMT on this. The Key Attributes require resolution plans to be drawn up for G-SIFIs by home and key host authorities working together. Recently the FSB has issued a consultative document that, amongst other things, sets out two broad types of resolution strategy (with a spectrum in-between):¹⁰⁵

¹⁰² See section 7 of the COMP part of the FSA Handbook.

¹⁰³ See http://www.financialstabilityboard.org/publications/r_111104cc.pdf

¹⁰⁴ See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52012PC0280:EN:NOT>

¹⁰⁵ See also FDIC, Resolution Strategy Overview, January 2012 http://www.fdic.gov/about/srac/2012/2012-01-25_resolution-strategy.pdf

- Single point of entry (SPE) resolution involves the application of resolution tools by the home authority at the top of a G-SIFI group to resolve problems in the group as a whole.
- Multiple point of entry (MPE) resolution involves the application of resolution tools by a number of home and host resolution authorities to multiple companies in the group, with the overall plan co-ordinated by the home authority.

4. Which type of resolution strategy is better for a particular group will depend on the structure of the group, the nature of its business, and the size and location of the group's losses. For an "SPE" resolution to be appropriate, loss-absorbing instruments must have been issued at the top of the group and be available to cover losses in the group's subsidiaries. This is achieved by imposing losses, for example through a bail-in, on the external creditors of the parent holding company and writing down the value of loans from the parent to its operating subsidiaries in a manner that ensures those subsidiaries remain solvent and viable. For "MPE" to be appropriate, it needs to be feasible to separate the group financially, operationally and legally along national or regional lines, and then for each distressed entity to be resolved on a stand-alone basis. The parts might be resolved using bail-in of external debt or other resolution techniques.

5. In either case, for bail-in to be the chosen resolution tool there needs to be sufficient loss-absorbing capacity in the relevant legal entities. The planned PLAC requirement helps this. But another precondition for the use of a bail-in resolution tool is that it is possible to form a reasonably good estimate of the size of the group's losses. In those cases where a group was toxic through and through, that would not be possible. Instead, the distressed business would need to be broken up into critical and less critical parts. In those circumstances, ICB-style ring-fencing of the domestic retail deposit-taking business comes into its own, as described below. The utility to the resolution strategy of the ring-fence of core services will be especially evident in such cases, where an SPE resolution from the top of the group was not feasible.

6. The rest of this note covers the specific questions raised by the Committee. An annex sets out how, on the current state of resolution thinking, the Bank would be likely to address the two case studies set out in the annex to the Committee's letter.

Questions 1 & 2: Which critical economic functions would you seek to protect? What resolution tools would you expect to use to achieve this, and how would they be applied?

7. In the case of a ring-fenced bank, the key operations would include deposits and payment services. In the case of the non-ring-fenced bank, it would be likely to include any international payments functions, clearing and settlement functions, and possibly wholesale market and capital markets activities where the firm had a dominant position in key markets. But it is not possible to provide in advance an exhaustive list of critical economic functions that would be protected in any individual resolution. The decision would be driven by what was needed to avoid systemic contagion as a result of (i) discontinuity in the key operations of the failing institution; (ii) spillovers due to the substantial value destruction arising from an uncontrolled wind-down of the whole or large parts of the bank's balance sheet at firesale prices; and (iii) just how bad things were. On the second, for many G-SIFIs, the stabilisation might need to go further than just preserving payments and transactions/deposits services inside the ring-fence and include trading and derivatives portfolios to the extent needed to avoid a disorderly unwind that could adversely affect the functioning of critical capital markets. On the third, the worse the situation, the more the Resolution Authority may have to focus on preserving the most elemental services (insured deposits and payments).

8. Resolution tools for banks have historically focussed—mainly in the US—on the ability to separate critical functions at the point of resolution, for example through the use of transfer powers, with the shareholders and certain creditors being left in a special insolvency procedure for the rump of the assets so that they bear any losses. These powers ensure immediate continuity of access to deposit services through the transfer of deposits to a private sector purchaser (what the US term a "purchase and assumption") or to a temporary bridge bank. However, the size and complexity of the books of most global wholesale banks greatly increases the challenge in rapidly separating the critical economic functions in this manner without causing severe systemic disruption. A standard p&a resolution strategy might well, furthermore, entail a destruction of value that would endanger wider stability. This is what led to the development of the concept of bail-in resolution strategies, in order to ensure that unsecured creditors are exposed to loss without having over a resolution weekend to split up a bank into critical and other parts that go into liquidation. Within the wider context of resolution work on G-SIFIs, the authorities of some key countries are developing ways to operationalise such bail-in strategies as described above.

Questions 3/4: Who would suffer losses or be otherwise adversely affected and where would public funds be put at risk?

9. For bail-in or other resolution tools to be effective, they must avoid putting public funds at risk. Under any resolution strategy, losses therefore fall, after equity holders, to debtholders instead, broadly following the creditor hierarchy that would apply in liquidation.

10. It will be open to the regulatory authorities to require a layer of debt that was subordinated to senior unsecured creditors. It could contribute to meeting the planned PLAC requirement. But it would be vital that

the minimum requirement did not put a cap on the quantum of liabilities of that class and of other classes that could absorb losses, whether via bail-in or other resolution tools.

11. Senior unsecured creditors exposed to loss could include the Financial Services Compensation Scheme (FSCS), which stands in for insured depositors. The *insured* deposits themselves are fully protected (up to the specified amount of £85,000). But the FSCS can contribute resources to resolutions, whether using resolution powers in the current Banking Act or to bail-in. In all such circumstances, any losses incurred by the FSCS would be recovered via the levy imposed on the banking sector (phased as necessary to limit the contagion risk). The EU's draft RRD provides for Deposit Guarantee Schemes to contribute to bail-in or other resolution tools in this way.

12. In terms of funding, the FSCS might need to access temporary funding from HMT. If a resolved bank were restored to solvency and viability, it would in principle be eligible to use the Bank's Discount Window or other liquidity facilities. Neither involves solvency support.

Question 5: *What would be the main risks to the success of this resolution plan?*

13. For those banking groups and entities operating in multiple jurisdictions, international cooperation will be essential to achieving an orderly resolution of the group as a whole. Although that would not be relevant for a purely domestic ring-fenced bank, it would be relevant to the other parts of the groups in which RFBs will be housed.

14. Without co-ordination, there would be a major risk that individual host authorities take unilateral action which threatens the viability of the group wide resolution plan. This could include seizing assets of the group in their jurisdiction, undermining the resolution strategy for the entire group. The Key Attributes put in place a framework for mitigating this risk through the development of both group resolution plans and cooperation agreements for each G-SIFI. These are being worked on in international crisis management groups (CMGs), consisting of supervisory and resolution authorities in the home and key host jurisdictions in which each G-SIFI has substantial operations.¹⁰⁶

15. More generally, these resolution strategies require the filling out of SRR powers that is planned via the EU RRD as well as sufficient information provided in advance through an effective RRP process.

Question 6: *What are the main potential obstacles to resolution which you would expect to address through the recovery and resolution planning process between now and 2019?*

16. The obstacles to resolution will differ between resolution strategies. It follows that the recovery and resolution planning (RRP) process will need to ensure that obstacles to effective implementation of those strategies are overcome. In SPE strategies, obstacles may arise from location of PLAC; debt instruments governed by foreign law; and inadequate management information systems that do not support rapid valuation of losses. In MPE strategies, obstacles include legal, financial and operational dependencies within a group. Obstacles relevant to both strategies include immediate rights of exercise of termination clauses in contracts held by a bank's counterparties and the exercise of cross-default clauses. Plans are being prepared internationally to tackle these impediments, which in some cases will be more easily pursued once the RRD has passed into law.¹⁰⁷

Question 7: *What are the wider reforms (eg implementation of a bail-in tool through European legislation) which would need to be in place to deliver your preferred resolution plan?*

17. The necessary wider reforms are: full implementation of the Key Attributes across the G20 jurisdictions; within the EU, implementation of the RRD; and, within the UK, a widening of the scope of the Special Resolution Regime as set out in the Financial Services Bill currently before Parliament and the implementation of the ICB proposals in the Banking Reform Bill.

ANNEX: CASE STUDIES

Case 1

1. Case 1 (annex to the Committee's letter) is about a distressed ring-fenced bank (RFB), financed largely by retail and wholesale deposits, whose losses are likely to render it insolvent. It is also stated that the parent does not have free capital to downstream, has not raised capital privately and has little wholesale debt in issue.

2. The scale of the RFB's deposit book and role in the payment system make it unsuitable for liquidation and rapid FSCS pay-out. In order to avoid any taxpayer solvency support in resolving the failed RFB, the unexpected losses need to be imposed on external creditors of the RFB. One way of doing this would be via a bail-in, extending beyond the liabilities included within the minimum PLAC requirement, to absorb current losses and recapitalise the RFB to withstand further losses. Given that the RFB is funded mainly by retail and

¹⁰⁶ See FSB Progress Report on Resolution of SIFIs, November 2012. http://www.financialstabilityboard.org/publications/r_121031aa.pdf

¹⁰⁷ See Annex VI of the FSB Consultative Document on the Effective Resolution of SIFIs (pp 61–65) that identifies measures to improve resolvability: see http://www.financialstabilityboard.org/publications/r_110719.pdf

corporate deposits, some losses would be borne by the FSCS, recovered in due course from the rest of the banking system, phased as necessary to limit the contagion risks.

3. Another resolution strategy, achieving the same economic effect, would be to transfer the RFB's remaining sound business and insured deposits to a private sector buyer (if a suitable bidder is immediately available) or temporarily to a bridge bank until a buyer is found, while the toxic assets and loss-bearing liabilities are left behind in the bank administration procedure. Again, the FSCS would probably end up contributing to covering any losses incurred by this transfer.

4. The case study states that the RFB requires official liquidity support but does not meet the solvency and viability criteria for access to the Discount Window Facility. Both of the resolution strategies (bail-in or transfer) would, however, be designed to deliver a resolved entity (whether the RFB itself or a bridge bank if used to house the RFB's sound business) that was restored to solvency and viability and, as such, might in principle be able to access market funding. Until that happened, temporary liquidity support might need to be provided by the authorities, fully collateralised to limit risks to public funds.

5. Either strategy will require the failing RFB to be separated from the group. The ring-fence should limit the extent to which separating out the RFB destabilises the remainder of the group. But if the other parts of the group, including overseas subsidiaries, failed, they would be subject to resolution in accordance with the group resolution strategy agreed amongst the relevant UK and international authorities.

Case 2

6. Case 2 states that the NRFB has suffered a large unexpected trading loss and may face other problems in its balance sheet, which could take its capital below the minimum threshold. It has substantial wholesale operations, including a large derivatives book, and is the owner of a large RFB. A transfer of part or all of its business is stated not to be in prospect. The scenario does not state that the bank goes into resolution, but that is assumed below.

7. In this case, a bail-in could again be appropriate. If the NRFB has a holding company that has issued external debt, the bail-in could be at group level. In that case, the operation would enable the holding company to recapitalise the NRFB and thereby stabilise the group, keeping its vital operations functioning and avoiding the disorder that would result from it suddenly ceasing to trade. Following this stabilisation period, the firm would be reorganised, culpable senior management replaced and the business restructured/wound down in an orderly manner as necessary. The bail-in could be structured to ensure that all subsidiaries of the NRFB, including the RFB, which the example states is well capitalised and stable, remained fully operational and viable, and as such did not need to enter resolution themselves. This top-down strategy would maximise the chances of the US and Asian host authorities cooperating with the bail-in, given that funds would be downstreamed as necessary to ensure that the subsidiaries in the US and Asia continue to trade.

8. If, despite the proposed requirements for quantum and location of PLAC, there was no holding company with sufficient debt in issue, the resolution would be carried out at the level of the NRFB. Initially loss-absorbing capacity created by intra-group debt would be drawn on. After that was exhausted, resolution of the NRFB might be by way of bail-in of external creditors and other creditors. This bail-in would have the effect that ownership of the NRFB would be transferred to those creditors. Resolution planning would need to cover this possibility.

9. A credible recapitalisation by means of bail-in, including a plan for the necessary restructuring, should enable the firm to access private sector liquidity. Until that happens, temporary liquidity support from the authorities may be needed given that the example states that the bank is facing immediate redemptions and that counterparties are rapidly withdrawing funding and requiring significant additional margin collateral. The RFB may also need temporary liquidity support to address contagion affecting the brand.

10. Other resolution techniques would be unlikely to work for the NRFB and its subsidiaries taken as a whole. If a bail-in strategy proved not to be feasible for whatever reason, then a MPE strategy would be needed for local subsidiaries. The RFB would, in these circumstances, be protected financially and operationally by the ring-fence from the resolution of the rest of the group; the resolution authority would have powers to transfer ownership of it away from the NRFB to a purchaser or bridge bank. Such a backstop strategy would also require advance planning. For that reason, the RRP process and the resolution strategies developed by the resolution authorities, once the RRD package is in place, must accommodate this eventuality.

Written evidence from the New Economics Foundation

INTRODUCTION

1. This submission is based on research carried out by **nef** over a number of years, and in particular draws on four publications:

Where Does Money Come From? A guide to the UK monetary and banking system (Sep 2011)

Quid Pro Quo: Redressing the privileges of the banking industry (Sep 2011)

Where Did Our Money Go? Building a banking system fit for purpose (Oct 2010)

The Ecology of Finance: An alternative white paper on banking and financial sector reform (Nov 2009)

These publications contain extensive references and so this submission has been kept clear of references and footnotes for the sake of brevity and readability.

2. Some observations in this submission also draw on the personal experiences of the authors of these reports who include a former investment banker in equities and corporate advisory at Barclays de Zoete Wedd and Credit Suisse First Boston, and a former investment banker in fixed income and derivatives at Goldman Sachs.

EXECUTIVE SUMMARY

3. The Commission's call for written evidence refers to three main objectives set out in the policy document "Sound banking: delivering reform" that accompanies the draft Bill, namely:

- making banks better able to absorb losses;
- making it easier and less costly to sort out banks that still get into trouble; and
- curbing incentives for excessive risk taking.

These three objectives were also set out in the reports of the ICB (Independent Commission on Banking) as being directed towards a broader aim "to create a more stable and competitive basis for UK banking".

4. Although undoubtedly containing many provisions that are useful in themselves, we submit that the draft Bill fails to address the promotion of stability and competition in two key respects:

- lack of recognition of the credit creation function of banks; and
- failure to eliminate the "too-big-to-fail" subsidy enjoyed by large banks.

Both of these failings are highly material to both stability and competition, and also of significance to the conduct of banking activities.

THE CREDIT CREATION FUNCTION OF BANKS

5. There is no recognition within the ICB Final Report or the draft Bill of the role played by retail banks in **supplying** sterling bank deposits through the extension of credit and purchase of assets, and hence creating the bulk of the UK's money supply. Instead reference is made to deposit-taking, which is an established phrase in regulation and describes part of what retail banks do. The far more significant role of banks is the **creation of new bank deposits**. A full explanation of this process is beyond the scope of this submission, but the selection of quotes below establish that this description is fully supported by central bankers and monetary economists:

By far the largest role in creating broad money is played by the banking sector... When banks make loans they create additional deposits for those that have borrowed.

Bank of England (2007)

Given the near identity of deposits and bank lending, Money and Credit are often used almost inseparably, even interchangeably...

Bank of England (2008)

Each and every time a bank makes a loan, new bank credit is created—new deposits—brand new money.

Graham Towers (1939), former Governor of the Bank of Canada

Over time... Banknotes and commercial bank money became fully interchangeable payment media that customers could use according to their needs.

European Central Bank (2000)

The actual process of money creation takes place primarily in banks.

Federal Reserve Bank of Chicago (1961)

In the Eurosystem, money is primarily created through the extension of bank credit... The commercial banks can create money themselves.

Bundesbank (2009)

When banks extend loans to their customers, they create money by crediting their customers' accounts.

Mervyn King (2012)¹

Banks do not have to wait for depositors to appear and make funds available before they can on-lend, or intermediate, those funds. Rather, they create their own funds, deposits, in the act of lending. This fact can be verified in the description of the money creation system in many central bank statements, and it is obvious to anybody who has ever lent money and created the resulting book entries.

IMF (2012)²

6. It is relevant to note that this credit creation function does not feature in most general equilibrium models of the economy used by orthodox economists. Recent academic debate, for example within the Institute of New Economic Thinking, has begun to consider whether this was a factor in the seeming inability of many economists and economic models to predict the financial crisis, and is investigating the role of unconstrained or poorly managed credit creation in maintaining, or rather upsetting, financial stability.

7. The draft Bill would therefore appear to be built on an analytical framework that is incomplete at best, and flawed at worst. We argue that in this key respect the theoretical understanding of banking that underlies the Bill will come to be seen as obsolete. This has implications for, inter alia, arguments for splitting retail from investment banking, stability of the banking system (and indeed broader macro-economic stability) and distortions in the retail banking market that prevent fair and effective competition.

SEPARATION OF RETAIL AND INVESTMENT BANKING

8. The proposed ring-fence does not separate the activity of credit creation from investment banking. This perpetuates the existence of conflicts of interest that was illustrated vividly by the LIBOR rigging scandal; a deposit taking bank (whether retail or wholesale) with no proprietary trading would have had nothing to gain financially from manipulating the market. Furthermore, it permits the use of credit creation for speculative purposes, such as the trading of commodities and other financial instruments, by the proprietary trading activities of the bank. This creates incentives for excessive credit creation for speculative activities which would not exist if the function of credit creation was entirely separated from trading activities.

ECONOMIC AND BANKING STABILITY

9. The role of banks as creators of the money supply has profound consequences for macro-economic outcomes, such as output, inflation, employment and the balance of trade, and also for relative activity levels in different sectors of the economy, such as SME investment, consumption, commercial property, speculation in financial instruments and residential property.

10. The key points are that the existing system has the following features:

- the quantity and quality of money supply is determined by the aggregate of banks' credit decisions, which are driven by confidence, short-term liquidity requirements, and often perverse financial incentives;
- it is therefore naturally pro-cyclical;
- new money will tend to be over-allocated to non-GDP transactions, leading to asset price inflation, followed by a credit contraction which prompts recession; and;
- this inherent instability in the money supply leads to greater general macro-economic instability than need be the case.

The failure of the draft Bill, and preceding ICB reports, to properly take account of these features hampers its effectiveness in preventing future banking crises or ameliorating their effects. The draft Bill thus cannot be said to satisfactorily address the promotion of banking stability.

11. By way of illustration, prior to the crisis, banks expanded the money supply by £496 billion in between 2004 and 2007; representing a 42% increase in broad money in just three years. Regulatory constraints such as capital adequacy and prudential regulation proved ineffective in preventing an increase in the supply of credit that was clearly out of all proportion to underlying productive economic activity.

12. In terms of sectoral allocation, in the decade from 1999 to 2009 the volume of lending to the commercial property sector (excluding construction of new buildings) more than tripled. Lending to this sector moved from being 60% less than lending to all other non-financial sectors to ending the decade 50% more than all these sectors combined. Commercial property is significant because it is prone to speculative bubbles and involves the trading of existing assets (economic rent-seeking) rather than the construction of new ones (wealth creation).

13. This experience, together with the economic history of many other countries and previous credit bubbles, shows the central importance of the quantity and allocation of credit creation to macro-economic and financial stability.

DISTORTION OF COMPETITION

14. The credit creation function leads to a distortion in fair and effective market competition. Banks with a high market share of transactional and savings deposit accounts have a liquidity advantage over banks with smaller shares, because a higher proportion of credit extended by large banks returns to them as deposits, reducing the relative quantity and cost of liquidity management compared with smaller banks.

THE TOO BIG TO FAIL PROBLEM

15. Proper recognition of the role of banks in creating the money supply highlights a paradox that is unique to the banking industry. The origination and allocation of the money supply is an important public good. One of the key functions of money is as a medium of exchange, and the supply of money must be sufficient to enable market exchanges to take place. The shrinkage of bank balance sheets is severely deflationary for the economy because it involves the withdrawal of money from circulation. Yet this public function is performed by private-sector commercial banks according to their own profit incentives. There is no good reason to expect the aggregate of these decisions to result in an optimal societal outcome.

16. This paradox is the underlying cause of what Mervyn King has referred to as moral hazard; that risks are effectively underwritten by the taxpayer. This happens in two ways. First, in order to prevent the sudden loss of confidence that can lead to a run on the banks, they are provided with a highly valuable deposit guarantee scheme that is effectively underwritten by taxpayers. This is compounded by the problem of institutions that are too systemically important to fail. The disruption not only to payments infrastructure but also to the supply of bank deposits that would result from a major bank failure is so great that the market assumes (rightly so given the experience of October 2008) that the government will always bail out a troubled bank. This is known as the “Too-big-to-fail” (TBTF) subsidy and estimates of the value of this implicit guarantee in the UK over the past five years, in terms of allowing banks access to cheaper capital, range up to £109 billion a year. Our calculation for 2010 was £46 billion for the largest four UK banks. The TBTF subsidy accrues almost entirely to the largest banks and acts as a significant distortion to market competition and a barrier to new entrants.

17. One of the aims of the draft Bill, in enacting the recommendations of the ICB, is to reduce the value of this implicit taxpayer guarantee. However, the failure to recognise the public utility function of banks as the creators of the money supply fails to identify one of the root causes of the implicit subsidy. We argue that the ring-fence should be relocated to fully divide licenced deposit-taking from investment banking (the Glass-Steagal division) for this and a number of additional reasons including better respecting the entirely different cultures and business models of each side of the industry, and to prevent market distorting cross-subsidisation.

18. However, the TBTF subsidy is not solved by separation. The economic impact of a bank failure, and hence the likelihood of a bail-out, is a function of its size and interconnectedness. As interconnectedness is also related to size, it can be seen that the key driver of the TBTF problem is how big the bank is. Hence Lehman Brothers had no retail banking activities but many large banking groups with retail banking activities had extensive direct or indirect counterparty exposures to Lehman, and so its failure caused major disruption to the banking industry. A banking industry comprising a handful of large retail banks with extensive exposures to a handful of investment banks would still be one in which all the large players of both types are too big to fail and will therefore attract the TBTF subsidy.

19. Instead, the key to solving the TBTF issue is to focus on size rather than function. As we have noted, the implicit taxpayer subsidy of banks’ funding costs arises only for the largest banks, and small banks derive no benefit from it. We argued in 2011 that the ICB was too quick to dismiss the question of size limits for retail banks, and we note the growing debate on the appropriate size of individual banks and the banking sector as a whole. While it is true that there is an international dimension to all banking regulation, and hence any action on size limits would be best applied throughout the G20, there may still be a case for investigating the cost-benefit trade-offs of applying such limits to UK domestic and domiciled banks even in the absence of international action. This need not impact on the competitiveness of London as an international financial centre, as this success has never been based on the promotion or protection of national champion banks.

20. The potential benefits of a more diverse banking system, comprising a greater number of smaller banks, are not limited to addressing the TBTF problem. More diverse systems display greater resilience to shocks. Evidence from Switzerland and Germany since the financial crisis reinforces this point. Both countries have a significant local retail banking sector comprising geographically focused smaller banks that are primarily depositor funded and concentrate on the needs of SMEs and personal customers. In both countries, lending to SMEs and individuals since the crisis by large international banks has shrunk in line with similar banks in the UK. However, in stark contrast to the UK, local retail banks in these countries have steadily increased credit provision to SMEs and individuals in line with their previous prudent expansion prior to the crisis. This has helped to insulate these economies from the financial crisis to a far greater extent than in the UK. The financial system is further strengthened by institutional diversity in ownership structure, sector expertise and customer focus as well as geographical focus and scale. This diversity is different from, and not delivered by, a focus on introducing large challenger banks who are similar in all substantive respects to the incumbents. The UK’s banking system was ultimately weakened by the demutualisation and consolidation of building societies and the acquisition of the Trustee Savings Bank by Lloyds. There are no provisions in the draft Bill that will

stimulate the diversification of the banking sector to any material extent, and we consider this to be detrimental for stability, competition and banking conduct.

THE CONDUCT OF BANKING—RISK AND REWARD

21. It has been widely observed that the TBTF problem leads to misaligned incentives for risk taking by banks. If profits accrue primarily to (senior) staff but when catastrophic losses occur these accrue to the taxpayer there is a clear incentive towards higher leverage and short-term speculative activity that carries high risks and rewards.

22. However, the structure of ownership is also significant in this regard, and provides an argument that has not been fully examined for separating different functions within investment banking. The divisions between advisory, execution and trading activities that existed before the Big Bang of 1986 not only served to prevent conflicts of interest, but also allowed the ownership structure of such firms to fully align risks and rewards for bankers. The equity structure of partnerships is far more effective in inducing prudent use of leverage than an institutional separation between managers who capture the returns, and shareholders (and taxpayers) who bear the risks. Corporate advisory services are not capital intensive and so are well suited to a partnership structure, as the legal and accountancy professions demonstrate. The same is true for execution-only broking services, and provision of advisory services to investors. It is the provision of market liquidity (market-making) and manufacture of derivative products that require sizeable balance sheets. The most appropriate funding structure for such activities is equity and wholesale debt (rather than retail deposits). It may be argued that if such activities were entirely separated from licenced deposit-taking banks then the effect would be to greatly reduce the scale of securities trading and manufacture of derivatives. If so, it may be argued in return that we should welcome this reduction as an appropriate realignment of risk and reward and return to appropriate scale of these activities.

THE CONDUCT OF BANKING—CULTURE

23. We conclude with some observations about the culture of banking. Many have argued that the cultures of retail and investment banking are quite distinct and that cross-contamination is unhelpful to the conduct of both. A distinction is drawn between transactional versus relationship banking, with the former characterised as a feature of investment banking, and the latter a feature of retail banking. While we would support the need for separation of retail and investment banking to allow the culture of each to reflect the nature of the underlying business activities, we would also argue that the problem is not primarily that “transactional” investment banking culture has infected “relationship” retail banking culture. The problem is that the culture of both sides of the banking industry have swung too far away from long-term relationship banking to a short-term focus on profit-maximising today’s deal. This change has been just as discernible within investment banking where activity used to be driven to a greater extent by long-term relationships and personal reputation. What has happened is that a culture of trading, or, some might say, gambling, epitomised in the first instance by large trading led US firms, has infected a culture of client-driven advisory and execution of corporate and investment business.

24. The reasons for this are complex, but some are common to both industries and certainly include the tendency toward large size and centralisation of decision-making within banks, and the misalignment of incentives. Drawing authority, responsibility and accountability to customers away from client-facing frontline staff bears the danger of damaging customer service in any type of large organisation from banks to railways. However, the danger is particularly acute in banking because of the nature of the products. The market for banking products suffers from the major imperfection of “information asymmetry” where the customer is at a severe informational disadvantage to the seller. Hence, banking conduct cannot be improved by competition alone; regulatory intervention to maintain the safety and transparency of products is required for banking in a way that it is unnecessary for, say, clothes retailing or hairdressing. For this same reason, incentivising bank staff on sales rather than customer services is entirely inappropriate to many bank products and we welcome the shift within UK retail banks away from sales-based remuneration for branch staff. However, it may be argued that a more effective answer to the problem of information asymmetry than regulation is a combination of customer ownership and smaller scale, whereby the interests of bank staff and customers become much better aligned.

20 November 2012

¹ King, M (2012) Speech given by Mervyn King Governor of the Bank of England to the South Wales Chamber of Commerce at The Millennium Centre, Cardiff, 23 October 2012. London: Bank of England

² Benes, J and Kumhof, M (2012) The Chicago Plan Revisited. (IMF Working Paper WP/12/202) Washington: International Monetary Fund

Written evidence from the federation of small business

Response to question 16:

The Government is considering whether to allow ring-fenced banks to offer simple derivatives to their customers. Should they be allowed to? If so, what safeguards would be necessary?

1. The Federation of Small Businesses represents 200,000 small and medium sized enterprises (SME's) in the UK.

2. The FSB is concerned that the principle set out in the Independent Commission on Banking report, that ring-fenced banks would only take **retail deposits, provide payment services and supply credit to households and businesses** is being threatened.

3. We strongly believe that the ICB report made good judgements on why these products should not be in the ring-fence.

- (i) Namely, the connection between the ring-fence and the financial markets should be minimal, while accepting some limited transfer.
- (ii) It is important that wellbeing of the financial markets, or not, should not impact on the core activities which small businesses need to operate.
- (iii) We also raise concerns about cost subsidy from mass products such as SME loans on complex derivatives products.

4. We agree with the ICB that simplicity increases the chances of well managed and run banks, with both senior bank managers and regulators understanding the nature of clients and products.

5. The FSB believes that customers need to know about products and as such, believe that "simple" does not exist in the derivative arena. As the interest rates swap issue has highlighted (which were mis-sold as simple products to over 40,000 small firms) product owners need to know more than just how the product behaves on the upside. Downside risks, which are less of a sale tool for the banks are often not discussed with or understood by small firms.

6. An important note to consider is that many small businesses behave and therefore purchase in a similar manner as consumers. This requires thought from the banks and from the Government, and the simplicity of products the Treasury has worked on with Carol Sergeant shows how clear and simple pricing of products can improve the financial market place.

7. There have been counter arguments that small businesses would want complex derivative products from the same bank manager which looks after the firm's loans or overdrafts. However, and as the banks and the regulators know, this does not occur as the majority of branch staff are not regulated to advise or sell these products. If a derivative product is currently sold to a small business, it would need an FSA regulated member of staff (and in most cases these individuals do not work in branches] to both advise and sell.

8. We can also envisage that if a small business wanted a derivative product, normal sales protocol would apply and the ring-fence would advertise the details of the non ring-fence part of the bank where this product could be purchased from.

9. Likewise, it is not only the major five banks which sell these products. Many other specialist groups sell products such as foreign exchange hedging products and this may lead to a more competitive market place. However, we once more urge that the Government look into how these products could be dramatically simplified for small businesses in the same way as the Carol Sergeant review of savings products for consumers.

12 November 2012

Written evidence from the Financial Services Authority

At our evidence session on Monday you asked us to articulate the points that would be useful to introduce in the draft Bill. We have set out below further elaboration on two points: (i) the interaction between the PRA statutory objectives, and (ii) the Ring-Fenced Bank (RFB) directors' statutory duties. The table in the Appendix to this letter summarises the key points that we made and builds on our written submission.

We agree with the PRA being given a new statutory objective regarding the continuity of core banking services. However, we believe it would be useful to have a better narrative regarding how the PRA's safety and soundness and continuity objectives interact. In our view, the continuity objective should be a subset of the safety and soundness objective, which would better contribute to the desired clarity of purpose for the PRA. However, the draft Bill instead implies that if there is a clash the continuity objective would prevail over the safety and soundness objective. It is not clear what this means. As a result, there is a risk that the Bill is creating an expectation that might not be fulfilled.

As I mentioned briefly in our evidence session, it is our view that the draft Bill should specify that RFB directors, and potentially the directors of other appropriate entities in the group that have influence over the

RFB, should have a legal obligation to ensure the integrity of the ring-fence. This obligation would, as an example, require directors to protect the RFB from contagion from the wider financial system. This would include risks arising from the rest of the banking group.

If you have any questions on this, please let me know.

Andrew Bailey
Managing Director
Prudential Business Unit

APPENDIX

The following table includes five suggestions to add further substance to the bill:

	<i>Recommendation</i>	<i>Bill Reference</i>
1	The draft Bill should clearly set out how the PRA's statutory objectives interact and their hierarchy.	Section 2
2	The draft Bill should enable the PRA to have a power to make rules over UK financial holding companies.	New addition
3	The draft Bill should enable HM Treasury to prohibit non ring-fenced banks (NRFBs) from owning ring-fenced banks (RFBs) as well as RFBs from owning NRFBs.	Section 4 (142E & 142H subsection 2)
4	The draft Bill should state that loss absorbency capacity should apply on a group basis, with the ability to exempt non-EEA subsidiaries only once the group has demonstrated that these operations will not pose a risk to UK financial stability.	Section 4 (142J)
5	The draft Bill should specify that the directors of a ring-fence bank and potentially other appropriate entities in the group should have a statutory objective to ensure the integrity of the ring-fence. This could involve ensuring that the directors have an obligation to protect the ring-fence bank from contagion from the wider financial system. This would include risks arising from the rest of the banking group.	New addition

Written evidence from Vedanta Hedging

The Government is considering whether to allow ring-fenced banks to offer simple derivatives to their customers. Should they be allowed to? If so, what safeguards would be necessary?

Vedanta Hedging is regulated by the Financial Services Authority to advise both large institutions and small firms on derivatives

It is our opinion that small firms in the UK should have access to derivatives.

1. RATIONALE FOR SMEs USING DERIVATIVES

1.1 For SMEs that import, export or have a material exposure to foreign currency movements, derivatives can help them to budget and plan their business more effectively. Significant currency swings can easily erode tight profit margins in an increasingly global and competitive marketplace.

1.2 SMEs that have a substantial amount of borrowing relative to the value of their assets (gearing) may also wish to use some type of derivative to protect themselves from rising interest rates. In the same way that an individual obtaining a mortgage will have an option of repaying their loan on a fixed, floating or tracker basis, SMEs should also be able to make such risk management decisions.

1.3 Some larger SMEs who have a material exposure to the price of a commodity, such as oil or copper for example should also be able to use derivatives to help manage their risk.

2. CREDIT RISK

2.1 The vast majority of derivatives that may be appropriate for an SME for the above risk management purposes will carry a contingent liability for the provider of that derivative. There are of course simple derivatives such as currency options, or interest rate caps which do not have any on-going potential liability since they are paid for up-front. An SME may not want to use this type of derivative however.

2.2 A bank that is providing some debt facilities to an SME will almost certainly have some security over some of the assets of the SME (typically a legal charge on property). For such a bank, it is relatively straightforward for it to allocate a portion of this security to underwrite the contingent liability for the derivative.

2.3 If a ring-fenced commercial bank was not able to provide derivatives to its SME customers, it would presumably have to suggest to its customer (on an agency basis), other banks and institutions that could provide it derivatives. The SME however is unlikely to have material banking relationships (if any) with more than one bank. Therefore, if the SME has their borrowing with “Ring-Fenced Bank A” for example they will need to provide extra security to “Investment Bank B” in order to obtain a derivative from Bank B. This would have to be in the form of cash collateral, or equity in their property for example, which are unlikely to be options that an SME would want or be able to provide. This in effect means that the SME would not be able to use derivatives for risk management.

2.4 Even if the SME does wish to provide additional security to Bank B, the overall costs of hedging are likely to be higher for both the SME and the bank because there is no common usage of the same security for the SME from the ring-fenced Bank A.

2.5 It is worth noting that if the SME was forced to seek derivatives from Bank B, this is forcing the SME to be exposed to increased credit risk on Bank B. This is because Bank B is by definition a “riskier” bank because it is a non-ring-fenced bank. Bank B will be a more complex bank than Bank A and is less likely to be able to rely on the Government for support if required. Bank B is a bank that is likely to be a bank more suitable for large companies or financial institutions. Just as there can be break-costs payable for an SME if they terminate a derivative ahead of expiry subject to market movements, there could also be a breakage gain for the SME. If Bank B failed, it may not be able to pay the SME the breakage gain owed to it under the derivative.

2.6 It could be asked if an SME could adequately or inexpensively hedge their exposures through alternative means such as exchange-traded hedging products, rather than using an Over the Counter (OTC) contract from their bank. The simple answer to this is no, because if it is appropriate for an SME to hedge their exposure, they must only do so via a derivative that is suitable for them. This means that the derivative must be of the right length, notional amount and amortisation profile to match the underlying borrowing. Exchange traded contracts do not allow such flexibility and are typically for sizes that would be too large for an SME. It may be possible for exchange traded derivatives to be provided for smaller notional sizes and duration’s, but these have not yet been developed and will require both cost and time to develop. A further issue with exchange traded derivatives is that they may also not match the underlying basis required by the SME, for example Base Rate. With OTC derivatives, a bank can provide a Base Rate derivative to an SME, whilst the bank (not the SME) absorbs the basis risk of doing so.

3. MIS-SELLING/CONDUCT

3.1 We do not believe that the above question can be answered without addressing the issue of the mis-selling of these products.

3.2 We disagree with part of the findings from the FSA on the 29 June 2012 which are particularly focussed on complex products (for which they use a set of products that could be described as “structured collars”). This is because, in our view, even “simple” products such as an interest rate swap, a fixed rate loan, or interest rate collar have and can be mis-sold. In cases where the derivative was provided for longer than the loan, for a larger amount than the loan, or the SME was not clearly shown the potential for large break-costs, there can be mis-selling even using “simple” products. In fact, on an equivalent basis, there will be many instances where it does not matter whether the SME was provided a “complex” structured collar, or a “simple” interest rate swap; the break-cost from either product at current levels of low interest rates will be very similar. The point we make here is that it is the manner and conduct in which these derivatives are sold, which is far more important than a label of a “simple” or “complex” derivative.

3.3 As we have already stated in our oral evidence to the Committee on 26 September 2012, this does not mean that derivatives are inappropriate for SMEs.

3.4 There are actually already robust rules provided by the FSA (the Conduct of Business Sourcebook) which require banks to assess the suitability and appropriateness of these derivatives for SMEs. Part of the problem has been that the compliance functions within these banks have failed in their duty to sufficiently check how and what the sales advisors were providing to the SMEs. In turn, the FSA has also failed to monitor and challenge the banks’ compliance functions for the adherence to these FSA rules in substance, rather than just via detailed written terms and conditions they provided to SMEs.

3.5 It is our view, that the derivatives provided within a ring- fenced bank should be of a relatively simple nature. Although more “complex” derivatives can be appropriate for SMEs, they can require a greater level of comprehension and analysis which some SMEs may not be able to undertake. By “simple” derivatives, we mean derivatives where there are no knock-in/knock-out or digital options (a feature of “structured collars”) and no ability for the bank to unilaterally extend or cancel the derivative. These “complex” products typically involve the SME selling one or more “options” to the bank. These types of derivative can be viewed as more akin to “speculative” products rather than “hedging” products. For example, a multi-callable swap whereby the bank can terminate the swap early cannot be considered a hedge because as soon as the bank feels interest rates are likely to move higher, they will cancel the swap. This means the protection is removed just at the time when it is likely to be required.

3.6 In addition, with regards to the appropriateness and conduct rules regarding the sale of these derivatives, we believe that they should always be of a term less than or equal to the term of the committed facilities provided by the bank. We also believe that the notional value of the derivative should be equal to less than the value of the committed loan facilities provided by the bank that is providing the derivative. We also believe that the underlying “basis” of the derivative must match the underlying index of the loan. For example, an SME with a Base Rate Loan should not be provided a LIBOR related derivative (subject to the exception mechanism below).

3.7 There may be legitimate risk management reasons why an SME may wish to request an exception from these rules. This should be permitted only after a significantly large “compliance hurdle” set by the Bank. For instance, requiring the authorisation from at least two FSA Authorised individuals, a Managing Director within the Bank and Compliance.

3.8 We believe that if ring-fenced banks are permitted to provide simple derivative risk management options as per above, this will actually improve the conduct of how these products are sold. This is because there will be tighter rules governing how and what may be sold to these SMEs. If the ring-fence bank cannot provide these derivatives, and the SME must seek an alternative (non ring-fenced bank) for them, there is nothing to stop that bank providing any type of derivative, for any amount of notional size and duration. In other words, the non ring-fenced bank could still mis-sell a derivative to an SME, which would become much harder to do so for a ring fenced-bank that had to adhere to some of the principles stated above.

Written evidence from Rt Hon George Osborne MP, Chancellor of the Exchequer

Thank you for your letter of 27 November following my appearance before you to give evidence.

Further to the sixteen page brief from officials that I sent on 12 November with additional information on the likely secondary legislation, please find attached the following:

- Annex A addresses the points raised by Andrew Bailey in his letter to you of 21 November and the points you raise with regard to the evidence of Paul Tucker in his appearance before you on 22 November.
- Annex B addresses points you raise with regard to written evidence you have received; and
- Annex C addresses points you raise with regard to the impact assessment.

I look forward to considering your recommendations.

Annex A

POINTS RAISED BY ANDREW BAILEY AND PAUL TUCKER

1. The draft Bill should clearly set out how the PRA’s statutory objectives interact and their hierarchy.

The draft Bill currently sets out how the PRA’s objective for ring-fencing and its general objective interact. When the PRA is acting in relation to matters related to ring-fencing, and only then, the PRA is required to act at all times compatibly with its continuity objective. To the extent that this remains unclear, the Government will consider any further specific recommendations from the PCBS.

Paul Tucker, in his evidence before the PCBS, raised the issue of where the “meat” of the ring-fencing regime should be. Mr Tucker agreed with the Government that the meat of the regime should be in secondary legislation, ensuring that the authorities can respond quickly to innovation in the financial sector. The Government has been careful to ensure that the important question of the location of the ring-fence—what constitutes core, excluded and prohibited activities, and what the ring-fence bank can do by way of exceptions to excluded activities—are within the purview of the Treasury and Parliament. This will be covered by clause 4, new sections 142A-F of the draft Bill, and secondary legislation made under those provisions. The PRA will be required to make rules with regard to the height of the ring-fence. The rules will ensure the economic and operational independence of ring-fenced banks from the rest of the group in which they sit. The regulator is best placed to deal with these matters but the outcome and objective will be clearly expressed in legislation.

2. The draft Bill should enable the PRA to have a power to make rules over UK financial holding companies

The question of powers over UK financial holding companies has been discussed at length between the Treasury and the regulatory authorities during the passage of the Financial Services Bill. The Government wants to ensure the regulators have the tools they need to conduct suitably robust supervision of financial holding companies. To that end, the Government has included clauses in the Financial Services Bill that confer on the regulators for the first time substantive powers in relation to the holding companies of authorised persons—specifically a power of direction over holding companies where the direction is considered desirable to advance PRA/FCA objectives. These targeted provisions extend and strengthen the regulatory framework, and strike the right balance between proportionality and delivering effective supervision.

The Government is working with the FSA and Bank of England to consider the merits of further powers over holding companies, both in the context of delivering effective supervision of financial groups and delivering the

ICB reforms. The supervision of holding companies is also an important area of international regulatory reform and the Government supports the intention to strengthen holding company supervision through the review of the EU Financial Conglomerates Directive due in 2013.

3. The draft Bill should enable HM Treasury to prohibit non-ring-fenced banks (NRFBs) from owning ring-fenced banks (RFBs) as well as RFBs from owning NRFBs.

The ICB recommended that ring-fenced banks should be prohibited from owning non-ring-fenced banks. The Government has accepted this recommendation, and the draft Banking Reform Bill includes provisions for its implementation. The ICB did not, however, recommend a prohibition on non-ring-fenced banks owning ring-fenced banks.

4. The draft Bill should state that loss absorbency capacity should apply on a group basis, with the ability to exempt non-EEA subsidiaries only once the group has demonstrated that these operations will not pose a risk to UK financial stability

The Government believes that setting an automatic PLAC requirement on a bank's overseas operations where they do not threaten UK or EEA financial stability if they were to fail would not be appropriate. To do so could create a perception that the UK takes responsibility for providing financial support for these overseas operations, and could dampen incentives for the banks to remove barriers to resolvability. When it comes to bailing out banks, it is the government of the day—on behalf of taxpayers—that pays the price, and is responsible for overall economic well-being of its citizens. It is therefore right that government has a role in ensuring banks hold the right amount of PLAC. It is not unusual for the regulator to consult the Treasury about matters that affect resolution. For example, the regulator needs to consult HMT and the Bank of England on the adequacy of individual firms' resolution plans.

The Government agrees that the circumstances in which it may be appropriate to exempt non-EEA subsidiaries of a group should be made clear in legislation. However, given that this would require rules as to the way in which loss absorbency capacity is to be calculated in relation to groups, and the technical nature of the provisions necessary, the Government considers that this should best be done in secondary legislation made under the power given to the Treasury in section 142J.

5. The draft Bill should specify that the directors of a ring-fence bank and potentially other appropriate entities in the group should have a statutory objective to ensure the integrity of the ring-fence. This could involve ensuring that the directors have an obligation to protect the ring-fence bank from contagion from the wider financial system. This would include risk arising from the rest of the banking group.

The ICB recommended that the directors of a ring-fenced bank and the group as a whole have a duty to protect the integrity of the ring-fence, and suggested this could be achieved through the Approved Persons regime. The Government agreed with this recommendation in its white paper. The Government believes that imposing a duty on directors through the Approved Persons regime may have advantages over a statutory framework, in particular allowing the regulator to use its powers under section 66 of FSMA to enforce the duty. But the Government will, of course, consider any recommendations on this from the PCBS

Annex B

POINTS RAISED WITH REGARD TO WRITTEN EVIDENCE RECEIVED

1. Whether the reference just to services in the UK in the continuity objectives is compatible with EU obligations

The Government considers that the reference in the objectives given to the FCA and to the PRA to the protection of the continuity of the provision of in the United Kingdom of core services is compatible with our EU obligations. Article 9 of the Treaty on European Union requires the Union to observe the equality of its citizens in all its activities. Nothing in the objective given to the regulators in any way detracts from the equality of EU citizens. Requiring the FCA and the PRA to protect the continuity of the core services in the UK rather than in the EEA as a whole reflects the fact that their jurisdiction is necessarily limited to the UK. In this the continuity objective is analogous to the integrity objective given to the FCA (to protect and enhance the integrity of the UK financial system) in the Financial Services Bill (see section 1D of the Financial Services and Markets Act 2000 (FSMA), as amended by the draft Bill), and to the financial stability objective given to the Bank of England in section 2A of the Bank of England Act 1998 ("to contribute to protecting and enhancing the stability of the financial systems of the United Kingdom").

2. Whether there is an intention to provide exemptions from the prohibition on trading as principal to permit trading on behalf of customers.

The excluded activity as set out in the draft Bill is the regulated activity of trading in investments as principal, as described in Article 14 of the Financial Services and Markets Act 2000. This definition is wider than, for example, proprietary trading, as it includes acting as a trading counterparty on behalf of customers as well as on its own account. However, this exclusion does not on its own prohibit a ring-fenced bank from

arranging deals in investments for customers, or from dealing in investments as agent—these are separate regulated activities. The ICB intended that a ring-fenced bank could act as an agent for customers seeking to trade in investments. The Government currently has no intention to designate arranging deals in investments, or acting as an agent on behalf of customers as an excluded activity.

3. Whether there will be a prohibition on the non-ring-fenced bank funding the ring-fenced bank.

The Government believes, as the ICB did, that, in order to achieve the objectives of the ring-fence, ring-fenced banks should have a high degree of legal, operational and economic independence from the rest of the wider corporate groups.

To achieve the necessary degree of economic independence, the Government believes that financial links between ring-fenced banks and other group entities should be managed on a third-party basis, and should be subject to limits on intra-group exposures.

Given the technical nature of the issue, the Government believes that it is appropriate for the details of intra-group exposure limits to be set by the regulator in rules. The draft Bill therefore requires the regulator to make rules “for the purpose of ensuring ... that any ring-fenced body which is a member of a group is able to act independently of other members of the group” (Clause 4 new section 142H(1)(b)). The government requires the regulator to restrict the payments that the ring-fenced body may make to other members of the group, but does not impose a similar requirement on the regulator in relation to payments from the non-ring-fenced body to the ring-fenced body. It will be for the regulator to determine whether such funding may compromise the independence of the ring-fenced body from the rest of the group, and whether therefore restrictions on such funding are necessary. This may not require an absolute prohibition.

4. Whether the Part VII transfer process is adequate to achieve separation of activities

The Government considers that the transfer process provided for in Part VII is appropriate to deal with transfers of businesses or parts of a business which are made by a bank to comply with the ring-fencing requirements. However, the Government has noted the comments made by those who have given evidence in relation to the proposed amendments of Part VII, and the Government is exploring with them whether any additional amendments may be necessary to meet their concerns.

5. Whether ring-fenced banks and building societies will be able to offer retail investment products, including structured deposits.

In its June white paper, the Government invited views on how simple retail investment products may be provided by ring-fenced banks in a way that is consistent with the principles of resolution and insulation. The Government received a number of responses on this question from stakeholders, which represented a wide range of views. The Government is also considering appropriate restrictions to place on ring-fenced banks’ own risk management practices and has asked the Parliamentary Commission on Banking Standards to advise on the conditions under which certain risk management products may be provided to customers. These issues will inform the approach taken to retail investment products. Subject to the restrictions on banks’ own risk management practices and the recommendations of the Parliamentary Commission on Banking Standards, the Government believes that there should be circumstances in which the provision of retail investment products would be permissible from within ring-fenced banks and building societies.

6. Whether building societies will face additional restrictions not applied to banks which enjoy a de minimis exemption from the ring-fence.

Building societies will not be subject to the ring-fencing requirements, but they will continue to be subject to the restrictions of the Building Societies Act 1986. The Government has stated its intention to amend the Building Societies Act to bring it into line with ring-fencing. The Government has concluded that, in order to maintain a single, coherent and safe approach for the building societies sector, it will not introduce a de minimis exemption into the Building Societies Act.

7. Whether new section 142F allows the Treasury to make orders which authorise it to make subsequent regulations or give directions without a need for Parliamentary procedure.

Section 142F does, as presently drafted, permit the Treasury to confer powers on itself in any order made under section 142A, 142B, 142D or 142E (though it does not expressly provide that the Treasury may give itself power to make regulations, or to give directions). The power is a subsidiary one, which could only be used in conjunction with the powers given to the Treasury under those sections. It would not enable the Treasury to give itself power to create new excluded activities or core activities, or to provide for exceptions to the core and excluded activities provided for in the face of the Bill without following the Parliamentary procedure provide for in relation to those sections.

8. What the expected timetable and process will be for publication, consultation and compliance with the various orders and rules

The Government intends to introduce this legislation early in the New Year. It will provide principal draft secondary legislation before House of Commons Committee, and publish full draft secondary legislation for consultation later in the year. The Government is committed to completing all primary and secondary legislation before the end of this Parliament in May 2015. The PRA will be empowered to make relevant rules once section 142H of FSMA as amended is brought into force. It will ensure that its rules are completed (including impact assessments and consultation) within sufficient time to ensure that affected banks are able to meet the requirement to have their ring-fence in place no later than the start of 2019.

9. Potential for the prohibition on contracting on non-EEA law to inhibit a range of important bank activities.

The proposed restrictions on operations outside the EEA are intended to ensure that the objectives of ring-fencing are met without impacting on important activities, such as trade finance. The Government's approach is intended to ensure that ring-fenced banks' cross-border arrangements do not expose a ring-fenced bank to increased risks, or create barriers in resolution, while at the same time enabling ring-fenced banks fully to support UK firms who wish to export outside the EEA and non-EEA firms who wish to invest in the UK. This will be primarily achieved by restrictions on the location of ring-fenced banks' branches and subsidiaries. The Government believes that this measure is proportionate and will not unduly affect customers' access to bank activities. The ICB also recommended that transactions also be subject to the law of an EEA state. The Government recognises the ICB's concern that banks' contractual arrangements may give rise to uncertainty as to the authorities' ability to ensure the continuity of core services in the event of bank failure. However, given the potential for unintended consequences to arise from limiting the governing law of major contracts, the Government is considering alternative approaches to ensuring that ring-fenced banks' contractual arrangements do not give rise to resolvability concerns.

10. Whether customers which are exempted from depositing with the ring-fenced bank will be able to access the full range of services from the non-ring-fenced bank.

The Government proposes that the deposits of large organisations (ie organisations that are not SMEs) and high-net-worth individuals should not be considered "core". This will allow such organisations and individuals to place deposits with non-ring-fenced banks if they so choose—though there will be no requirement for large organisations or HNWI to do so.

Each individual non-ring-fenced bank will decide what services it will offer to its customers (including depositors), according to its own commercial strategy. Depositors with non-ring-fenced banks will be able to access such services as those banks choose to offer.

11. Whether prohibitions on dealing with other financial firms will restrict relationships and distribution of products which do not involve risk and exposure.

The Government proposes to prohibit ring-fenced banks from having exposures to other financial institutions, in order to insulate ring-fenced banks against shocks arising elsewhere in the financial system and to prevent arbitrage of the ring-fence via exposures to institutions that carry on excluded activities. The Government intends to deliver this prohibition using the power granted by Clause 4 new section 142E(1)(a) of the draft Bill.

The Government does not propose to prohibit relationships that do not result in ring-fenced banks having any exposure to other financial institutions. For example, the Government does not propose to prohibit ring-fenced banks from selling products, such as insurance policies, to their customers acting as an agent for a third party.

12. Whether intra-group exposure limits are intended to be more restrictive than exposure limits with third parties.

The draft Bill requires the regulator to make ring-fencing rules regarding the terms on which ring-fenced banks enter into contracts with other members of their group, and to restrict payments from the ring-fenced bank to other members of the group, for the purposes of ensuring that the ring-fenced bank is not harmed by acts or omission of other members of its group, and is able to act independently of the rest of its group. The precise rules on intra-group large exposure limits will be a matter, therefore, for the regulator. However, in the Government's white paper, the Government expressed support for the principles that were set out in the ICB's original recommendations with respect to intra-group large exposure limits.

13. How legal liability will be allocated between the ring-fenced and non-ring-fenced banks for any activity conducted before the split (e.g on mis-selling or LIBOR manipulation).

Liability for any activity conducted before a banking group is split into a ring-fenced bank and a non-ring-fenced bank will remain with the legal entity which was responsible for the activity in question before the

split. So if mis-selling was conducted by X bank limited before the ring-fencing was conducted, X bank limited will remain liable for that activity, whether or not it becomes a ring-fenced bank after the split.

Banks will have some flexibility about how they implement the ring-fence. It is therefore possible that in implementing ring-fencing a banking group will create new companies, but this would not mean that liabilities for activities such as mis-selling would be transferred to the new entities. If by contrast implementation of the ring-fence led to the dissolution of a company, that company's liabilities would be cancelled. In that case a creditor or other third party may be able to restore the company in order to bring a claim against it. However, we would not expect implementation of the ring-fence to involve the dissolution of any company. Legal liability for past action is therefore unlikely to be affected by the introduction of ring-fencing.

A bank's approach to implementing the ring-fence will almost certainly require sanction by court order under Part VII of FSMA, and under the amendments proposed in the draft Bill, any application for approval of a part 7 transfer must be approved by the PRA. The regulator is unlikely to approve any scheme involving the dissolution of a company within a banking group if that would affect any liabilities for mis-selling.

Annex C

POINTS RAISED WITH REGARD TO THE IMPACT ASSESSMENT

1. Please provide a copy of the Regulatory Policy Committee's scrutiny of the Impact Assessment.

The Impact Assessment published alongside the draft Banking Reform Bill was not submitted to the Regulatory Policy Committee (RPC) for scrutiny. This was agreed by the Reducing Regulation Committee (RRC) in order to minimise delays in implementation of the ICB's recommendations and thus mitigate risks of instability as a result of market uncertainty. An Impact Assessment to be published alongside the Banking Reform Bill on its introduction to Parliament has been submitted to the RPC for scrutiny.

2. Why is the net benefit of the Draft Bill measures (£117.6 billion) assessed to be significantly higher than the net benefit of the complete package of the ICB reforms (£68.2 billion) when the Draft Bill excludes measures such as bail-in?

See answer to Question 5 below.

3. What are the differences between the policy measures included in the IA of the Draft Bill and policy measures included in the IA of the Banking Reform white paper?

The policy measures included in the white paper IA are detailed in paragraphs 6–12. The draft Bill IA has fewer policy measures than included in the white paper. The excluded measures are a bail-in tool, and loss-absorbency measures (including higher capital requirements for ring-fenced banks, and requirements to maintain a minimum of level of loss-absorbing debt) that the Government expects to be delivered by other legislative means, such as through EU law. Paragraphs 6–12 in the white paper and paragraphs 6–9 in the draft Bill IA give detail of measures included in each of the IAs. Where necessary for the purposes of impact analysis, assumptions have been made as to the loss-absorbency requirements that will apply—these assumptions are described in Annex A of the draft Bill IA.

4. Have any of the benefits or costs of the policy measures been revised since the IA of the Banking Reform white paper was carried out?

The estimates of the costs to GDP are calculated from the impact that the measures have on the private costs to banks. The estimate of the private costs to banks was calculated using scenario modelling data provided by the affected banks themselves and after scrutiny of the data. The modelling for the private costs is detailed in paragraphs 27–32 of the draft Bill IA.

The balance sheet scenario modelling was not revised between the publication of the white paper and the draft Bill. The policy assumptions underlying the post-ring-fence balance sheet scenario remained the same for the draft Bill as for the white paper.

The scenario modelling undertaken by the banks was intended to capture the impact of the policy measures in the long-run “steady state”. Both the baseline scenario and post-ICB implementation scenarios were modelled as “steady state” future scenarios, in order both to ensure that impact of regulatory changes such as Basel III that are not yet in full force were captured in the baseline, and to reduce the sensitivity of the scenario modelling to short-run changes in the market environment.

5. Please provide a reconciliation between the net benefit calculated for the Draft Bill and the net benefit calculated for the complete package of the ICB reforms in the IA that accompanied the Banking Reform white paper.

The present value costs and benefits used to calculate the net present benefit figures in the Banking Reform White paper and draft Banking Reform Bill IAs are set out in the table below:

	<i>PV Cost to GDP</i>	<i>PV Benefit to GDP</i>	<i>Net Present Benefit to GDP</i>
White paper IA	£16.6bn	£84.8bn	£68.2bn
Draft Bill IA	£13.7bn	£131.3bn	£117.6bn

Note that the costs and benefits being compared are those to GDP. This is appropriate because although implementation of the measures in the draft Bill (and White paper) would have a first-round cost to UK banks, the benefits that would result (from improved financial stability) will be to the economy as a whole. Hence the appropriate cost to compare to this GDP benefit is the second-round cost to GDP.

As the table above shows, the present value cost estimate for the White paper IA was higher than that in the draft Bill IA. For the White paper, the present value cost was calculated from a central estimate annual cost to GDP of £770 million. This annual cost estimate was produced using the NiGEM model as described in the IA. For the draft Bill, the annual GDP cost estimate was lower—£720 million—reflecting the exclusion from the cost calculation of measures such as bail-in that were not included in the draft Bill. Hence the present value GDP cost given in the draft Bill IA was lower than that in the White paper IA.

On the benefits side, the present value figure for the draft Bill IA was higher than that in the White paper IA as a result of a change in method. In both IAs, the Government discussed the uncertainties involved in estimating the costs of financial stability, and argued that it was only possible to convey the scale of the potential benefits of greater stability through illustrative calculations. Using assumptions made by the ICB as a starting point, the White paper IA presented an illustrative calculation showing that if “baseline” regulatory reforms reduced the costs to GDP of financial instability by 30%, and if implementing the measures in the White paper further reduced the probability of future financial crises by 10% and the impact of future crises on GDP by 25%, this would result in a benefit to GDP equivalent to £9.5 billion per year in 2010–11 terms. For the draft Bill IA, a similar illustrative calculation was presented—but with lower assumptions on how far the draft Bill measures would reduce the costs of future crises (the draft Bill illustrative calculation used a reduction in the GDP impact of crises of 15%, not 25%). This was to reflect the exclusion from the draft Bill of measures such as bail-in. The adjusted illustrative calculation for the draft Bill IA therefore gave an illustrative benefit to GDP equivalent to £6.9 billion per year in 2010–11 terms.

The illustrative benefits calculated in the draft Bill IA were therefore lower than those calculated for the White paper IA—this reflects the exclusion from the draft Bill of measures such as bail-in.

To this point, the methods used in both IAs were the same. The difference in method between the two IAs was in how the illustrative annual benefits to GDP were used to calculate present value benefits.

For the White paper IA, alongside the illustrative calculation of benefits, the Government presented an analysis of the sensitivity of the illustrative calculation to the assumptions made on the pre-measures cost of financial crises. This analysis showed that if, instead of the using the ICB’s assumptions for the annual cost of crises, the lowest estimate in the academic literature, then applying the same illustrative calculation as described above would still give an annual benefit to GDP of £2 billion per year. The White paper IA thus had a range of GDP estimates from £22 billion to £9.52 billion per year. From this range, a mid-point estimate (£4.72 billion per year) was drawn, and this figure was used to calculate the “best estimate” present value GDP benefit figure, £84.82 billion.

However, for the draft Bill IA, a different approach was used. Given that the pre-measures cost of crises could be higher than the ICB’s assumption as well as lower (the ICB’s assumptions were averages of figures available in the academic literature), the Government considered it more appropriate to use as its “best estimate” the results of the illustrative calculation based on the ICB’s assumptions, ie the £6.92 billion per year figure. The present value benefit to GDP presented in the draft Bill IA was calculated using this figure, giving a present value benefit to GDP of £131.32 billion.

The increase in the present value benefit figure presented in the draft Bill IA relative to the figure in the White paper IA was therefore the result of this change in method. Had the method used in the draft Bill IA been used for the White paper IA, the present value benefit in the White paper IA would have increased to £171.32 billion (higher than the PV benefit figure in the draft Bill IA—reflecting the inclusion in the White paper of measures such as bail-in that were not included in the draft Bill), which would have given a net present benefit figure for the White paper IA of £154.72 billion.

In both IAs, the Government made clear the uncertainties involved in estimating the benefits to financial stability of the measures included, the illustrative nature of the calculations presented, and the assumptions to which they were sensitive. See paragraphs 87–94 of the White paper IA and 71–80 of the draft Bill IA for further details.

6. Para 15 states that “when secondary legislation is made, following the passage of the Banking Reform Bill, there will be further IAs covering the contents of that secondary legislation”. Please outline the framework that will be used to assess the costs of the secondary legislation, and explain the manner in which it will drive the nature of the rules produced.

In line with Better Regulation guidelines, the Government intends to publish Impact Assessments (IAs) of the provisions of secondary legislation made under the Banking Reform Bill at the same time as draft secondary legislation is published for consultation.

The process for modelling the impact of the measures in the secondary legislation will be similar to that for the impact of the draft Bill. The Government intends to ask the major UK banks to model their balance sheets first under a baseline scenario incorporating the effects of regulatory changes going ahead independently of the Banking Reform Bill and its subsequent secondary legislation, and then under a scenario including the impact of the Bill and the draft secondary legislation. As was the case for the draft Bill IA, in order to reflect the flexibility of the ring-fence, banks will be left free to choose whether activities that are neither “core” nor “excluded” are carried out inside the ring-fence or not. Comparing the modelled balance sheets under the “baseline” and “with Bill and secondary legislation measures” scenarios will allow the incremental impact of the measures in the secondary legislation to be estimated. Similarly to the IA for the draft Bill, the private cost to UK banks will be analysed in four main elements: capital costs, funding costs, operational costs and transitional costs.

Given that banks will need to take account of the full range of ring-fencing requirements in order to model how they would separate their balance sheets, it will not be possible to assess the impact of each of the provisions of the secondary legislation in isolation (either from other secondary legislation provisions or from the provisions of the Bill itself). For example, in deciding whether to place the deposits of organisations that are not SMEs inside or outside the ring-fence, banks will need to take into account not only the definition of SME set in the draft secondary legislation but also what activities are defined as “core” and “excluded” in both the Bill itself and in the secondary legislation. Secondary legislation IAs will therefore assess the impact of the measures in the draft secondary legislation in packages, not in isolation. Given that the broad principles of ring-fencing and depositor preference have already been settled, the focus of impact analysis for the secondary legislation will be to inform decisions on the precise calibration of the different policy measures: for example, the decision on where exactly to set the threshold for defining an “SME” for the purposes of ring-fencing, not on whether SME deposits should be considered as “core”.

In assessing the impact of the measures in the draft secondary legislation, it will be necessary to make a number of assumptions, for example on the wider macroeconomic environment and on the behavioural responses of bank customers and management. The results of the cost-benefit analysis will be sensitive to these assumptions, as well as subject to uncertainty over future market developments. The key assumptions, sensitivities and risks will be set out in the secondary legislation IAs.

10 December 2012

Written evidence from the Bank of England

Thank you for your letter of 19 November 2012. As requested, in this note I set out options for including in the Bill powers to require reorganisation or separation, on a contingency basis, if banks were to breach the ring-fence—the so-called “sword of Damocles” reserve power. In the time available, I have not been able to do full justice to all of the legal and practical issues this might raise, but wanted to give you some tentative thoughts on a possible framework. While I have discussed these issues with colleagues here at the Bank, the views are personal ones.

The backstop power as an incentive-correcting mechanism

The first thing to say is that this reserve power is most usefully thought of as a means of reinforcing the ring-fence, not as a means of supplanting it. Suitably designed, this power would have no impact on any firm intending to abide by the letter and spirit of the ring-fence proposals. For those at risk or gaming or arbitraging the ring-fence, it would provide potentially powerful incentives not to do so.

The benefits from backstopping the ring-fence are, then, that this would create self-reinforcing incentives on the part of ring-fenced banks’ management to avoid leaks and breaches. That would make the job of policing the ring-fence, both by the board of the ring-fenced bank and the regulator, somewhat easier. In other words, a reserve power would lessen the “negotiation risk” between firm and regulator highlighted by the Governor in his testimony.

The key question is how to make such a reserve power operational. In thinking about that, it is useful to set out the ladder of actions and sanctions that could be imposed on a firm or set of firms in the event of breaches of the ring-fence. For each, the key thing would be to have absolute clarity in legislation on the scope of these actions and sanctions.

The first line of defence should be the board of the ring-fenced bank. As I said in my evidence to you, it would be extremely useful to impose on the board a duty to ensure the integrity of the ring-fence. Indeed, that duty might be extended to the board of the parent company. This could take the form of a relatively narrow duty to preserve the ring-fence or a wider obligation to support the purposes of the ring-fence—for example, continuity of service to depositors and borrowers. Such objectives would augment directors’ duties to shareholders under Company Law.

The second line of defence should be the prudential regulator, which in future will mean the PRA. Again, it would be extremely useful in this respect if the PRA were given a clear role in ensuring the integrity of the ring-fence. That might mean setting out, perhaps in secondary legislation, a clear mandate for the regulator defined in terms of policing the ring-fence, making clear the powers that exist to enforce this policing.

On powers of enforcement, under the supervisory framework anticipated in the Financial Services and Banking Reform Bills, the PRA could take the following actions if a firm were to be breaching its rules or objectives:

- Impose higher capital requirements under Pillar 2, or tighter liquidity requirements.
- Take action under the approved persons regime, potentially including removal of approvals.
- Impose a financial penalty.
- Varying a bank’s authorisations to limit or prevent activities.
- Removing links to owners and group companies.

These are a potentially powerful set of regulatory sanctions for helping reinforce the ring-fence.

A further potential rung in the ladder of sanctions could be a regulatory power to require a restructuring or reorganisation of the business of any bank breaching the ring-fence. The Financial Services Bill falls short of providing such a power. But such powers are not without precedent in other contexts. So it is plausible to think they could be made operational.

One case study here would be the draft EU Recovery and Resolution Directive (RRD), mentioned by Paul Tucker at the hearing. The range of sanctions envisaged in the RRD is extensive, including divestment, limiting or ceasing certain activities and, ultimately, requiring changes to the legal or operational structures of the firm. At the hearing, Paul said he believed that, if enacted, these RRD powers may be sufficient. The rationale for a reserve power would be slightly different than in a resolution context (continuity of core service rather than resolvability) but the underlying rationale would be the same (protecting financial stability).

A second example would be the powers of reorganisation and restructuring granted to the competition authorities under competition law. For example, the Competition Commission can seek undertakings or make orders requiring firms to divest businesses or assets which are contrary to competition objectives. And as we have seen in EU State Aid cases, significant restructuring requirements can be imposed on financial firms to meet EU competition objectives. In both cases, the underlying principle is that powers of reorganisation might be required to meet public policy objectives.

Such powers, as in a resolution or competition context, would need clear triggers and appropriate checks and balances, which would need to be set out in legislation. For example, the regulator would need to evaluate the reason for the breach of the ring-fence, assess its materiality, determine what measures had already been taken to avoid these breaches and provide an assessment of why they had been insufficient. There might also be safeguards in application of the power, for example to ensure the bank was given sufficient time to effect organisational change without incurring excessive costs.

A final rung on the ladder of potential sanctions might be to require a restructuring or reorganisation not of an individual firm, but of the system as a whole. This is a significant power. Asking the regulator to execute such a re-organisation across the financial system as a whole would be a significant task, both operationally and politically. And the threshold for executing this power would need to be demonstrably higher—for example systematic failure of the ring-fence. In this situation, it is possible that a fundamental defect in the ring-fence had arisen, for which separation might not necessarily be the right solution.

It is reasonable to think that a decision of this magnitude might legitimately lie with Parliament, rather than with a regulator with delegated powers, as the Governor made clear at the hearing. So an alternative to a wide-ranging, across-the-system, power would be to pre-commit to a Parliamentary review of the operation of the ring-fence at some pre-determined point in the future. This option was raised by the Governor at the hearing. This would help strengthen incentives to comply with the ring-fence, while leaving the ultimate decision to Parliament.

Unintended consequences

Finally, at the hearing you asked about potentially unintended consequences which could arise from having a reserve power on the statute books. One possibility here is that the power might exacerbate uncertainty or risk-aversion on the part of banks, perhaps causing them to hoard capital or liquidity instead of lending, or unwilling to innovate in new financial products for fear of falling foul of the ring-fence.

On the face of it, it is difficult to see why hoarding financial resources would be a natural response to the addition of a reserve power. Nor is it obvious that this would stifle financial innovation, which can anyway take place in the non ring-fenced bank. Nonetheless, fear of the unknown plainly could be a factor shaping the decisions of a ring-fenced bank. If so, three factors would be crucial in mitigating this risk, all of them in the spirit of requiring as much clarity as possible.

First, this strengthens the case for absolute clarity about the position of the ring-fence. That would mean having the objectives and the position of the ring-fence set out clearly, perhaps in secondary legislation. The same would be true of the duties of both ring-fenced bank directors and the regulator in policing the ring-fence.

Second, there would need to be clarity about the triggers which might prompt intervention by the regulator, including the ultimate sanction of reorganisation. These might specify how the risk posed by a breach of the ring-fence might translate into regulatory sanction.

Third, there would need to be clarity about the constraints within which the regulators would need to act when making a decision about reorganisation. These could be similar in principle to the “no creditor worse off” provisions under the existing resolution regime, suitably adapted. Both the second and third issues would require further work.

I hope these preliminary thoughts are useful to you and the Commission when reaching decisions on this very important issue.

Andy Haldane, Executive Director

6 December 2012

Written evidence

Written evidence from Barclays

CALL FOR EVIDENCE ON PROPRIETARY TRADING

The Parliamentary Commission on Banking Standards published its First Report on pre-legislative scrutiny of the Government's draft Financial Services (Banking Reform) Bill on 21 December 2012. The Commission identified the need for further consideration of the implications of introducing a prohibition on groups containing a ring-fenced bank from engaging in proprietary trading.

The Commission requests responses by Friday 11 January.

The Commission would welcome responses to the questions below. It is not necessary to address every question, and those submitting evidence should feel welcome to address other relevant matters not raised in the questions.

INTRODUCTION

The definition of proprietary trading is fundamental to this issue generally, as well as the specific questions posed by the Commission.

Defining “proprietary trading” is notoriously challenging. Most commentators define it as “principal trading” (or taking a position for the purpose of profiting on the position itself), but activity that could be regarded as “principal trading” arises from a range of activities in banks, particularly in the context of a client-facing/market making business. Any debate about the appropriateness of proprietary trading must clearly distinguish among three different instances or examples where a bank may assume a principal trading position:

1. Trades performed by “stand-alone”, ring-fenced proprietary trading desks that are organised by a bank with the specific purpose of trading in a firm’s own capital to profit from short-term price movements;
2. Principal positions entered into within the context of market making/client-facing activities; and
3. Risk-mitigating hedging activities undertaken to offset risks that materialise as a result of a bank providing services to clients.

It’s important to stress that trading as principal in the latter two categories, in particular, is beneficial to the liquidity of the market, so any definition should give full regard to this.

For context, it is worth noting that the FSA also employs a definition of “Proprietary Trading”—substantially for the purposes of the UK’s “Approved Person” regime—as follows:

“(in SUP 10 (Approved Persons) and APER) dealing in investments as principal as part of a business of trading in specified investments. For these purposes dealing in investments as principal includes any activities that would be included but for the exclusion in Article 15 (Absence of holding out) or Article 16 (Dealing in contractually based investments) of the Regulated Activities Order.”

This is a very broad definition that does not make the distinctions noted above. For the sake of capturing individuals who could be involved in “proprietary trading”, this broad definition is appropriately conservative, but it would not be appropriate for the purposes of making decisions about whether or not to prohibit any activity.

Any new statutory framework or prudential regulations would need clarity in what the UK wants to capture within its definition, and where this aligns with/diverges from international standards that exist at the moment or may develop over time. The Basel Committee on Banking Standards could play a role in defining this, to ensure a harmonised playing field.

STABILITY

1. What prudential concerns does proprietary trading within banks give rise to? To what extent are any concerns being addressed through existing measures and proposals, including ring-fencing?

Barclays has made previous submissions on the prohibition of proprietary trading, for instance to US authorities in the context of the Volcker Rule.

Our position was, and still is, supportive of a prohibition, providing that the definition of proprietary trading is suitably narrow and concise. More specifically, we support a prohibition on proprietary trading desks that are established by a bank for the specific purpose of trading for the firm’s own account. These desks tend to be set-up with segregated capital and with separate teams of people whose compensation structure mirrors those of hedge fund managers, rather than other traders within the bank, and have minimal or no interaction with client business. These “stand-alone” proprietary traders typically sit apart from traders who serve clients as a part of steps taken to address the potential for conflicts of interest.

A wider definition could bring considerable limitations. Both ring-fenced banks and non-ring-fenced banks need to take some proprietary positions to prudently hedge their risk (eg, Interest Rate in the Banking Book). The Government's Draft Bill made important exemptions in this regard for "Treasury hedging activity", and these should remain. A similar case can be made for market marking activity, which provides a stabilising effect; government bond trading is a good example of the importance of this facility within a well risk-managed non-ring-fenced bank.

Prudential concerns can be generated by any concentration of risk which is not appropriately managed by a combination of eg, internal governance and control tools (including the Board-approved risk appetite framework, and the three lines of defence which include independently managed and incentivised control and control functions) within a firm as well as wider prudential regulatory controls that gauge risk appetite, as applied and monitored by the regulator, whether that risk is generated by trading on "own account" or purely to facilitate client facing business. Our expectation is, therefore, that to the extent that other reforms are not appropriately addressing these prudential risks, simply prohibiting "proprietary trading", however defined, will not address this gap in the reform process.

STANDARDS

2. To what extent does the presence of proprietary trading activity alongside client-facing activity in banks create the potential for conflicts of interest and affect remuneration practices, culture and banking standards?

The extent to which the presence of proprietary trading activity alongside client-facing activity creates the potential for conflicts of interest depends on the nature of the risk involved. This, in turn, is determined by whichever type of proprietary trading is taking place (see the introduction section above, on definition).

Certain trading activity, including trading activity undertaken to support client facing business, has the potential to generate conflicts of interest. Firms are under a clear obligation to manage these risks fairly and expressly to address such conflicts as they might arise between a firm and its clients.

The risk of any proprietary trading influencing broader remuneration practices, culture and standards depends entirely on the specific scale and nature of the proprietary trading, especially in relation to other activities undertaken by the relevant firm. We would posit, based on our experience, that any proprietary trading (even broadly defined) would have to be unusually large in order to have any discernable influence on any of these.

3. How adequately do current conduct rules manage any potential for conflicts and harm to standards? To what extent could stronger conduct rules address any problems?

This question is best answered by the FSA.

4. Are there stronger grounds for concern about proprietary trading when it is conducted in a group which contains a ring-fenced bank than if it is conducted by a standalone wholesale bank? If so, why?

There is nothing unique about the risk created by proprietary trading compared to other forms of risk present in a non-ring-fenced bank, apart from the difference in objective of the trading (ie, creating profit for own account rather than only facilitating client activity). Furthermore, there is no greater risk presented in a group that contains a non-ring-fenced bank, over a standalone non-ring-fenced bank, so no special interventions would be required for such a group.

PRACTICAL CONSIDERATIONS

5. How, if at all, would prohibiting proprietary trading by banking groups affect the case for implementing a ring-fence? Would there be any practical benefits from implementing both such measures at the same time?

There would be no noticeable effect. The two are very different actions, serving different purposes. The purpose of the ring-fence is to facilitate resolution of critical economic functions, whereas a ban on proprietary trading would simply prohibit certain forms of risk that are otherwise present inside a non-ring-fenced bank.

That said, this also therefore implies that a ring-fence and a prohibition on proprietary trading could function alongside each other, if both are defined appropriately.

6. What powers does the regulator already have that could be used to prohibit banks from conducting proprietary trading? What are the constraints on any such powers?

Proprietary trading itself is not a specific regulated activity under the Financial Services and Markets Act (Regulated Activities) Order 2001. However, the FSA does have OIVOP (Own Initiated Variation Of Permission) powers—under s.45 of the FSMA, although these have been used sparingly in practice. It might be worth encouraging the FSA to use their powers to validate risk limits more actively. We expect the FSA could comment more fully on the practicality and benefit of doing so.

7. *What are the main challenges in defining proprietary trading, and how could these best be addressed?*

This question has been answered in the introduction.

OVERALL ASSESSMENT

8. *Given the factors above, how would you assess the case for:*

(a) *Including a prohibition on groups containing a ring-fenced bank from engaging in proprietary trading within the Banking Reform Bill*

As covered in the answer to Q4, we see no distinction in terms of the risks to financial stability between a proprietary trading entity that sits within a group containing a non-ring-fenced bank, and one on its own, especially if ring-fencing has been completed. So no particular benefit would be gained from applying such a prohibition only to a non-ring fenced bank within a group containing a ring-fenced bank.

(b) *Implementing or creating reserve powers for a proprietary trading ban through some other form*

To an extent, reserve powers already exist; as such, it's unclear what an additional power would add and what its objective would be.

(c) *Requiring that future reviews of the operation of the ring-fence have an explicit mandate to consider and report on the case for such a prohibition*

As set out in the answer to Q5, we do not believe that a ring-fence and a prohibition on proprietary trading are related, so there would be no need to review these separate issues together.

(d) *Using the Banking Reform Bill to give the regulator a reserve power to impose such a prohibition on individual banks if it concluded that it was necessary*

As with part (b) above, we do not think there is a clear purpose behind such a power given the other observations we have made within this evidence. In particular, if the Authorities were to determine that proprietary trading was too risky for one particular firm, it would seem odd not to make a similar determination for all firms generally. If that is because of deficiencies within the particular firm, with respect to governance, tools and/or capabilities, it would surprise us to understand that the FSA does not already have the power to prohibit any individual institution from undertaking any activity in such circumstances.

14 January 2013

Written evidence from Finance Watch

PRELIMINARY REMARKS

Finance Watch is an independently funded public interest association dedicated to making finance work for the good of society. We are pleased to have this opportunity to contribute to the PCBS's scrutiny of the Financial Services (Banking Reform) Bill on the question of whether to introduce a ban on proprietary trading within banking groups that contain a ring-fenced entity.

Finance Watch is an advocate of structural separation of commercial and investment banking activities. Whilst proprietary trading raises prudential concerns, we feel that these are best addressed by strengthening the ring-fence proposal. Separating proprietary trading is difficult and, for example, increases complexity and the possibility of loopholes. Therefore, on balance, our analysis argues against a ban on proprietary trading. In our view, trading activities should be located in well regulated, supervised, and capitalised investment banks, not least to facilitate visibility and control.

In short, the simpler the rules the stronger the ring-fence. The stronger the ring-fence the less need there is to ban proprietary trading.

SUMMARY

- Proprietary trading gives rise to general concerns, more specifically proprietary trading within banks gives rise to prudential concerns because of the possibility that losses will be borne by society, most directly via some form of bail-out.
- Additionally, recent research from Germany has shown that the presence of proprietary trading activity alongside client-facing activity in banks creates the potential for conflicts of interest directly related to banking standards.
- These concerns are to some extent addressed by ring-fencing; however compared to full structural separation there remain concerns that the ring-fence will not completely remove “perceived implicit guarantees” and their related subsidies.

- A strong ring-fence is therefore the priority. A ban on proprietary trading could reduce risk but the difficulty in defining and enforcing such a ban and the likelihood that this would allow loopholes to undermine the overall robustness of the ring-fenced approach is a greater risk.
- Separating proprietary trading from market making, or indeed hedging from speculation from arbitrage, is very difficult. For example both market making and hedging necessarily involve taking a view on price moves and expressing that view on your own account.
- Proprietary trading is one among a number of investment banking activities that are best located and regulated within a well-capitalised investment bank structurally separate from commercial banking activities and subject to prudential controls. For example, the majority of market making faces only the financial sector. Less than 10% of OTC derivatives face non-financial firms (BIS), less than 15% of UK debt securities are issued by non-financial firms (ECB), world trade is less than 5% of total foreign exchange activity (WTO & BIS).
- The difficulty of distinguishing between different types of trading activity and its overwhelmingly financial nature underline the need for a simply defined, robust ring-fence that will resist attempts to undermine it over time.
- The UK and European banking sectors continue to rely on sovereign support, whether through direct ownership, central bank liquidity or other measures. Far from imposing a cost on banking and hence on society, we consider that structural separation, (including in the form of a strong, loophole-resistant ring-fence) is key to stabilising the sector and would help to restore the flow of credit between banks and from banks to the real economy.

Questions:

STABILITY

1. *What prudential concerns does proprietary trading within banks give rise to? To what extent are any concerns being addressed through existing measures and proposals, including ring-fencing?*

Proprietary trading within banks gives rise to prudential concerns because of the possibility that losses will be borne by society, most obviously via some form of bail-out.¹ Own-account trading of any kind conducted within an entity which is partly or wholly backed by implicit or explicit state guarantees, such as banks, encourages asymmetric risk-taking (heads I win, tails the taxpayer loses). This contributes to micro- and macro-prudential risk and can increase resource misallocation and systemic risk.

These concerns are to some extent addressed by ring-fencing, in particular if the ring-fence effectively separates trading from those parts of the banks which must be bailed out and if the investment banking entity which bears trading losses is not too-big-to-fail. However compared to full structural separation (which Finance Watch advocates),² prudential concerns remain. As the PCBS's first report notes, ring-fences are fallible (see also our response to question 4 below). Given a leaky, badly maintained or weak ring-fence, there is a danger that losses from proprietary trading could cause problems for ring-fenced entities. Resolution tools, no matter how well designed, can only deal with so much. Therefore, there remains a danger that State intervention at taxpayers' expense will be required and that "perceived implicit guarantees" will remain.

Furthermore, allowing some trading activities within the ring-fenced entity could increase prudential concerns. All own-account trading contains a proprietary element, including those which are labelled hedging and market making (see our response to question 7 below for more details).

We note that the government's response to the PCBS report states that it "strongly agrees with the PCBS that the overall objective of banking reform should be to curtail any perceived implicit guarantees enjoyed by banks seen as 'too big to fail'" (para 2.6).

The draft legislation published 4 February 2013 provides for some trading activities to be allowed inside the ring-fence in certain circumstances provided they do not threaten the continuity of core services (142D).

This gives rise to some concerns in part because proprietary elements are present in all trading activity, making it difficult to distinguish between trading activities on this basis. Allowing trading activities within the ring-fenced entity increases prudential risk, as noted above, but is also likely to weaken the ring-fence, as former ICB members Sir John Vickers and Martin Taylor have testified to the PCBS. Attempts to distinguish between different types of trading will require constant monitoring of loopholes that arise and give banks an incentive to "innovate" in order to benefit from explicit guarantees.

The same logic applies to any attempted ban on prop trading. As has been seen with the implementation of the Volcker Rule in the United States, distinguishing and separating proprietary trading can lead to complex

¹ Proprietary trading, with its focus on profiting from short-run price moves, also gives rise to more general concerns. Prop traders must form beliefs about the beliefs of other market participants, most famously explained by Keynes' beauty contest analogy. Finance Watch believes that assessing and investing for long run returns of underlying projects is more "socially useful" than betting on price moves (see our report "Investing not Betting" at <http://www.finance-watch.org/2012/04/investing-not-betting-download-finance-watches-position-paper-on-mifid-2-2/>).

² See Finance Watch responses to the Liikanen consultation and final report: <http://www.finance-watch.org/wp-content/uploads/2012/06/Finance-Watch-response-to-consultation-on-EU-banking-structure.pdf>, and http://www.finance-watch.org/wp-content/uploads/2012/11/12.11.13_Answer_to_EC_Consult_SENT.pdf

rules. The danger exists that the more complex the rules the more likely banks will “innovate” to benefit from (in the proposed UK case) implicit guarantees created by weaknesses in the ring-fence. In addition, clarity is reduced for investors and regulators in this situation.

[NB—The general objective of the PRA as amended by section 1 of the 4 Feb draft bill, which can be summarised as ensuring the continuity of core services in the face of internal and external threats and of ring-fence bank failure, appears to us to be narrower than the three objectives set out by the ICB, which can be summarised as protecting taxpayers, ensuring the continuity of essential services and curtailing government guarantees (PCBS 130).

In particular there is no express reference to “mak[ing] it easier to sort out both ring-fenced banks and non-ring-fenced banks which get into trouble, *without the provision of taxpayer-funded solvency support*” or to “*curtail[ing] government guarantees*, reducing the risk to the public finances and making it less likely that banks will run excessive risks in the first place.” (PCBS 130, emphasis added)

Framing those two ICB goals as subsidiary parts of the continuity of core services objective, for example by reference outside the legislation to resolution and bank conduct (Govt. response para 2.15), is not enough in our view to ensure that the ICB’s public policy goals are fully taken into account by the PRA. We fear that the ICB’s objectives will not be fully translated into legislation without an explicit reference in the PRAs statutory objectives to reducing the role of taxpayers in bank failures and to curtailing government guarantees.

The public policy grounds for doing so are summed up clearly by the PCBS: “*A guarantee, whether implicit or explicit, distorts incentives of managers and creditors, encouraging them to pursue excessive risk and leverage. It also distorts competition, and the allocation of resources, away from smaller banks to those large enough to be regarded as systemic*” (PCBS 104). These objectives are central to the effectiveness of the secondary legislation envisaged in the bill and to the PRA’s statutory review of ring-fencing and should therefore be clarified to ensure that the purposes of the ring-fence as outlined by the ICB are not undermined or eroded (PCBS 171).]

STANDARDS

2. *To what extent does the presence of proprietary trading activity alongside client-facing activity in banks create the potential for conflicts of interest and affect remuneration practices, culture and banking standards?*

Research from Germany into banks which managed assets for clients and undertook proprietary trading shows that:³

- Banks systematically push stocks from their proprietary portfolio into their retail customers’ portfolios.
- Those stocks systematically underperform compared to both other stocks in banks’ proprietary portfolio and other stocks in households’ portfolios.
- Customers’ portfolio performance at banks with prop trading is significantly worse than at those without.

A strong ring-fence, or better still full structural separation, would go some way to mitigating this problem by separating commercial banking from the trading culture of investment banks. One way in which separation would help is if it gives investors a clearer choice between investing in commercial or investment banking and thereby going some way to insulating investors in retail banks from investment banking culture. For example, there is evidence that investors would rather that investments in retail banks were insulated from cases of miss-selling in investment banks.⁴ Steps to shift the focus of financial markets from short term price moves to long term investing would also help in this regard.

3. *How adequately do current conduct rules manage any potential for conflicts and harm to standards? To what extent could stronger conduct rules address any problems?*

4. *Are there stronger grounds for concern about proprietary trading when it is conducted in a group which contains a ring-fenced bank than if it is conducted by a standalone wholesale bank? If so, why?*

Yes. Proprietary trading within a group that contains a ring-fenced bank raises concerns that may not apply to proprietary trading in a standalone investment bank because funding and subsidy leakages may occur between the parts of a ring-fenced entity. As mentioned above and in the PCBS’s first report, fences may be leaky, may require maintenance and may be blown over in a crisis.

For example (a) if the ring-fenced and non-ring-fenced operations are funded with capital raised at the holding company level, the blended cost of that capital would necessarily include a subsidy; (2) if, in a crisis,

³ For Presentation of this research at the Banque de France (December 2012): http://www.banque-france.fr/fileadmin/user_upload/banque_de_france/Economie_et_Statistiques/slides_Fecht.pdf. For a fuller write up at an earlier stage see: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1783679

⁴ See quote from Investment Management Association in the following article: http://thetradenews.com/news/Asset_Classes/Derivatives/Derivatives_key_to_success_of_UK_banking_reforms.aspx

the ring-fenced bank were able to transfer surplus capital and/or liquidity to the non-ring-fenced entity, that would also represent the extension of a subsidy to the proprietary trading operations; (3) if the market were to doubt the effectiveness of untested resolution mechanisms it might supply capital to the non-ring-fenced proprietary trading activities at artificially low rates; (4) in a worst-case scenario, a serious failure in one part of the group resulting from proprietary trading could result in a loss of market confidence in other entities in the group and require government support for one or more of them.

Full separation of well-regulated and well-capitalised, not-too-big-to-fail, investment banks would greatly reduce the reasons for a ban on proprietary trading. Such investment banks would be able to take more or less proprietary risk as they saw fit (and as their shareholders saw fit) without posing systemic risks. Likewise, within a group containing a ring-fenced entity *the stronger the ring-fence the less the need for a ban* (the strength of the ring-fence is also affected by its location, as is discussed more fully in response to question 7). From a regulatory and a reporting perspective such investment banks offer the best chance to regulate and report on a variety of investment banking activities including proprietary trading.

Bank lending and facilitating lending via securities markets are fundamentally different banking activities. Allowing these activities to mix freely has proved very costly for the economy and financial system in the past

PRACTICAL CONSIDERATIONS

5. How, if at all, would prohibiting proprietary trading by banking groups affect the case for implementing a ring-fence? Would there be any practical benefits from implementing both such measures at the same time?

A ban on proprietary trading does not undermine the case for ring-fencing. Structural separation remains a critical mitigant of prudential concerns. Any ban on proprietary activity would aim to support structural separation. However a ban on proprietary trading may not be the best way to strengthen the effectiveness of separation.

It is likely that for practical purposes only a small part of proprietary trading could be banned from groups containing a ring-fenced entity, ie dedicated proprietary trading activities (see our response to question 7 below). The remaining investment banking activity would still require a robust ring-fence.

Implementing a ban in addition to the ring-fence might remove a source of potential loss and asymmetric risk-taking from a ring-fenced group; however, the difficulties of regulating and enforcing such a ban are likely to be considerable, as has been seen in the United States. In our view, the benefits of eliminating a small amount of dedicated proprietary trading are likely to be outweighed by the strong likelihood that gaps elsewhere in the ring-fence would be systemically exploited. The complexity of defining and enforcing such a ban could undermine the overall robustness of the ring-fenced approach.

6. What powers does the regulator already have that could be used to prohibit banks from conducting proprietary trading? What are the constraints on any such powers?

7. What are the main challenges in defining proprietary trading, and how could these best be addressed?

Distinguishing and separating proprietary trading from other trading activities including from market making and from hedging, is very difficult. Trading is trading.

Market making necessarily involves taking a view on how prices are going to move, and necessarily involves holding an inventory. These are also the two essential elements of prop trading. All market making (as opposed to broking) involves an element of prop trading.

To make markets involves standing ready to buy and sell, and communicating to others in the market the prices at which you are willing to do so. Deciding on those prices requires deciding how happy, or not, you are to have the instrument in question on your book and adjusting your bid and ask prices accordingly. Market making does not involve simply adding a margin to a (hypothetical) mid-price, it involves adjusting your price to buy and your price to sell to “win” or “miss” client trades and to adjust your inventory accordingly, all the while bearing in mind your reputation.⁵

Similarly hedging necessarily involves transforming rather than eliminating risks. Simply put the only way to eliminate a risk is to sell the source of that risk. A hedge, by definition, is something other than selling the underlying source of risk. Therefore hedging always involves taking a proprietary view eg on counterparty risk, on the movements in an index vs. the price moves of a component, on movements in prices of similar instruments with different maturities and so on.⁶

⁵ This might be thought of as a traders view. A more theoretical view might argue that the separation of prop from market making (and for that matter of arbitrage from hedging from speculation) is a theoretical separation which relies on the hypothetical idea of complete markets. In such markets a single pure market price exists at which markets clear. This theory is adjusted through various market imperfections to account for market makers and their bid-ask where market makers add a margin to the pure or mid price. But this logic is in fact inverted. The perfect market does not, cannot exist except as an abstract and mathematical idea. For the market to exist requires market makers. With this, alternative, theoretical starting point the first and fundamental prices to exist are the bid-ask prices of those that make the market. Any “mid” price is then derived from bid-ask (and not the other way around).

⁶ Even insurance ie against a specific and even deliverable loss involves taking counterparty risk, as counterparts to US monoline insurers and to AIG found in the recent financial crisis.

Managing derivatives positions implies by definition opening risk positions on multiple parameters (market level, interest rates, volatility, correlation, etc...) and in the reality of a trading operation there is very little, if any, economic difference between “pure prop trading” and the management of client facing derivatives positions that require the bank to take a view on the evolution of those market parameters. This issue is particularly important in the UK case given the size of derivatives positions held by the largest UK banks.⁷

The fundamental similarity between all trading activities and their difference from commercial banking activities is one reason why we prefer full structural separation to ring-fencing; and, in the absence of full separation, a strong ring-fence that would keep all market making activities out of the subsidised ring-fenced entity.

The difficulty of distinguishing between trading activities provides a strong argument for simplicity, with regard to proprietary trading but also in the location of the ring-fence. Aside from the possibility of losses, a complex definition of permitted trading activities, either inside the ring-fenced entity or elsewhere in the group, will be subject to attempts at regulatory arbitrage and to degradation over time. Simple rules, on the other hand, would simplify the choices of investors in commercial and investment banks with their respective risk profiles.

Simple rules that group trading activities in an investment bank, separated from commercial banking activities, would aid regulatory control, including addressing public interest concerns across a range of investment banking activities. For example market making involves activities that might not be fully in the public interest. The “real” economy might need investment banking (to raise large scale finance) but, funding subsidies aside, one can reasonably ask how much investment banking needs the “real” economy. The majority of investment bank trading appears to be directed elsewhere. Less than 10% of OTC derivative notional outstanding faces non-financial firms.⁸ Less than 15% of UK securities outstanding (excluding shares) are issued by non-financial firms.⁹ World trade is less than 5% of foreign exchange activity.¹⁰ In short, the vast majority of financial market activity is not concerned with financing the “real” economy. Nevertheless it is banks, and only banks, that organise the issuance of these securities and make markets in them. It is not simply proprietary trading that should be insulated from public support, but also finance-to-finance securities and derivatives trading that should be forced to stand apart from (implicit) public support.

It is sometimes argued that separating all market making activity from ring-fenced subsidies would have costs as well as benefits. Specifically, it might increase market making costs for securities that are issued by non-financial firms (market making in corporate bonds), or instruments that are used by non-financial firms to hedge, eg interest rate and foreign exchange risks. We would contest this, above all we would note:

First, we would fundamentally contest the premise of the trade-off. While UK and European banking remains in dire shape (in public hands and often in receipt of central bank liquidity provision) measures to stabilise the sector and bring a return of confidence are more likely to decrease (stand-alone) funding costs than to increase them. Comparisons between a banking system post-structural separation and a theoretical healthy banking system pre-structural separation serve no purpose in assessing current policy options.

Second, as pointed out above only a small percentage of investment banking activity relates to non-financial firms. Removal of the funding subsidy (in conjunction with other measures) might remove some trading activity which does not relate to financing non-financial firms. This could be considered as a positive development for taxpayers as it would reduce both systemic risk and the “taxpayer put” subsidy for these activities.

Third, there is no reason that a loss of subsidy would necessarily be passed on to corporate customers. Given the right incentives banks could choose to reduce their margins rather than pass on any increased funding cost.¹¹ Investment banks in recent years have been targeting very high returns on equity eg much higher than GDP growth.

Fourth, for essential activities like making markets in Government bonds, funding of inventory is not an issue as the assets traded (Government bonds and bills) can be easily financed through repurchase agreement (“repo”) operations which are, regardless of market circumstances, always the easiest and cheapest way of refinancing available for such activities.

Fifth, if one considers the total cost of funding of a bank (and therefore of a universal bank) is a direct function of the risks taken on the asset side of the balance sheet and if excluding a number of risky trading activities increases the cost of funding of these activities, this will also mechanically decrease the cost of funding of ring-fenced activities which, by definition will be positive for the economy and for society.

In short, there is great difficulty in distinguishing and separating proprietary trading from other trading. All own-account trading contains elements of proprietary trading, including market making and hedging of “simple

⁷ For example the Liikanen report (p124) shows that RBS and Barclays held considerably higher percentages of derivatives than other large European banks with the exception of Deutsche Bank.

⁸ <http://www.bis.org/statistics/derstats.htm>

⁹ <http://www.ecb.int/stats/money/securities/html/index.en.html>

¹⁰ <http://www.bis.org/publ/rpfx10t.htm> and http://www.wto.org/english/news_e/pres12_e/pr658_e.htm#table4

¹¹ Given non-financial firms’ lack of financial market experience relative to banks it is possible that they are already charged higher margins than eg, hedge funds (in fact this is very likely to be the case).

derivatives” and other trading activities that the law as currently drafted might allow inside a ring-fenced entity. We feel the challenges of distinguishing and separating proprietary trading are best addressed by not attempting to do so—and instead by corralling all trading activity into well regulated, supervised and capitalised investment banks.

OVERALL ASSESSMENT

8. *Given the factors above, how would you assess the case for:*

(a) *Including a prohibition on groups containing a ring-fenced bank from engaging in proprietary trading within the Banking Reform Bill*

While proprietary trading in banks gives rise to prudential concerns, attempts to prohibit it also come with dangers. On balance, Finance Watch feels that rather than trying to ban prop trading, the best approach is to strengthen the ring-fence to ensure that losses from proprietary trading cannot blow it over.

Only the most obvious proprietary trading could be banned with ease, while the remaining own-account trading will retain proprietary elements. Moreover any attempt to define proprietary trading is likely to create opportunities for banks to “innovate” around the definition. Simple rules reduce the opportunity for lobbying¹² and are easier for regulators to enforce.¹³ Simple rules also increase the transparency for investors. Finally there are also regulatory advantages from keeping proprietary trading in investment banks under the control of banking supervisors and regulators and capitalised under Basel and Capital Requirements Directive regulations.

Finance Watch has been active in the banking separation debate in several places in Europe (see our responses to the Liikanen Commission and Report, and to the French Parliament for example).¹⁴ We would note that the proposed approach in the UK is closer to that of the EU’s Liikanen Commission, which did not recommend a ban on proprietary trading, than current proposals in France and Germany are. In this regard, the UK has the opportunity to inspire a race to the top.

(b) *Implementing or creating reserve powers for a proprietary trading ban through some other form*

(c) *Requiring that future reviews of the operation of the ring-fence have an explicit mandate to consider and report on the case for such a prohibition*

(d) *Using the Banking Reform Bill to give the regulator a reserve power to impose such a prohibition on individual banks if it concluded that it was necessary*

ABOUT FINANCE WATCH

Finance Watch is an independently funded public interest association dedicated to making finance work for the good of society.

Its mission is to strengthen the voice of society in the reform of European financial regulation by conducting advocacy and presenting public interest arguments to lawmakers and the public. Finance Watch’s members include consumer groups, housing associations, trade unions, NGOs, financial experts, academics and other civil society groups that collectively represent a large section of European citizens.

Finance Watch’s founding principles state that finance is essential for society in bringing capital to productive use in a transparent and sustainable manner, but that the legitimate pursuit of private interests by the financial industry should not be conducted to the detriment of society.

13 February 2013

Written evidence from the Financial Services Authority

STABILITY

1. *What prudential concerns does proprietary trading within banks give rise to? To what extent are any concerns being addressed through existing measures and proposals, including ring-fencing?*

Whenever banks engage in trading activities they take on risks—in particular the risk that their investments will fall in value (market risk) and the risk that the counterparties to their investments will fail to pay them (counterparty credit risk). Losses caused by these risks will erode a bank’s capital base. Banks are required to hold capital to protect against such risks. Whether banks are trading for proprietary reasons, or to facilitate client business, they will be exposed to some market and counterparty risks. The key difference is the scope and breadth of these risks.

When facilitating client business a bank is likely to try and “hedge” most of its risks. However this will never be certain as: (i) there will often be some mismatch between the position and the hedge—known as basis

¹² As noted in previous evidence. Eg, MTaylor Q386
<http://www.publications.parliament.uk/pa/jt201213/jtselect/jtpebs/c606-vii/c606vii.pdf>

¹³ As noted in previous evidence. Eg JVickers Q2574
<http://www.publications.parliament.uk/pa/jt201213/jtselect/jtpebs/c606-xxiii/c60601.htm>

¹⁴ See <http://www.finance-watch.org/2013/01/finance-watch-proposes-amendments-to-french-bank-reforms/>

risk; (ii) there will be a need, and a cost, to “rebalance” hedges as market moves alter risk profiles; (iii) there will always be a reliance on the “hedge counterparty” to remain solvent.

When undertaking proprietary trading, banks will try and target certain risks that they wish to take, and hedge others—thus all the same hedging risks apply. However, additional risks will be taken in order to try and profit from a wide range of market movements. Whilst this activity can be extremely lucrative it also means that a much wider scope and breadth of risks can impact a bank’s capital base. Ultimately, as with any risk, if losses are large enough this could lead to a bank’s insolvency.

We consider that a strong ring-fence should help insulate the provision of core financial services from losses that could arise from proprietary trading. We also note that the Basel Committee is conducting a review of the capital requirements for trading activities which will further supplement the changes to the capital regime made following the banking crisis.

2. To what extent does the presence of proprietary trading activity alongside client-facing activity in banks create the potential for conflicts of interest and affect remuneration practices, culture and banking standards?

Where a bank decides to engage in proprietary trading there is a potential for increased principal-agent conflicts with its clients. This is because the bank stops being a mere provider of banking/financial services to its clients and becomes a potential competitor. This means that the bank’s incentives may become less aligned with its clients. This conflict becomes more pronounced when the proprietary trading operations of any given bank are more material to the bank’s profitability than its client operations.

Where a bank conducts proprietary trading the handling of client information is a particularly sensitive issue. For example, client order flow information has to be shielded from the bank’s proprietary trading desks, as the bank could make improper profits off the information to the detriment of its clients. This can be challenging to do if, for example, the proprietary trading desks are located in close proximity to the client trading desks on the trading floor.

In terms of remuneration, front office staff across different industries tend to have pay and bonuses linked to sales and profitability. In a highly volatile environment such as trading in financial instruments, this can bring along unwelcome incentives in the form of excessive risk taking and short-termism.

To help address this, the objective of the FSA’s Remuneration Code, which implements the remuneration provisions of the Capital Requirements Directive III, is to ensure that firms adopt remuneration policies which are consistent with and promote sound and effective risk management. The code recognises that perverse incentives encourage excessive risk taking. These incentives exist in varying degrees across banks’ operations as a whole and are not restricted to one type of activity.

Overall, the PRA’s approach to improve banking standards will be to expect the banks’ governing bodies to embed and maintain a firm-wide culture that supports the safe and sound management of the firm. The PRA will expect boards and management to understand clearly the circumstances in which the firm’s viability would be under question and to take action to address risks on a timely basis.

3. How adequately do current conduct rules manage any potential for conflicts and harm to standards? To what extent could stronger conduct rules address any problems?

The current conduct regulatory framework (both rules and high level Principles for Businesses) provides the requisite degree of flexibility for supervisors to exercise the necessary degree of supervisory judgment. The framework takes into account the variety of activities and business models in the financial sector, together with the multiplicity of circumstances in which conflicts of interest and risks may arise in practice as a result of firms’ proprietary trading activities.

For these reasons, it is not currently envisaged that the FCA will introduce additional conduct rules to strengthen the current framework. That said, it is important to note that the FSA’s rules derive from European legislation with the trend continuing to be for Europe to adopt directly applicable regulations.

Conduct risks, and potential conflicts of interest are ubiquitous in the financial services industry although the potential for risks to arise is likely to be greater under the universal investment banking model where firms provide a wide range of financial services and activities. In this context, the potential for conflicts of interest where firms engage in proprietary trading in addition to providing services to their clients is particularly acute.

The FSA manages the risk of detriment to clients arising from firms’ proprietary trading activities in two ways.

- First, across all client categories (including eligible counterparties), the FSA requires special attention to be given by firms to their senior management arrangements and systems and controls where they undertake proprietary trading in addition to providing services to clients. We expect firms which carry out proprietary trading to ensure that they take all reasonable steps to identify, manage, and where necessary, disclose any conflicts of interest that arise from their activities. The organisational and administrative measures we expect firms to put in place to manage the conflicts should be proportionate to the size and organisation of the firm and the nature, scale and complexity of its business.

- Secondly, we recognise that some clients need to be afforded higher regulatory protection than others depending on their knowledge, skills and expertise and the FSA's rules reflect this through placing a number of more onerous requirements on the conduct of the firm when providing services to retail and professional clients. For example, best execution duties, the requirement not to misuse information they have on clients' pending orders, and the requirement to provide appropriate information to clients outlining the key risks of any service provided. We do however recognise that some proprietary trading activities are undertaken in pursuit of legitimate business, for example, market making or risk management purposes. Therefore an exemption to the rules is available in certain circumstances.

With the changes to the UK's regulatory structure the FCA's approach to supervising the conduct of firms' wholesale activities will undergo an evolution. The regulatory framework will not change, however the FCA's approach to supervising against it will. The FCA will place more focus on the rules and supervising against them. The FCA will recognise that the wholesale conduct and the internal organisation and arrangements of firms can pose risks to all participants in the conduct of their activities and cause harm to retail consumers.

For this reason, in order to enhance trust and the integrity of financial markets, the FCA will be willing to intervene in a greater range of client relationships. This will mean that areas which have not been a focus for the FSA in the recent past will be looked at more closely. This will be through the FCA's Supervisory Framework or event-driven work.

4. Are there stronger grounds for concern about proprietary trading when it is conducted in a group which contains a ring-fenced bank than if it is conducted by a standalone wholesale bank? If so, why?

Yes, potentially. There are three reasons for this.

Firstly, if the ring-fence does not prove to be fully effective then there could be contagion from the non-ring fenced bank to the ring-fence entity threatening the provision of core banking services.

Secondly, it would be inappropriate if the cost of funding of the proprietary trading business in a group with a ring-fenced bank would be lower than a standalone wholesale bank solely because of the presence of the ring-fenced bank in the former group. Whether this will be the case depends on how the legislation and rules pertaining to the height of the ring-fence develop and the markets view on whether this removes the potential for any government support from the non-ring fenced bank.

Thirdly, depending on the height of the ring-fence, proprietary trading may directly impact on retail clients either through losses threatening the provision of core services or through the group putting its interests ahead of those of its clients in an improper way, such as the miss-selling of financial products.

It is important to note that even standalone wholesale banks can indirectly threaten the provision of financial services. For example, the failure of a large wholesale bank may cause the wholesale funding market to temporarily dry up leaving retail banks unable to access wholesale market funding.

PRACTICAL CONSIDERATIONS

5. How, if at all, would prohibiting proprietary trading by banking groups affect the case for implementing a ring-fence? Would there be any practical benefits from implementing both such measures at the same time?

Enforcing total separation of proprietary trading alongside or instead of ring-fencing could provide a stronger barrier against global market contagion to core financial services, but the difficulty is in designing a proprietary trading prohibition that works in practise.

The ICB concluded that its reform package for the UK would achieve the main aims of full separation at a lower cost, and without creating a potential risk to financial stability that could come from having undiversified, correlated, stand-alone domestic retail banking.

A strong ring-fence can achieve the banking reform objectives as set out by the ICB; however, if the intention is to focus additionally on reducing the potential for conflicts of interest to arise then some form of the Volcker rule may provide additional benefits to ring-fencing but, as stated previously, we consider that enforcement of existing conduct rules and principles can address conflicts of interest issues that arise.

6. What powers does the regulator already have that could be used to prohibit banks from conducting proprietary trading? What are the constraints on any such powers?

Firms' permissions could potentially be restricted to prohibit such trading. That could be done under present regulatory authority, but it would be highly preferable that if such restrictions were to be imposed across a class of firms (ie all RFBs) for reasons designed to promote structural separation that primary legislation specifically authorise the regulator to impose such restrictions across such a class. This would be to reduce litigation risk.

The Banking Consolidation Directive (BCD) is silent on the question whether such restrictions on firms that would otherwise qualify to undertake such activities is consistent with it. The FSA's General Counsel Division

has taken the view that because the ICB's proposals go beyond matters within the BCD, it would not be impermissible for such constraints to be imposed. However, this view has not been tested and is open to argument. Primary legislation that specifically authorises the regulator to impose such restrictions is therefore desirable also to anticipate and blunt such a criticism.

The exercise of the regulator's powers to prohibit groups containing a ring-fenced bank from engaging in proprietary trading is likely to be constrained by provisions of EU law which limit the grounds on which a competent authority may object to a proposal to acquire a qualifying holding in banks. These provisions were introduced by the Acquisitions Directive [2007/44/EC] which amended the BCD to provide that a competent authority may oppose a proposed acquisition of a bank only if there are reasonable grounds for doing so on the basis of specified criteria.

We consider that a ban on the acquisition of UK retail or ring-fenced banks by UK investment banks would be beyond the scope of the BCD, provided it is for the purpose of the prudential supervision of UK investment banks. However, a blanket prohibition on the ownership of UK retail or ring fenced banks by EEA investment banks or holding companies that also own investment banks could be incompatible with the BCD.

7. What are the main challenges in defining proprietary trading, and how could these best be addressed?

The main challenge is defining proprietary trading in a manner that banks could not circumvent by claiming to be engaging in some form of market making activity on behalf of their clients. For example, some banks may claim that they are hold positions (stock) in a market in the expectation of future client needs. This is because it is always possible to sell products to a client and then immediately hedge the resulting market risk. However, clearly until they offset the market risk they have a proprietary position.

There are two ways of addressing this issue. The first way is through very prescriptive rule-making combined with intensive supervision. The second way is through a purpose based restriction.

There are problems with both of these approaches which is part of the reason why the ICB and Liikanen both avoided trying to distinguish between proprietary trading and market making.

A prescriptive approach is resource intensive to supervise and banks, if they are so inclined, will eventually find a way around the rules. A purpose based approach will not provide clarity to banks or their clients about what is permitted. It also does not provide supervisors with a clear consistent framework for exercising their judgement, particularly as derivative trading is a highly complex area where "risk management hedges" can quickly become sizable proprietary losses due to poor modelling of risk.

A combination of these approaches is currently being considered in the US and it may be a number of years before we can be sure that such a prohibition is possible to enforce in a meaningful way.

OVERALL ASSESSMENT

8. Given the factors above, how would you assess the case for:

(a) Including a prohibition on groups containing a ring-fenced bank from engaging in proprietary trading within the Banking Reform Bill

This proposal amounts to overlaying (some of) the Volcker rule on top of ring-fencing. Both ring-fencing and the Volcker rule seek to address similar objectives. In our view, the size of the benefits arising from overlying the Volcker rule on top of ring-fencing is dependent on two factors: (i) how robust the fence will be, and (ii) whether in practice we will end up with ring-fenced banks that effectively undertake all banking services that we would want to preserve in a time of crisis.

The stronger (and wider) the fence the lesser the case for overlying the Volcker rule on top of ring-fencing. In any event, trying to do both ring-fencing and the Volcker rule at the same time may lead to overly complex pieces of legislation and regulation.

Assessing the development and practical effects of the Volcker rule in the US could form part of the proposed independent review of the ring-fence.

(b) Implementing or creating reserve powers for a proprietary trading ban through some other form

The reserve power that was suggested in the Parliamentary Commission's first report could potentially be used to impose some form of prohibition.

(c) Requiring that future reviews of the operation of the ring-fence have an explicit mandate to consider and report on the case for such a prohibition

If this is an issue that Parliament wishes to consider then it could be included in the terms of reference of the future review of ring-fencing.

(d) Using the Banking Reform Bill to give the regulator a reserve power to impose such a prohibition on individual banks if it concluded that it was necessary

See response to b) above. There is a legitimate question as to whether powers giving effect to structural reform of this magnitude is a matter for the regulator or for Government and/or Parliament. Although clearly there is a role for the regulator in advising Parliament as to whether such a prohibition would help it meet its statutory objectives.

15 January 2013

Written evidence from HSBC

PREAMBLE

It is important at the outset to recognise that banks act as principal in virtually all transactions and therefore all market price movements accrue to the stated capital position of the bank either through the profit and loss account or directly to reserves in defined circumstances. Accordingly, it is not possible to define proprietary trading by reference to the beneficiary of market price movements as the impact of all such movements accrue to equity holders yet only a subset of activities would be regarded as trading and only a subset of these would be regarded as proprietary trading by most analysts. Proprietary trading definition is both complex and subject to considerable interpretation challenges.

We hope the comments below are helpful to the Commission in its deliberations on this important topic. The comments follow the pattern of questions set out in the Commission's request for an additional submission.

STABILITY

1. What prudential concerns does proprietary trading within banks give rise to? To what extent are any concerns being addressed through existing measures and proposals, including ring-fencing?

The prudential risks of proprietary trading arise in three main areas:

- (a) the ability of banks and supervisors to properly understand and thereby calibrate the risks which are being taken in this area, in particular tail risks, and so apply the correct capital treatment so that banks have sufficient resources to absorb losses if these occur; and
- (b) the risk that unexpected losses in proprietary trading may diminish capital resources and curtail the ability of a bank to provide sustainable support to the real economy—with the potential consequence that some form of intervention is required to restore such lending, thereby creating a moral hazard; and
- (c) the risk that an unexpected loss is of such magnitude or nature that unsecured creditors restrict or withdraw funding until they have clarified and understood the cause of the loss, once again thereby causing credit capacity to be curtailed.

A further risk increasingly being recognised arises from the possibility of market disruption from algorithmic or high frequency trading where the impact of programming errors or mis-keyed data input can cause a huge volume of automated trading to occur with potential to disadvantage other market participants who deal in the period of market disruption. While algorithmic and high frequency trading can improve pricing and transparency for all market participants automated trading systems do not have behavioural standards—they simply do what they have been programmed to do.

Valuation and calibration concerns

The run-up to the financial crisis saw increased and widespread acceptance of and reliance on internal models by both management and regulators. These proved defective in many ways; they were highly pro-cyclical, they took inadequate account of leverage and liquidity risks and, because there had not recently been crises, most did not reflect adequately the potential scale of tail risks inherently accepted. The complexity of the models however created a false sense of precision of risk metrics which allowed a build-up of directional and tail risk. As a result many risk models failed to be valid at precisely the point where they were most needed—with the realisation of tail events.

To address these issues the completeness and adequacy of trading book risk models has now been extensively re-assessed. Pro-cyclicality remains, but with the introduction of various incremental models for tail risk, capital standards for bank trading books have been strengthened by a multiple. Wider reforms in the capital markets, in particular a substantial increase in trading book capital requirements, will also reduce the quantum of trading assets and the associated capital risks carried by banks. In large part this is because higher capital and liquidity standards have rendered arbitrage trading activity that relied on leverage uneconomic.

Even with more comprehensive models, improved calibration and strengthened capital levels, there remains some residual danger that these have not been calibrated for all possible risks. For less sophisticated banks, for example, there is a residual risk that standardised capital requirements have been wrongly calibrated, and that their proprietary trading operations, albeit smaller, could create a risk of unexpected capital loss. Valuation,

particularly in illiquid market conditions will remain an issue and be most difficult for the more complex instruments or structured products, in particular so called Level 3 assets, as defined for accounting purposes, where the inputs to valuation are not observable and the valuation has therefore a greater element of judgment.

Contagion

The creation of central counterparties for standardised derivatives and the severe capital penalties for using OTC derivatives will be an important structural mitigant against contagion from proprietary position-taking through derivatives. In addition, for the six largest banks in the UK, the ring-fencing proposals together with recovery and resolution planning including bail-in debt will protect systemically important retail and commercial banking activities from exposure to risks from inaccurate risk calibration or valuation of proprietary transactions. However, the current ring-fencing proposals do not address:

- (a) the risks which may still reside in smaller banks which could continue to take deposits and engage in proprietary trading; or
- (b) the potential impact on the other important but non-proprietary trading activities which are outside of the ring-fenced bank; for example lending and money transmission for non ring-fenced corporate entities.

The proposals from the High Level Expert Group chaired by Erkki Liikanen have set out a different approach to addressing the risks arising from trading activities within banks by considering both the absolute size of these operations and their size relative to the remainder of the firm. Once a materiality threshold has been reached on both bases, a separate subsidiary would be required. This structural requirement is premised on an assessment of the extent to which risks from trading activity could damage the capacity of the bank to support its other activities. It also reflects a judgment that trading risks, of an appropriate size and properly capitalised, within a much larger balance sheet should give rise to no more prudential concerns than an equivalent risk profile arising from any other asset classes such as UK mortgages or SME loans which could also be subject to material fluctuations in value.

By combining proprietary trading activity with other markets activity, neither the UK nor the Liikanen proposals address the risks that contagion from proprietary trading could disrupt other important markets activities which support customers. In the UK proposals, relationships with financial institutions and market-making activities are required to be excluded from the ring-fenced bank and so like the Liikanen proposals they are specifically included alongside proprietary trading activities within a separate subsidiary.

But these markets activities are also systemically important. They are considered to be Critical Economic Functions by the FSA for resolution purposes and, in the case of market-making, the creation of a deep and liquid trading market is essential to the financing of the real economy through securitised funding.

We note that both the US and proposed French approaches to structural reform have recognised this by drawing the line for ring-fencing simply to separate all the activities which are established to support customers from any residual proprietary trading activities. This recognises, amongst other things, the importance of acceptable market-making to facilitate client funding and investing activity.

STANDARDS

2. To what extent does the presence of proprietary trading activity alongside client-facing activity in banks create the potential for conflicts of interest and affect remuneration practices, culture and banking standards?

As noted in the preamble, whether in proprietary activities or in market making or other financial markets activity, banks trade as principal and therefore there are inherent conflicts which are addressed through formally regulating conduct—best execution standards for example—and through firms' own conduct rules. The key structural protection arises from the firm's own conduct rules bolstered by regulation around transparency, conduct, concepts of fairness (including addressing information asymmetry) and most importantly classification of which customers are regarded as sophisticated enough to deal on a principal basis with banks. Essentially the inherent conflicts are regarded as acceptable and manageable if there is clear disclosure of the nature of the potential conflicts and clients are regarded as sufficiently sophisticated and well informed to deal with the bank on a principal basis, understand all aspects of the transactions being undertaken and have alternative suppliers for these services.

There is clearly the potential for conflict when firms have both proprietary trading activities (which have no client relationship) and client-related activities, and the two operations have underlying positions which are in conflict; the most obvious example in the recent crisis was where some firms were positioning for a collapse of the US housing market while continuing to service and promote client demand for exposure to that market. Although firms have clear "chinese walls"—internal separation—to reduce potential conflicts of interest, there will inevitably be instances when a bank will profit from a proprietary transaction positioned on the other side of client facing activity.

It should be understood that, by definition, market activity requires two sides to a transaction and therefore differing views on market movements. As a consequence, banks and their counterparties will always have both same way and offsetting exposures at any point in time. The inherent conflicts have less behavioural

implications when they arise from market making or risk management activity as opposed to proprietary trading; essentially this is because the firm is not seeking in these activities to benefit from directional moves and so has no incentive to attempt to influence pricing. Remuneration from market-making and the firm's own risk management activities is also not structured around trading profits as would be the case in respect of proprietary trading.

Some of these issues were highlighted in the report of the US Senate's Permanent Subcommittee on Investigations into Wall Street and the Financial Crisis: Anatomy of a Financial Collapse published on 13 April 2011. We would expect that firms which engage in proprietary trading and client-focused will have modified their activities in the light of these findings.

However, given that we do not undertake proprietary trading activities, HSBC does not feel it is in a good position to comment further.

3. How adequately do current conduct rules manage any potential for conflicts and harm to standards? To what extent could stronger conduct rules address any problems?

There is no reason why the current rules should be viewed as inadequate in principle, yet it is clear from recent experience there is little confidence that in practice they are being adequately monitored and enforced. In reality, no matter how strong the conduct rules are, there will always be concerns over their application particularly where a proprietary trading function is seen to benefit at the expense of clients.

4. Are there stronger grounds for concern about proprietary trading when it is conducted in a group which contains a ring-fenced bank than if it is conducted by a standalone wholesale bank? If so, why?

In terms of standards of conduct, it is difficult to see a material difference between proprietary trading conducted in a group which contains a ring-fenced bank (which will necessarily be in a separate subsidiary from the ring-fenced activities) and through a stand-alone wholesale bank. Again we note the US and proposed French solution is simply to prohibit proprietary trading absolutely in banks of any shape.

PRACTICAL CONSIDERATIONS

5. How, if at all, would prohibiting proprietary trading by banking groups affect the case for implementing a ring-fence? Would there be any practical benefits from implementing both such measures at the same time?

If the UK's ring-fence proposal had been based solely upon the perceived risks to critical activities arising from proprietary trading, then the prohibition of such trading would have been the most appropriate parameter for the ring-fence. This would have been in line with the US approach and what is now being contemplated in France.

But this was not the case and the UK ring-fence draws a distinction between retail activities, where customers are less sophisticated in their ability to assess the position and stability of their bank and have fewer options for their financial needs, and wholesale activities, where customers do have the capacity to understand these risks and manage or switch their providers accordingly. The UK approach also is designed to offer a distinct resolution approach for the retail ring-fenced bank versus the non ring-fenced bank, with the former to be restructured using bail-in of unsecured uninsured creditors but leaving the option of liquidation open for the latter (although the practicalities of that distinction are questionable).

As an effective ring-fence should protect the retail activities, having gone down the ring-fence route, it is difficult to see what additional practical benefits would arise from a total prohibition on proprietary trading, unless there are now concerns about the systemic importance of the wholesale activities to be contained in the non ring-fenced bank. Any conclusion that this is the case would logically re-open a discussion about the positioning of the ring-fence so that all economically-critical activities, whether wholesale or retail, could be protected from proprietary trading. This is a discussion which is taking place in Europe but it was not the approach adopted by the Independent Commission on Banking ("ICB").

If there is to be further consideration of the nature of the ring-fence, we believe that the Commission should also reflect on the increasing trend towards geographic subsidiarisation which has developed since the ICB took its evidence and produced its first report. We see a significant trend towards this in recent proposals from the US on the regulation of Foreign Banking Organisations and in the actions of our own FSA to restrict the authorisation of branches for non-EU banks. This will significantly change the nature of banks in the UK—at the time of the ICB's interim report, we estimated that drawing a perimeter to exclude non-EEA assets would reduce the scale of the UK domestic banking sector by some 30% and so offer potentially considerable protection to UK financial stability from risks arising from non EEA operations.

In essence we are now seeing four distinct types of ring-fencing emerging:

- the UK ICB proposals based on ring-fencing critical activities, drawing a distinction between retail and wholesale;
- the US approach based on prohibiting defined proprietary trading;

- the proposed French approach defining acceptable market making and risk management activities and prohibiting everything else; and
- geographic ring-fencing in a variety of formats.

6. What powers does the regulator already have that could be used to prohibit banks from conducting proprietary trading? What are the constraints on any such powers?

We believe that if the supervisor has concerns about the risks involved in any proprietary trading operations, it has the ability and authority already effectively to prohibit these activities in an individual bank if so required. At the simplest level, this could be achieved by increasing the capital requirements under the bank's Individual Capital Guidance (Basel Pillar 2) on the basis of protection against prudential risks, to levels which would effectively make the targeted proprietary trading activities non-viable. Additionally, supervisors have wide powers to constrain activities based upon their assessment of the capabilities and capacity of individual firms to control and manage the underlying risks. Finally, in the current environment, reaching out to the Board of the bank concerned would undoubtedly, at least in an HSBC context, be effective in curtailing activity of concern to the supervisory authorities; a Board would not lightly go against a regulatory concern over a trading operation.

7. What are the main challenges in defining proprietary trading, and how could these best be addressed?

The most useful definition which goes to the heart of where there are public policy issues is that "proprietary trading" is specific risk positions taken by banks solely in pursuit of their own profits and not undertaken to support clients or to hedge the bank's own risk profile including prospective risks. Proprietary trading would typically be identified as activity undertaken by separately identified trading desks with identified capital, risk limits and specific proprietary trading goals in terms of profitability.

The main challenge is that there can be a lack of distinction between positions which are undertaken to support client activity or hedging and "proprietary trading"; this makes it difficult to set out clear technical and legal distinctions. Again as set out in the preamble, all banks trade as principal and therefore the price risks from market positions are identical irrespective of the purpose of the trade. The largest exposures to capital within banks typically arise from structural interest rate and foreign exchange positions rather than any trading activities and these risks are inherent in the core business model of lending long at market interest rates funded by short term deposits priced at administered interest rates, as well as deploying a portion of the capital base in markets other than the domestic base of the bank.

Even the simplest core banking activity exposes a bank to market risk as principal. Consider a bank making a fixed rate mortgage offer: it will hedge its interest rate exposure risk on those loans through interest rate swaps or by raising fixed rate funding from the market. It can do this in two ways:

- (a) it can raise a tranche of fixed rate funds for lending in advance of the mortgage sales, but with the risk that it will not be able to distribute these funds and so be left with an amount of fixed rate funding unmatched by fixed rate loans; or
- (b) it can build a portfolio of loans with the expectation that these can be hedged in tranches as the portfolio is built but thereby accepting the risk that it might be unable to fund the loans at the expected price after it has committed the fixed rate to the borrower.

Banks will choose which approach to use depending on their own circumstances (for example, do they have an existing source of funds or is additional funding required) but both have risks—there is a danger that the mortgage loans cannot be originated or the funding risks cannot be hedged. Most practitioners would not regard this as proprietary trading but, in both cases, since any gains or losses which occur during the transition period are taken by the bank to the profit and loss account, it might fall under some definitions of "proprietary trading".

More generally, banks do not perfectly match the risks which they accumulate from their dealings with customers and from the risk mitigation contracts which they place in the market; partly this is infeasible and partly this is a management decision to run an inventory of open risk to facilitate market-making and to profit from knowledge gained from market flow information. For example, if there is a pattern of investment managers moving into Japanese equities, a foreign exchange desk is likely to hold a long Yen position in anticipation of the demand for settlement currency, in exactly the same way as retailers adjust their summer stock depending on projected weather patterns; the difference is the bank is marking its open currency (stock) position to market daily as opposed to the retailer marking down unsold stock in the end of season sale. The point being highlighted is that banks routinely have positions held as principal from which they may gain or lose but a practitioner would regard only a very limited and bespoke portion of these as "proprietary trading".

The most difficult areas in attempting to identify proprietary trading are how to distinguish this from both client-driven activities such as market-making and risk management operations of the bank, hedging its own exposures including structural exposures. Essentially there are two possible routes to go down; first a very precise definition of activity that is regarded as proprietary trading—for example investment in hedge funds—with everything else not so regarded; or alternatively a definition of what is not proprietary trading based on purpose and intent of the underlying transactions with everything else regarded as proprietary trading.

In seeking to define proprietary trading, regulators and commentators have used a number of dimensions to separate the mainstream activities which enable banks to support customers and manage their own risks from “proprietary trading”. These include:

- direct links to specific client activities;
- links to overall bank risks arising from multi-client activities (ie hedging);
- expected and actual investment durations;
- relative and absolute scale of risk positions;
- organisation (separation, desks); and
- profitability (volatility of daily/weekly profits).

We believe that these dimensions can be used to create a good working definition of proprietary trading and, indeed, these will underlie the French approach to structural separation. Within this, there will be a definition of acceptable market-making and this has already been developed in a number of areas including the EU Short Selling Regulation which contains an exemption for market-making.

For the purposes of this response, a working definition of proprietary trading might be: “*transacting in contracts, assets and securities not directly related to:*

- (a) *activities undertaken on behalf of customers; or*
- (b) *the prospect of activities to be undertaken by customers; or*
- (c) *market-making; or*
- (d) *the hedging of such market making , or actual or prospective activities; or*
- (e) *the management of balance sheets and structural risks arising from activities undertaken to support customers”.*

This is consistent with the underlying approach of the Volcker Rule in the US and the French proposals on separation published on 19 December 2012.

OVERALL ASSESSMENT

8. *Given the factors above, how would you assess the case for:*

- (a) *Including a prohibition on groups containing a ring-fenced bank from engaging in proprietary trading within the Banking Reform Bill*
- (b) *Implementing or creating reserve powers for a proprietary trading ban through some other form*
- (c) *Requiring that future reviews of the operation of the ring-fence have an explicit mandate to consider and report on the case for such a prohibition*
- (d) *Using the Banking Reform Bill to give the regulator a reserve power to impose such a prohibition on individual banks if it concluded that it was necessary*

We are concerned that adding at this stage in the process a prohibition on proprietary trading in groups containing a ring fence bank could lengthen the implementation timetable for the current ring-fencing proposals because of definitional challenges. This may not be warranted given that ring-fenced banks will already be prohibited from undertaking these activities.

We note also that the Commission has suggested that regulators should have a reserve power to require the full separation of the non-ring fenced bank and as this would necessarily include any proprietary trading activities within that bank it would be possible to distance the ring-fence bank further if thought desirable in the future.

If there is concern that the non ring-fenced bank has exposure to proprietary trading risks that could critically damage the important real economy activities that will reside in the non ring-fenced bank then there would be a case to prohibit such activities. In such circumstances we believe the French approach of defining what is not proprietary trading is the better solution to address the definitional challenge.

However, given that the ring-fence is intended to prevent contagion from non-core activities, any requirement for a prospective review to consider the possible case for a prohibition of proprietary trading should be part and parcel of a more general review of the effectiveness of ring-fencing, the appropriateness of the location of the ring fence, and the sustainability of critical business activities and infrastructure across both the ring-fenced and non ring-fenced banks.

Finally, we believe that if the supervisor has concerns about the risks involved in any proprietary trading operations, it can already with existing powers effectively prohibit these activities in an individual bank if so required.

Written evidence from Lloyds Banking Group

We refer to your letter of 21 December 2012 and welcome the opportunity to comment on the implications of introducing a prohibition on banking groups containing a ring-fenced bank from engaging in proprietary trading, as being considered by the Parliamentary Commission on Banking Standards (“PCBS”). For clarity, we assume your question related to whether banking groups can conduct proprietary trading anywhere in the group.

DEFINING PROPRIETARY TRADING

To answer the specific questions raised in your letter, it is useful to start by defining proprietary trading. We would define proprietary trading as the risking of a bank’s own capital by taking positions in financial instruments in order to make gains from market movements, where such activities are speculative or run as a specific business with the sole aim of the bank making a profit for itself. It would typically be an activity that banking groups would undertake through a dedicated unit, segregated from client facing business areas and often with segregated capital, limits and remuneration policies. Typically the positions would be recorded in the trading books of the entity.

Lloyds Banking Group (the Group) has no such segregated unit.

Answers to specific questions:

STABILITY

1. What prudential concerns does proprietary trading within banks give rise to? To what extent are any concerns being addressed through existing measures and proposals, including ring-fencing?

Having “true” proprietary trading within the same legal entity as insured retail deposits raises the risk that capital and funding could be mis-allocated and a “cross-subsidy” could occur, in terms of lower cost of funding and lower cost of capital. Placing any such proprietary trading activities into a separately capitalised and funded subsidiary outside the ring fenced bank ensures that these activities would be subject to a stand-alone cost of capital and funding that appropriately reflect the activities’ risk.

STANDARDS

2. To what extent does the presence of proprietary trading activity alongside client-facing activity in banks create the potential for conflicts of interest and affect remuneration practices, culture and banking standards?

As noted above, to the extent that the presence of insured deposits alongside “true” proprietary trading results in proprietary trading activities not facing a cost of capital and funding that appropriately reflects the risk of these activities, then this could result in a mis-allocation of capital and funding towards these risky activities.

In view of the cyclical nature and higher risk of proprietary trading, the remuneration of management and staff should be designed to discourage conflicts of interest. Remuneration at banks (as is the case at the Group)—including that of trading staff—should always reflect a balance of a broad range of objectives. These should cover client service and franchise development, risk management and financial performance.

3. How adequately do current conduct rules manage any potential for conflicts and harm to standards? To what extent could stronger conduct rules address any problems?

The current conduct rules provide an adequate framework for the identification and management of potential conflicts of interest. The current regime combines a high level principle (Principle 8: “a firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client”) with detailed requirements contained within the Senior Management Arrangements, Systems and Controls requirements (“SYSC”) section of the FSA’s Handbook. SYSC requires firms to take reasonable steps to identify conflicts of interest, to maintain a record of the kinds of activity and service which give rise to potential conflicts of interest and to put in place arrangements to prevent or manage these conflicts. These arrangements may include physical separation of conflicted business areas, controls on information sharing and other organisational and administrative arrangements. SYSC specifically identifies proprietary trading as one of a number of areas which require special attention in the context of a firm’s conflict of interest policy.

4. Are there stronger grounds for concern about proprietary trading when it is conducted in a group which contains a ring-fenced bank than if it is conducted by a standalone wholesale bank? If so, why?

No, all other things being equal, there should be lower concerns. Ring fencing should be sufficient to remove risks that any proprietary trading within the remainder of the group poses to a bank’s retail and commercial operations. Ring fencing would eliminate any potential mis-allocation of capital and funding which could result from banks which conduct proprietary trading having access to the insured deposits at a retail and commercial bank. Furthermore, ring fencing ensures that if problems emerge in relation to any proprietary trading activity, this will not impact the continuity of the bank’s retail and commercial operations. Banning proprietary trading

would therefore be redundant if the activities which are permissible within the ring fenced bank are clearly set out, including those activities indicated above as *not* constituting proprietary trading.

For the avoidance of doubt, the Group does not have a segregated proprietary trading unit.

PRACTICAL CONSIDERATIONS

5. How, if at all, would prohibiting proprietary trading by banking groups affect the case for implementing a ring-fence? Would there be any practical benefits from implementing both such measures at the same time?

Different jurisdictions are taking different approaches to containing risk taking activity in banks. In the US, via the Volcker rule, a ban on proprietary trading is being developed as an alternative to the UK's ring-fencing of core activities. The Liikanen proposals are another option where the proposal is that large-scale market activities are ring-fenced from the rest of the bank group.

In our view, a properly implemented ring fence should be sufficient to insulate the key economic functions of a ring fenced bank from any risks posed by any proprietary trading elsewhere in the group. Furthermore, ensuring the continuity and security of key economic functions is better served by identifying those activities, rather than the reverse, as proposed by Liikanen.

6. What powers does the regulator already have that could be used to prohibit banks from conducting proprietary trading? What are the constraints on any such powers?

The regulator already has the powers to restrict or suspend any permission which a firm has to carry on regulated activity, including dealing in investments as principal. Exercise of these powers would be subject to the existing constraints on the FSA's exercise of its regulatory authority.

7. What are the main challenges in defining proprietary trading, and how could these best be addressed?

Defining proprietary trading as distinct from market-making is clearly difficult, as evidenced by the volume of regulation that has sprung up in the context of the Volcker Rule. Given the importance of providing groups which contain retail and commercial banks with the tools necessary for providing a sufficient range of services to their customers and managing their own balance sheet in a prudent manner, it is particularly key to identify activities which should be excluded from the scope of any discussion on proprietary trading, and therefore permissible in a group containing a ring-fenced bank.

In our view, the purpose for which activities are undertaken should play a role in determining whether an activity is classified as proprietary trading. In particular, the following should be excluded from the definition of proprietary trading, to the extent undertaken by a banking group containing a ring fenced bank:

- (1) Own balance sheet risk-mitigating hedging and asset and liability management activity.
- (2) Underwriting securities and associated primary issuance transaction support.
- (3) Transactions on behalf of customers (such as the purchase or disposal of securities).
- (4) Provision of non-complex hedging to customers.
- (5) Providing capital to businesses and public welfare entities as a general investing activity.
- (6) Any insurance business (including the investment by insurance companies for their general account).
- (7) Initial investment by way of providing seed capital to asset management funds.
- (8) Buying and selling government and municipal debt securities, to the extent this activity is carried out:
 - (a) by or on behalf of the treasury function of the Group for the purposes of the bank liquidity portfolio; or
 - (b) purely for the purposes of gilt edged market making.
- (9) Market making.

Market making is an essential part of the services provided by retail and commercial banks to their clients, and should be distinguished from proprietary trading. As a simple analogy the bank will, like a retailer, hold a certain number of days of anticipated turnover of relevant inventory to meet future client demand efficiently and cost-effectively. If the bank was unable to hold inventory, this would impact clients both in terms of timing—the client may have to wait until the bank could find an offsetting order against which to match the demand—and effectively would leave the client carrying the market risk exposure until an offset could be found.

At the Group, and many other banks, the degree of market risk taken in order to facilitate client activity, is carefully controlled and sized relative to the volume of that client activity. Specifically the scale of market risk undertaken by the (Trading) market-making desks is strictly limited by risk controls set by the overall Board risk appetite and specific risk limits for:

- Overall Group risk limit which are determined by the Board Risk appetite. These limits are cascaded down to business divisions and ultimately desks and are monitored by an independent Risk function which reports via the CRO to the CEO; and
- A specific Value At Risk (VAR) limit for the Trading desks in aggregate and at a sub-desk level (calculated on a 1-day 95% confidence level, ie a 1 in 20 day worst case scenario) This is sized as a very small percentage of the overall revenue budget for the Sales & Trading (client market transactions) business. The VAR limit can be temporarily increased in exceptional cases to meet larger than normal client flows with clearance from the Risk function.

Since some of the activities listed above may evidence similar characteristics to proprietary trading, even though they pursue different objectives, it is important to have strong risk policies, procedures and regulation to help overcome these challenges.

We agree that banking entities should have and maintain a robust and comprehensive set of internal policies and procedures, meeting regulatory standards, to ensure that only permitted activities are carried out and to identify when breaches have occurred. By way of example, it could be required that banking entities produce operating procedures for each business/desk regarding permitted trading activity, and including (i) the mandate of each trading unit/profit area, (ii) a description of how revenues are generated and positions hedged, (iii) activities engaged in by the trading unit/profit area, (iv) a list of the types of products approved for transactions, (v) a description of the remuneration policy for those engaged in risk-taking activities; (vi) the types/levels of risk which are permitted to execute the stated mandate of each such trading unit/business, and (vii) the review and escalation procedures for breaches of limits and controls.

Developing and maintaining these policies and procedures at the level of each business/desk will help avoid a generic approach in a banking institute which could inadvertently prohibit a permitted activity or permit a prohibited activity. It would also assist with the supervisory assessment of the appropriateness of overall compliance programmes.

OVERALL ASSESSMENT

8. *Given the factors above, how would you assess the case for:*

- (a) *Including a prohibition on groups containing a ring-fenced bank from engaging in proprietary trading within the Banking Reform Bill*
- (b) *Implementing or creating reserve powers for a proprietary trading ban through some other form*
- (c) *Requiring that future reviews of the operation of the ring-fence have an explicit mandate to consider and report on the case for such a prohibition*
- (d) *Using the Banking Reform Bill to give the regulator a reserve power to impose such a prohibition on individual banks if it concluded that it was necessary*

As outlined above, we reaffirm our support for strong and clear rules to be put in place to create a ring fenced bank to establish a delineation between traditional client-oriented banking/banking group management and higher-risk activities to be kept outside the ring fenced bank. To the extent that the above guidelines can be agreed for identifying what should be excluded from the scope of proprietary trading, or identifying what activities should be permitted within a ring fenced bank/its group, this will strongly support the aim of the ICB and the draft legislation in promoting a stable retail banking system providing client-oriented services. Subject to this, we consider that it is unnecessary and redundant to ban proprietary trading by any banking group containing a ring fenced bank. Additionally it would add a further level of complexity to the regulatory structure without providing additional protection to the ring fenced bank or to general financial stability of the United Kingdom.

As with any extensive new reform, however, it is reasonable (as suggested by the PCBS) to conduct reviews into the effectiveness of the legislation after a suitable period of time has elapsed, and of the relevant banking groups internal controls and compliance, risk management and conflicts of interests systems. If these reviews find that the ring fencing reforms are not meeting the objectives of the legislation or that the internal measures put in place by the groups are not sufficient to identify and restrict risk, then it would be at that stage that further measures could be designed to address any shortcomings identified. Including measures in current legislation to anticipate potential future problems gives rise to the risk that regulators' tools are ill-suited to their needs.

Written evidence from The Royal Bank of Scotland Group plc

OVERVIEW

We respond below to the Commission's consultation in relation to proprietary trading and the potential impact that proprietary trading may have on the stability of financial groups that include a ring fenced bank.

1. INTRODUCTION

A. As in most forms of commerce, a degree of build up of stock or inventory forms a component of a bank's trading activities. In relation to customer driven activities inventory is built up to allow the bank to anticipate and meet customer driven demand.

Trading activity may consist of a combination of activities undertaken purely for the bank's own account (where the bank trades against its own capital to build up potentially illiquid positions which are held with the intent of generating profit and not as part of supporting customer activities) and other own account trading which is connected to customer activities. If the bank is using its capital for its own account to generate profits (and risking taking losses) from illiquid inventory, disconnected from customer activity, then that is "pure" proprietary trading. If the position taking that results in a build up of inventory is related to actual or anticipated customer activity then that is still a form of own account risk taking (but is not "pure" proprietary trading) but is an activity that we believe is necessary in order to support customer activity and drive overall economic activity (see 3. below).

Given that the own account trading that RBS undertakes is predominantly connected to customer activities and given the risk controls we have in place (see section 5. below) we do not believe that there is a material risk that such trading could disproportionately affect RBS' financial or capital position. Our analysis is based upon an assessment of both the character of the activity undertaken and the controls and cultural changes we have introduced since 2008 to better manage the risks associated with these activities.

B. When considered through an analytical (objective) lens the trading risk that is created in banks as a result of "pure" proprietary trading is potentially hard to distinguish from that which is connected to actual or anticipated customer activities (including market making), meeting customer portfolio needs and portfolio hedging (as described in section 3. below). Both forms of activity can result in the build up of significant volumes of inventory. Some of this inventory may be present on banks' balance sheets for extended periods of time. This poses a significant challenge when considering how law and regulation might be used to restrict proprietary activity as there is no bright line that can be drawn to differentiate between the two types of activities.

In the US designing the implementing regulations for the Volcker Rule which seeks to address proprietary trading has proved challenging (please see section 4. and response to Q7. below).

C. We believe the concerns expressed by the Commission about the risks associated with "pure" proprietary trading are fair but that they can be addressed: (i) by ensuring that banks are prudently managed, that their own account trading activities are prudently controlled and restricted to trading connected to customer activities; and (ii) through exercise of existing regulatory and supervisory powers supplemented by granting a reserve power to the regulator to impose a restriction on the nature and scale of own account trading activity undertaken in any regulated institution, which power could be invoked if the regulator concludes the institution is not being prudentially managed.

D. We believe that any absolute prohibition on own account trading activity within a financial group that includes a ring fenced bank would be unlikely to deliver material additional prudential or systemic benefits beyond those that are achievable through a combination of the existing regulatory controls and the other structures proposed by the Commission.

Conversely we believe that such a prohibition (that goes beyond "pure" proprietary trading and extends to own account trading activity connected to customer activity) would: generate very significant costs for the relevant financial groups; be complicated for regulators to administer; call into question the investment case for shareholders in those financial groups; and would have a significantly adverse impact on customer services and related levels of economic activity.

2. TRADING, MARKET AND CREDIT RISK

For banks almost any activity could be described as taking a "proprietary" risk and, if that risk relates to credit, trading or market risk then it is possible for that to be "proprietary" trading in a general common language sense.

For example, even when making a simple loan the bank is taking a credit risk which is itself proprietary. That is the bank has deployed capital under the reasoned assumption that it will see its capital plus interest in return, within an agreed time period. The bank will then consider its risk and either dispose of some of that risk through a proprietary transaction or alternatively hedge its credit risk in the market by entering into a transaction with a market counterparty which hedge itself will be a proprietary transaction.

The hedging of its loan position creates its own trading risk, where the bank may or may not realise a profit on that transaction with reference to price agreed at the purchase and sale of the asset. Another common trading activity which is needed by our customers and which gives rise to trading risk is market making (where we offer prices to buyers or sellers of assets traded in those markets in order to create liquidity), a core activity necessary to support stable economic activity.

There are risks created by any kind of trading, proprietary or not and whether in financial assets or physical goods. Businesses looking to sell traded goods to customers need to hold inventory in order to allow prompt satisfaction of customer orders. The holding of inventory also gives rise to trading risk—before inventory can be sold to clients the prevailing market price may move against a trader (or in his favour). It is the change in the underlying economic indicators and market confidence (equity prices, interest rates, commodities) that may result in a market risk that needs to be managed and controlled.

The difference in the level of trading risk associated with a given transaction relates principally to the relative liquidity of the goods traded—ie the ease with which the goods can be sold—and how long the trader is likely to hold them for, not whether the trader's intent at the time of purchase was to sell the asset to an end user or for its own financial gain. This risk is “market risk”.

The same risk analysis applies whether the trader is buying and selling refrigerators, commodities or financial products singularly or in bulk, ie, building inventory of goods or financial positions or assets. In more volatile and illiquid markets the management of this market risk is much more important, particularly for businesses taking market risk on a material scale. The longer the inventory is intended to be held the greater the exposure to price volatility and market risk.

The key issue to address in order to determine whether the credit, trading and/or market risks the bank or other commercial party is taking are manageable is whether the quality of the controls and analysis that that party is using to measure and manage its trading activity on an informed risk basis are sufficient to allow that party to take controlled risks within its stated risk appetites. Please see section 5. below for a summary of the controls we have in place and which we believe are satisfactory to manage the own account trading risks we undertake in connection with our customer activity.

Given the analysis in Section 1. and this Section 2. above, our response is intended to explain both why: (i) the risks associated with “pure” proprietary trading are not wholly different, except in relation to the motivation for the original build up of inventory, from those associated with trading connected to client activities, market making and client related hedging activity; and (ii) nevertheless we do not believe our business model would be adversely impacted by restrictions upon “pure” proprietary trading.

3. RBS CONTEXT AND CUSTOMER ACTIVITY

As part of its post-2008 restructuring plan RBS decided to exit and transfer to its Non Core division those activities which it regarded as involving material levels of “pure” proprietary trading. Further, as part of the State Aid resolution reached by HMG with the European Commission RBS was committed to not re-engage in any such activities. The scale of “pure” proprietary trading which remains within the RBS Group today is not material and is predominantly held within the Non Core division. We do, however continue to provide a range of customer services that require us to undertake own account trading activities. These result in the Bank holding market positions and substantial volumes of inventory for its own account. These activities include:

- Being an active participant in government bond auctions, in both the UK and other countries. This activity results in inventory holdings of government bonds which, while generally liquid, normally are not driven by specific client demand and consequently create market risk for RBS.
- Market making in the markets we are active in to ensure liquidity for our customers and the issuers we support.
- As part of offering services to our investor/customer base we trade actively to build inventory, in particular in expectation of forthcoming customer orders. Moreover, where we are trading to fulfil client orders, the available trades in the market may not exactly match the order, leaving a residual balance on the RBS trading book. Controls are in place to ensure the liquidity of the portfolio, and the quality of the balance sheet held at any time (see section 5. below).
- In some instances, we also conduct trading, and build and hold strategic inventory positions, in anticipation of longer-term customer orders. (Those strategic inventory positions are taken in connection with our customer related activities which include providing our customers with related asset analysis and market intelligence). This activity can result in the build up of significant volumes of inventory and result in our holding that inventory for significant periods of time. Again, this activity is conducted within specific controls and risk appetites including specified risk limits and inventory ageing policies.
- We execute trades to hedge the risks held in our banking and trading books. These hedges are often necessarily undertaken at portfolio level and not ascribed to specific client transactions, particularly where we are supporting SMEs and smaller corporate.

The purpose of these activities is to support actual or anticipated customer business needs or to enable us to manage the risks we take when supporting our customers.

We presume the type of activities listed above would be exempted from any prohibition on “pure” proprietary trading as they are connected to offering services to our customers and are core components of economic activity. If our presumption is correct, the impact on RBS of a prohibition would mainly be associated with the challenges and expense of monitoring and tracking any additional regulatory requirements introduced to measure and control “pure” proprietary trading and/or own account trading rather than any significant reduction in activities undertaken in connection with our customer activities.

4. PROVIDING A CLEAN DEFINITION OF PROPRIETARY TRADING IS CHALLENGING

We do not oppose the introduction of a rule that restricts the conduct of “pure” proprietary trading within a group that includes a ring fenced bank. RBS’ strategy is focused on the own account trading activities described at 3 above. Nonetheless we do not think there is a simple analytical way to distinguish an asset bought with the intent solely to speculate upon the future value upon sale to another trader (which would be “pure” proprietary trading) from the same asset bought with the expectation of sale to an end user customer—as we said above there is no bright line that allows the activity to be readily and objectively differentiated solely on the basis of the intention that motivated the purchase of the inventory. The principle distinction between these two types of trading activity is the intent or motive for entering into the trade. The key way to control the risk is the same—through effective controls, surveillance, capital charges and by ensuring the culture in the business is the right one (see section 5. below).

The US regulators preparing the detailed regulations for the Volcker Rule have struggled with the problem of definition for two years. The current draft implicitly recognises the difficulty of identifying what is “pure” proprietary trading and relies on complex analysis of 17 different indirect metrics they have determined might be indicators of proprietary trading. (See response to Q7. below for more detail.)

We believe that monitoring and tracking such indicators will be expensive both for institutions involved and for the regulators. We believe the better approach is to impose general principles requiring own account trading activity to be connected to customer activity, with specific requirements (as already exist) for capital, market and risk limits and controls to be in place, supported by robust compliance, monitoring and surveillance activities and with a strong emphasis on the correct culture and risk appetite. If at any time the regulators are not satisfied that a bank is managing its own account trading activities prudently the regulator can then invoke a standing power to restrict that activity, use existing powers to vary the bank’s permissions or otherwise impose additional capital requirements.

5. RBS CONTROLS AROUND ITS OWN ACCOUNT TRADING

During the past four year, RBS has reviewed and enhanced its risk and control environments and has put in place a comprehensive Supervisory Control Framework (the SCF) to address and manage the trading risks of the Bank. The SCF establishes Risk Limits (Golden Rules) and addresses trading and markets risks in turn through: i) Dealing Authorities, ii) Independent Pricing Valuations (IPV) and Reserving, iii) Aged Position Marks and iv) Aged Asset and Stale Inventory amongst other indicators. The SCF places upon the senior managers of the business the authority, responsibility and accountability of addressing trading risks with a robust focus on the correct culture and behavioural standards.

The Bank’s Golden Rules place upon the senior business management, in conjunction with market risk management the responsibility to define the overall market risk limits, structure, ownership and delegation for business units. Along with credit risk management, senior business leaders define the overall credit risk limits, structure, ownership and delegation of risk controls. The Golden Rules provide for clear determinations and sanctions of rule transgressions.

More specifically, these trading risk management measures provide senior executives and control teams with the risk programme and the tools to approve and monitor:

- traders’ permissions, overall position limits and utilisation triggers,
- monthly P/L, reserve balances and IPV data, including inputs on explanation, methodology and justification, Independent Pricing Valuations and Reserving,
- Key Risk Indicators (KRIs), trends and trigger breaches as well as the review of position marks across trading desks, Aged Position Marks, and
- Review of KRIs that assist in the responsibility and review of a desk’s stale/aged positions with the intent to take action or escalate any concerns identified (Aged Asset and Stale Inventory).

With respect to Aged Assets and Stale Inventory monitoring, RBS calculates the position age at issue level of the individual security/ISIN. The data points used are very granular and include:

- position age that accrues on a “First-In” basis—the oldest transaction on record after a zero balance in inventory is set as the age date,
- measurement of directional increase of the position which after the first trade inherits the inception date of the “First-In” exposure,
- age measures that reset to zero when reduction of 20% of the nominal amount of the position is achieved in one day, and

— designation of an asset as “aged” if held for more than 90 days without a reset.

CONDUCT RISK

In addition to the empirical data that make up our markets and trading risk measure, the SCF is supported by our Conduct Risk programme which focuses on conduct risk and staff behaviours (including ensuring incentives are aligned to behaviours, not pure revenue targets).

To back up our words with actions, we have made conduct risk management a commercial imperative. For our staff, we have enhanced our recruitment and performance measurement disciplines (eg, 360° feedback, independent Risk function inputs); ensured that all bonus awards are subject to objective remuneration committee oversight, and robust risk adjustment; and claw back has been applied to historic bonuses awarded to individuals responsible for risks and losses that have been identified after the fact.

6. RESPONSES TO THE COMMISSION’S QUESTIONS

Q1: What prudential concerns does proprietary trading within banks give rise to? To what extent are any concerns being addressed through existing measures and proposals, including ring-fencing?

Uncontrolled “pure” proprietary trading exposes a bank’s capital to significant risks as well as exposing the bank to reputational harm and posing potential risks to overall financial stability. Any form of own account trading activity and risk taking requires robust controls and a culture where risk is taken on a controlled and informed basis. As described at section 5. above at RBS we have implemented detailed risk management controls that measure and manage the scale of market and other risks that the bank is exposed to and have implemented significant cultural changes to ensure that a prudent approach is taken to managing risk and servicing customer needs. Tighter capital and liquidity rules, together with prudential controls as proposed by both Basel III and the ICB recommendations for PLAC will have the effect of restricting the appetite of any bank for own account trading. We believe the existing controls (plus the regulatory powers described at section 4. above) are sufficient to control trading activities within a group that includes a ring fenced bank.

The prudential risks inherent in any “own account” positions are independent of the intent of the trade (whether proprietary or client-driven), and we consider them to be adequately covered by the current legislative framework and our own risk controls. The resolvability of a bank and overall systemic risk would of course be materially affected by the presence of uncontrolled trading and inventory within a banking group.

ICB regulation will of course ensure that depositors in the ring-fenced bank are further protected from risks posed by permitted trading activities.

STANDARDS

Q2: To what extent does the presence of proprietary trading activity alongside client-facing activity in banks create the potential for conflicts of interest and affect remuneration practices, culture and banking standards?

Q3: How adequately do current conduct rules manage any potential for conflicts and harm to standards? To what extent could stronger conduct rules address any problems?

Q4: Are there stronger grounds for concern about proprietary trading when it is conducted in a group which contains a ring-fenced bank than if it is conducted by a standalone wholesale bank? If so, why?

The nature of any trading activity requires buyers and sellers to take different market positions. As such any trading activity can give rise to potential conflicts of interest between a bank and its customers. This is true for all trading that results in the bank holding positions on its own account, regardless of whether the intent is hedging risk, building customer inventory or generating proprietary gain; these risks also exist where the bank is providing non-traded products and services to customers. These are risks managed through existing, well established, regulations and controls (including the requirements under FSA General Principle 8).

We recognise the risk that the presence of “pure” proprietary trading could give rise to cultural issues and consequent misconduct. However, we do not agree that own account trading connected to actual or anticipated customer activities per se creates a negative influence on a bank’s culture. Issues such as Libor manipulation or swap mis-selling are more likely to stem from a poor, revenue driven, culture in which incentives are not aligned with the creation of long term value for clients and prudent risk management.

Within RBSG, very significant efforts have been made to address these broader cultural concerns and to enhance our overall control environment. Details of these changes do not properly belong in this letter but we have summarised them in section 5 above.

The creation of the ring-fence will create an additional legal and financial fire break to protect customers within a ring-fenced bank from any volatility in market risk exposures that arise as a result of banks conducting own account trading activity connected to customer services.

Based on the analysis in this letter we do not believe that own account trading activity conducted in connection with customer activities within a financial group (but outside a ring-fenced bank) poses risks to that

ring-fenced bank (or the financial system) that cannot be properly controlled (or that are disproportionate) by having effective internal controls, as overseen and supervised through regulatory powers.

PRACTICAL CONSIDERATIONS

Q5: How, if at all, would prohibiting proprietary trading by banking groups affect the case for implementing a ring-fence? Would there be any practical benefits from implementing both such measures at the same time?

We believe that the simultaneous imposition of ringfencing and a ban on own account trading would create additional costs for both the banks and the regulators, increase costs and materially and adversely impact liquidity, customer services and economic activity without materially reducing either risks of resolvability for a bank or systemic risks.

Q6: What powers does the regulator already have that could be used to prohibit banks from conducting proprietary trading? What are the constraints on any such powers?

The FSA and other international lead regulators have multiple powers to require financial institutions to be run on a well managed/prudent basis, to have effective controls in place and to ensure that operations are run with skill, care and diligence, effectively controlled and that customer interests are respected and conflicts managed. We believe the existing powers available to the FSA, including the ability to impose additional capital requirements on firms that are not being prudentially managed and ability to vary regulatory permissions are sufficient to control the own account trading activities continuing within banking groups that include a ring-fenced bank. It is possible that the current powers may take some time to exercise and therefore the introduction of an additional overarching power that allows the FSA to act immediately to require own account trading activities of a bank that is not being well managed to be reduced or suspended at short notice (whilst maintaining effective management of risk and avoiding unintended systemic consequences) may be additive to the overall powers of the regulators.

Q7: What are the main challenges in defining proprietary trading, and how could these best be addressed?

The experience of US regulators suggests that establishing a clear and unambiguous definition of proprietary trading is difficult. There is no bright line that can be drawn between “pure” proprietary trading and own account trading connected to customer activity including market making. After several years the US regulators have yet to agree upon a clear definition and have moved away from attempting any direct operational definition. Latest drafts focus on establishing a process for monitoring the relative trading position of any organisation vs. its peers, across a range of 17 different metrics, which the regulator regards as useful indirect indicators of whether an activity is proprietary in intent. Senior US regulators have queried the rule and its implementation. Jeffrey Lacker, president of the Federal Reserve Bank of Richmond, was quoted as saying “Work on the [Volcker] rule is diverting resources from more essential requirements in the [Dodd Frank] act”, while Sheila Bair, former Head of the Federal Deposit Insurance Commission, was quoted as telling Congressional hearings that “the Volcker rule is so complicated that regulators should consider starting over”.¹

There is a danger that the implementation and subsequent monitoring of highly complex rules across multiple metrics could serve more to distract from ensuring that “pure” proprietary trading is prevented (or controlled depending on the institution) and that all own account trading is otherwise conducted in an appropriately controlled way, with controls being placed at the heart of a well managed culture aimed at serving clients’ best interests. In particular, past experience across many spheres of regulation suggests that complex regulations promote a search for workarounds and loopholes whereas a simpler, principle-based approach can be more effective. Given that, if a definition were required, we would advocate a simple, principle-based view—for example, requiring all trading that results in an own account position to be conducted in connection with actual or anticipated client activity or for the purpose of hedging the bank’s risks.

OVERALL ASSESSMENT

Q8: Given the factors above, how would you assess the case for:

(a) Including a prohibition on groups containing a ring-fenced bank from engaging in proprietary trading within the Banking Reform Bill

Since 2009 RBS Group has changed its’ operational focus, and consequentially we do not envisage that our business model would be significantly affected by the introduction of a Volcker style rule in the UK presuming this is designed to restrict “pure” proprietary trading but to still allow own account trading in connection with customer activity of the type referred to at 3. above.

Nonetheless we do not believe that there is likely to be a material benefit from introducing a full prohibition on banks conducting “pure” proprietary trading in the UK. We consider that the tighter capital and prudential controls put forward post-crisis and the other controls referenced above will have the effect of restricting the appetite of any bank for increasing its “pure” proprietary activities. It is also clear from the US example that the complexity of operationally defining proprietary trading and the cost of development, implementation and monitoring of these proposals is likely to be substantial, both for the banks and the regulators. This is unlikely

to be proportionate to the perceived benefits and could detract from the already complex process of introducing the ring-fencing reforms.

Nevertheless, we do consider it appropriate that the regulators satisfy themselves that banks have appropriate risk controls in place (and that the culture and incentive schemes in the trading businesses rewards good, risk sensitive and client focused behaviours and punishes poor risk decisions and bad behaviours) such that regulators are satisfied banking groups are being prudently managed and do not pose reasonably avoidable systemic risks.

(b) Implementing or creating reserve powers for a proprietary trading ban through some other form

(c) Requiring that future reviews of the operation of the ring-fence have an explicit mandate to consider and report on the case for such a prohibition

(d) Using the Banking Reform Bill to give the regulator a reserve power to impose such a prohibition on individual banks if it concluded that it was necessary

We have no objection in principle to the regulator holding a reserve power to impose a restriction on the nature or scale of proprietary trading of any individual bank. However, as discussed above, we do not consider that an outright prohibition on proprietary trading is likely to deliver benefits in any way proportionate to its costs. Therefore, we see no advantage in creating either a mandate for regular review of the need for such a prohibition or reserve powers to implement a blanket ban.

10 February 2013

REFERENCE

ⁱ Both quotes from Bloomberg article, 4 April 2012: *Fed's Lacker Says Volcker Rule May Be "Impossible" to implement*

Written evidence from Standard Chartered Bank

STABILITY

1. *What prudential concerns does proprietary trading within banks give rise to? To what extent are any concerns being addressed through existing measures and proposals, including ring-fencing?*

Whilst Standard Chartered has a client-focused business and has no dedicated proprietary trading desks, we do not believe that proprietary trading was a significant contributory factor in the financial crisis. If we look at those banks that failed during the crisis their failures were broadly driven by a range of simple failures such as highly leveraged structured credit, ineffective liquidity or risk management and/or poor corporate governance.

Even with no focus on proprietary trading, there are legitimate and important reasons that banks would take on market risk in order to meet the needs of clients. Much of the current regulatory approach seems to be based on the belief that trading can be achieved with exact and instantaneous risk layoff, as if it were undertaken on a stock exchange and that trading desks could in fact be brokers. This is not the case in the many over-the-counter ("OTC") markets (eg government and corporate bonds, commodities, foreign exchange and interest rate derivatives). Often a market maker will need to run a risk after trading with clients, either due to illiquidity or mismatch between the client product and available interbank hedges. These issues are particularly true in the emerging markets in which Standard Chartered operates because the markets may not be sufficiently liquid. So a market maker is forced to become an active risk taker in order to facilitate quoting clients. The alternative is that a client must wait until matching buyers or sellers have been found, dramatically reducing liquidity.

For instance, if a mutual fund was looking to liquidate a position in an emerging market bond to meet some redemptions then they would require us to offer them a firm price to take the bonds immediately. In turn, we may not be able to find a buyer immediately at a reasonable price so we would purchase the bonds on our own account and subsequently seek to sell the position which would require us to take market risk until the bonds have been all sold.

As another example, if we are helping a client hedge the risk it faces from a large iron ore order it may take several days to undertake the trades that are necessary to reduce the risk we take on as a result of this trade, and we may still not be able to eliminate the risk entirely. These subsequent trades will be necessary for us to meet the needs of our clients but they will not be as a direct result of an order from these clients.

We would be very concerned if a prohibition on proprietary trading resulted in a restriction on banks' participation in private equity. Whilst we understand the concerns about US banks' involvement as principals in highly leveraged buyouts in the period before the crisis, we think there is a compelling economic case for banks being able to provide equity to their clients as part of our overall role as providers of capital. Smaller companies do not typically have access to public equity markets, and in many of the countries in which we operate, alternative sources of equity finance are extremely limited. Constraining banks to providing debt will only magnify the risk of over-leverage. A ban on private equity would therefore diminish banks' ability to provide appropriate capital solutions to SMEs.

Risk oversight is a critical focus for our business, including limiting exposure to country, sector or other relevant forms of risk in the portfolio. This is supported by a track record in which, of 30 investments, our loss ratio is 2% of the total investment.

We understand the concerns about private equity in the context of advanced economies, such as the US, given the history of very large, highly leveraged buyouts. This is not the sort of private equity business we conduct and we suspect such transactions would in any case be much more difficult to execute in the post-crisis environment, not least because the capital treatment under Basel III is very different. Standard Chartered would not be opposed to the imposition of limits on the proportion of RWAs that banks could deploy in private equity (for example, not more than 10% of total RWAs). Such an approach highlights the importance of banks operating models in which their risks are effectively diversified.

Rather than spend time defining proprietary trading and splitting it out from risk taking associated with market making, regulators ought to monitor the overall risk profile of banks. This approach is likely to lead to a more fruitful discussion on the approaches being taken by banks rather than a tick box approach to compliance with rules. It is the sustainability of a bank's business model with which regulators ought to concern themselves. Regulators should measure how a bank is allocating its overall risk envelope. Is it for facilitating client business or is it undertaking standalone proprietary trading? Furthermore is the risk envelope appropriate given its client flows and revenue streams? This is really only a task that can be undertaken through effective supervision and not blunt rules. Such fundamental questions will help supervisors understand whether a bank's business model is sustainable. To this end we welcome the focus the Prudential Regulation Authority has said it will take with the use of judgement-based supervision which will be more likely to identify and address emerging risks.

STANDARDS

2. To what extent does the presence of proprietary trading activity alongside client-facing activity in banks create the potential for conflicts of interest and affect remuneration practices, culture and banking standards?

Please see answer to question 3.

3. How adequately do current conduct rules manage any potential for conflicts and harm to standards? To what extent could stronger conduct rules address any problems?

The current conduct rules (reinforced by the Financial Services Authority ("FSA") Principle 8) address the fact that conflicts of interest can take many forms. Whilst these rules are prescriptive, to the extent that they require firms to have effective arrangements in place to manage such conflicts (and evidence this in a policy with mandatory content), they do not seek to pre-empt all potential conflicts that could arise nor prescribe how such conflicts should be managed. We believe there is justification for such an approach, not least because the types of conflict, and the arrangements required to effectively manage them, will depend on the size and organisation of the firm in question and the scale and complexity of its business.

The FSA has also undertaken a number of thematic reviews in this area over the last few years and issued a number of Market Watch newsletters, setting out very clearly what its expectations are in relation to conflict management in certain specific areas. Most recently, we have received a "Dear CEO" letter asking us to review how conflicts of interest are managed when undertaking asset management activity and to pro-actively attest that the firm's arrangements in this area are sufficient and in compliance with FSA rules.

The effective management of conflicts of interest and the fair treatment of our customers form an integral part of our Group Code of Conduct which reflects our Group values and sets out our expectation for minimum standards of behaviour. In addition, we have a framework of policies and procedures in place globally for the identification and management of conflicts of interest. These are supported by mandatory training for staff.

4. Are there stronger grounds for concern about proprietary trading when it is conducted in a group which contains a ring-fenced bank than if it is conducted by a standalone wholesale bank? If so, why?

We do not believe that the creation of ring-fenced banks will improve financial stability; indeed, it could do the reverse, as it will concentrate risk in a legal entity. We believe it is better to diversify risk to ensure the risks created by one part of a bank can be mitigated by other parts.

PRACTICAL CONSIDERATIONS

5. How, if at all, would prohibiting proprietary trading by banking groups affect the case for implementing a ring-fence? Would there be any practical benefits from implementing both such measures at the same time?

We have stated in our previous responses to the PCBS that we do not believe ring-fences are an effective means by which to regulate banks because they do not fundamentally address risks in the financial system. We believe it is more appropriate to address the risks associated with activities rather than to create structural solutions.

6. *What powers does the regulator already have that could be used to prohibit banks from conducting proprietary trading? What are the constraints on any such powers?*

The FSA already has the power under the Financial Services and Markets Act 2000 (“FSMA”) to determine which activities a bank can undertake. These begin with the initial licensing and approval of an institution under FSMA (Part IV permission), authorisation of individuals to undertake an activity and the associated permissions for the undertaking of regulated activity and any exclusions or categorisation of counterparty, granted under such an approval. Undertaking regulated activity without the appropriate authorisation is a criminal offence.

Regulated activities are set out in the Regulated Activities Order. If a firm is to undertake any proprietary trading activities it will need a permission for “Dealing in investments as principal” since this is a regulated activity. The activity is defined as:

“Dealing in investments as principal: Buying, selling, subscribing for or underwriting securities or contractually based investments (other than investments of the kind specified by article 87, or article 89 so far as relevant to that article) as principal is a specified kind of activity.”

Additionally, once approved, a firm will be subject to ongoing supervision of these activities. Regulators have a number of options to control the firm and its activity on a risk-based approach eg capital charges applied under Pillar 2. The ultimate action is that the regulator can force the business to stop an activity via forcibly amending its permissions/license (removing the legal approval to undertake the regulated activity).

With the creation of Recovery and Resolution Plan (“RRPs”), regulators have additional opportunities to address concerns about a bank’s business models. Where they believe business activities or structure will impede the ability of supervisors or a resolution authority to resolve a failing bank they will enter into dialogue with the bank to find a way of removing such risks.

7. *What are the main challenges in defining proprietary trading, and how could these best be addressed?*

As discussed above, it is difficult to draw a distinction between proprietary trading and risk taking as banks undertake trades in order to facilitate client activities and although all of these activities may not relate directly to a client order these trades will help banks to maintain the liquidity to meet the needs of clients. Without such activities the cost of finance would be both likely to increase and clients may find they are simply unable to access the services they need within the time frames they currently expect. Even dedicated proprietary trading may be difficult to define and identify unless it is already structurally separated eg an internal hedge fund.

OVERALL ASSESSMENT

8. *Given the factors above, how would you assess the case for:*

- (a) *Including a prohibition on groups containing a ring-fenced bank from engaging in proprietary trading within the Banking Reform Bill*
- (b) *Implementing or creating reserve powers for a proprietary trading ban through some other form*
- (c) *Requiring that future reviews of the operation of the ring-fence have an explicit mandate to consider and report on the case for such a prohibition*
- (d) *Using the Banking Reform Bill to give the regulator a reserve power to impose such a prohibition on individual banks if it concluded that it was necessary*

We believe such decisions would be best made by supervisors who would be able to consider the extent to which the activities of the ring-fenced bank may inhibit the ability of the bank to implement an effective RRP. We believe it is best to provide supervisors with such powers to apply them where they see necessary.

18 January 2013