SUBMISSION BY THE BRITISH BANKERS’ ASSOCIATION

Introduction

The British Bankers’ Association welcomes the opportunity to input to the inquiry by the Economy, Energy and Tourism Committee on the implications of the recommendations of the final report of the Independent Commission on Banking for the banking and financial services sector and for the Scottish economy in general. We represent 220 banks from 60 countries on UK and international banking issues.

The ICB report was published only 10 days ago and we are still in the process of analysing key aspects in consultation with our members and other interested parties. We are pleased to share our initial assessment with the Committee, but would underline the tentative nature of the views that we are so far able to express.

Overview

The ICB report explains that the international reform agenda – notably the Basel process and European Union initiatives – is making important headway but adds that the ICB considers that this needs to be supported and enhanced by national measures, which the ICB sees as especially important given the position of the UK as an open economy with very large banks extensively engaged in global wholesale and investment banking alongside UK retail banking. It sees part of the challenge for reform to reconcile the UK’s position as an international financial centre with stable banking in the UK.

The ICB explains that it sees further reform measures as necessary in order to ensure not only greater resilience against future financial crises and removing the risk from banks to the public finances, but also to achieve a banking system that is effective and efficient at providing the basic banking services of safeguarding retail deposits, operating secure payment systems, efficiently channelling savings to productive investments, and managing financial risk.

The UK Coalition Government has welcomed the ICB’s recommendations in principle. This however is not to say that there will not be an opportunity to put on the table any considerations that we see as critical to decision-making on the recommendations within the report going forward. While our intention overall is to work as far as possible with the grain of the recommendations, much detailed work remains given the organisational, legal and operational challenges involved and the likely economic impact of the measures.

This written submission next looks at each of the three areas of specific recommendations made by the ICB - the retail ring-fence, loss-absorbency and competition - and then turns to issues concerning international competitiveness and the implementation timetable.

The retail ring-fence

The ICB recommends the introduction of a ‘ring-fence’ between retail banking and investment banking. The retail-ring fence will be required to be a separate legal entity and to meet regulatory requirements for capital, liquidity, funding and large exposures on a standalone basis, with dedicated operational and support services, an arm’s length relationship with the wider group, and an independent board. The ICB allows for some flexibility for banks to choose how much of their corporate banking business they put inside
the ring-fence, but not for banks to allow funding to pass through it. The ICB envisages ring-fenced banks being able to provide ‘one stop’ services to their customers through agency agreements between the ring-fenced bank and other parts of the group.

The ICB views the retail ring-fence as:

- Providing a more proportionate response to the crisis than a total separation of retail and wholesale/investment banking and a means by which many of the benefits of diversification within a universal bank can be maintained.
- Offering additional protection to core retail services including greater assurance of being able to implement a resolution plan in the event of financial difficulty being encountered.
- Enable banking groups still to service fully the needs of corporate and other clients through the use of ‘agency agreements’ between the retail ring-fenced bank and other parts of the banking group.

The retail ring-fence is a vastly different proposition from the recovery and resolution plan initiative currently underway. It puts in place a firewall that reduces the prospect of the retail entity being exposed to untenable losses in the wider group but comes at a cost of increased organisational complexity, some loss of the benefits of diversification and arguably may work against financial stability by reinforcing the pro-cyclical nature of retail and small business lending. It is also arguable that the ring-fence is based on a misdiagnosis of the UK experience of the financial crisis where losses arose principally from retail and commercial lending and not wholesale/investment banking. Measures are already being taken to address shortcomings in this area, not least the introduction of a macro-prudential element to banking supervision to be guided by the new Financial Policy Committee. The ICB report, and its cost/benefit analysis, places insufficient attention on the relevance of other causes of the financial crisis and the benefits accruing from other measures being progressed.

A significant consideration on the cost-side should be that the UK adopting the ring-fence approach will provide a lead to other jurisdictions favouring the application of legal and regulatory requirements on a local basis leading to the trapped pools of capital and liquidity, which comes at an economic cost.

Other concerns relate to the operability of the retail ring-fence and whether the ICB is right in its belief that a ring-fenced bank will still be able to make available a full range of financial services to customers. This will be dependent upon the way in which a banking group will be able to organise its business in light of the division between mandated, permitted and prohibited activities described in the first three ‘principles’ upon which the retail ring-fence is to stand and needs careful consideration. Further thought also needs to be given to whether there are unforeseen consequences from the fourth and fifth principles respectively setting out the legal and operational expectations upon the retail ring-fence and the expectation that any economic linkage between the ring-fenced bank and the wider corporate group be entirely on a third party basis. This, together with large exposure limitations, may work to unduly constrain the extent to which a ring-fenced bank can meet the needs of its client base.

The types of issue that this gives rise to are questions around whether there may be a ceiling upon services that can be offered to corporate clients and whether treasury operations can in fact be organised on lines compatible with good risk management. We are
also becoming aware of concern amongst smaller banks that flexibility intended to deliver a proportionate approach may require clarification or refinement in order to ensure that they are not unduly impeded from organising their businesses to meet the specialist needs of their customer bases in a reasonable way under the new arrangements. The ICB appears to have made assumptions (for instance in paragraph 3.15) about these providing services mainly inside (or outside) the ring-fence and this may not be the case. The recommendation as currently drawn up may therefore involve disproportionate reorganisation and reporting costs for small banks. This is a point that may be of particular interest to the Scottish Parliament given that a number of relatively small providers of investment management and banking services with a presence in Scotland will be subject to the retail ring-fence and may need to review their operations accordingly.

A further issue may be the appropriateness or otherwise of limiting the ring-fence to services integral to the provision of payments services to customers in the European Economic Areas (EEA) or to intermediation between savers and borrowers within the EEA non-financial sector. Accepting the intention to protect the ring-fence from direct exposure to global financial markets and activity that would significantly complicate its resolution, we would nevertheless question whether the EEA is necessarily the right place to draw the line. The geographical criterion is based on the UK’s international treaty obligations determining that the geographic scope of the ring-fence needed at a minimum to be to the EEA and we are unsure that this leads us to the right conclusion.

**Loss absorbency**

The ICB recommends that:

- Large ring-fenced banks holding more than the equivalent of three per cent of UK GDP in risk-weighted assets (RWAs) be required to hold at least ten per cent equity capital and for similar arrangements to apply for medium-sized banks (defines as those with a ratio of RWAs to UK GDP of 1%-3%) on a sliding scale.

- All UK headquartered banks and all ring-fenced banks respect the Basel III leverage ratio of three per cent (i.e. putting in place a backstop based on lending being no more than thirty-three times total assets) and requires this to rise to a little over four per cent (or a lending ratio of a little under 25 times) for the larger ring-fenced banks.

- Resolution authorities should be given primary powers over a new class of bail-in bonds and secondary powers to impose losses on other unsecured liabilities; FSCS insured depositors be given creditor preference in insolvency and resolution.

- UK-headquartered global systemically important banks (G-SIBs) and the larger ring-fenced banks as defined above be required to hold capital and bail-in debt equivalent to 17 per cent; and that the supervisor of UK-headquartered G-SIBS and medium-sized ring-fenced banks as defined above be entitled to require the bank to hold an additional loss-absorbing capacity of up to 3 per cent if they have concerns about the resolvability of the bank.

The ICB makes clear that its proposals for a retail ring-fence and increased loss-absorbency should be viewed as a ‘package’ and that without structural change they would be recommending even higher capital requirements. A mirror image of this would be to ask whether the proposals together – the ring-fence which reduces the integration of the
universal bank offering, the bail-in proposals and the proposed introduction of depositor preference and other changes in the creditor rankings combine to make investment in UK ring-fenced banks and non-ring-fenced G-SIBs an unattractive proposition for senior debt holders. We need therefore to work through the different component parts of the package to ensure that each adds more than it removes from the equation. The minutes of the latest meeting of the Monetary Policy Committee explain that one consequence of the recent turbulence has been the virtual closure of corporate bond and bank term funding markets to new issuance and that a consequence of UK banks being unable to access unsecured term funding markets may be a pressure to reduce lending\(^1\). This illustrates the importance of understanding the effect of the proposals on funding markets.

Our initial assessment is that need for depositor preference may add very little to the loss-absorbency recommendations given the increased capital levels and the European initiative expected to result in a measure of pre-funding for deposit protection schemes and so the consequences of this aspect of the ICB’s recommendations in particular may outweigh the benefits. While we fully understand the desire to remove the possibility of the taxpayer providing a backstop we nevertheless believe this may be an unnecessary measure when considered within the context of other actions being taken.

**Competition**

The Commission made a number of recommendations on competition. First, it wishes to see the LBG divestiture result in the emergence of a ‘challenger’ brand. Second, it wishes to see progress made on account switching and transparency. And third it proposes that the new Financial Conduct Authority be given a statutory objective for competition. It has further recommended that if sufficient progress has not been made on these recommendations by 2015 then the Office of Fair Trading should think about making a market referral to the competition authorities.

In most respects, these recommendations are in line with developments in train and so the report can be seen as the Commission setting out with clarity what it wishes to see achieved - and by when. The industry, for example, is working on an initiative for improving accounts switching and the ICB has set a demanding - but by no means unachievable – standard and timetable. On the recommendation that the FCA be given a statutory objective for competition, our main concern would be to ensure that there is clarity in terms of the expectations that this places on the FCA and the way in which this lines up with primary responsibility for competition resting with the competition authorities.

We should add that the report is published within a changing marketplace for Scotland. The inclusion of 187 Lloyds TSB Scotland branches in the LBG divestiture will create Scotland’s third largest branch network (after RBS and Bank of Scotland) and this follows Santander becoming Scotland’s fifth largest bank (after Clydesdale) following the RBS divestiture. HSBC and Barclays are also growing as challenger banks. As a result of these changes competition in the Scottish market will return to the levels seen before the financial crisis.

**International competitiveness**

The ICB report (in paragraph A3.104) explains that ring-fenced banks may seek to offset part of the increase in costs associated with the restructuring by charging higher prices to

\(^1\) Paragraph 5, *Minutes* of the 7\(^{th}\)&8\(^{th}\) September MPC meeting
borrowers. It dismisses this however since a) where there are already alternatives to loans and other services provided by UK banks, such as financing from the capital markets or from non-UK banks, the ability of banks to pass higher costs through would be limited and b) that while UK banks may react by raising lending spreads, the effect on the total supply of credit to customers would be limited as they switch into substitutes. The report (in paragraph 5.82) concludes that the competitiveness of wholesale/investment banking should not be unduly reduced since the UK banks represent only 15% of the international financial services sector as a whole. We would view these statements as being strongly indicative of the ICB being unduly dismissive of the potential competitive effect on the prospective retail ring-fence banking groups and the potential consequences for their customers, whether retail or corporate. The analysis assumes the continued availability of non-UK bank finance and implies that if the price of services from a ring-fenced bank increases significantly then a reasonable reaction may be for customers to move their business to non-ring-fenced banks.

Implementation timetable

While the 2019 timeline for the retail ring-fence has been questioned by some, it needs to be appreciated that the organisation, legal and administrative tasks involved in bringing about the ring-fence will be substantial and that implementation will necessarily be preceded by legislation and detailed regulation. We would therefore say that a realistic approach would be to put in place the statutory and regulatory framework in as feasible a time as possible and then to give an extended implementation period. The ICB recognises that introducing the retail ring-fence is likely to involve substantial legal and administrative challenges, including the obtaining of third party consent to the transfer of contracts and the separating out of contracts between the ring-fence and other group entities – but does not view these as insurmountable. One issue which may merit consideration is whether the introduction of the ring-fence may be made less disruptive through the introduction of grandfathering arrangements or some other transitional arrangement for existing contracts.

The ICB has proposed an extended implementation timeline of 2019 for its loss-absorbency proposals, which coincides with the timetable for the introduction of the higher capital standards agreed under Basel III. While some have described this as too long a period, others have questioned whether it is long enough, recognising that banks need time to build up their capital if further demands upon them are to be met by means other than restricting lending. The additional loss-absorbency proposals may also have a significant effect on the supply and cost of bank funding. These are serious potential consequences of the loss-absorbency recommendations and require further detailed consideration. It also needs to be borne in mind that the UK is one of the jurisdictions that have committed to introducing a counter-cyclical capital buffer of up to and possibly above 2.5%.

Closing remarks

We would reiterate that we are only at the early stages of our consideration of the ICB report and that we plan to give the issues outlined above further thought over the forthcoming weeks and months. While it is our intention to work with the grain of what the ICB has proposed we cannot rule out the identification of aspects of the proposals that would merit significant revision.

We would also underline the effect that the proposals will have on the ability of banks to lend into the broader economy and the imperative therefore of any Government proposals
building on the ICB’s recommendations to be accompanied by a robust cost/benefit analysis, with consideration given to the need for an extended implementation period if we are not to unduly impede the lending activities of UK ring-fenced banks.

We are also not convinced that the ICB gave sufficient consideration of the competitive effect on UK institutions and their diversity and whether this could be to the detriment of their client-base, whether retail or corporate, and therefore the good of the economy.

British Bankers’ Association
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