The CBI perspective

1. The CBI is the UK’s leading business organisation, speaking for some 240,000 businesses that together employ around a third of the private sector workforce.

2. Our contribution to the Independent Banking Commission, and submission to the Treasury Select Committee inquiry, focuses on the “business user” view of the banking system and the impact of potential reforms on business.

3. The CBI’s membership encompasses companies of all sizes and sectors, including banks, so we are uniquely well placed to do this.

Executive summary

4. Business wants greater stability in the banking sector, but the immediate need is for an unrelenting focus on bank lending to support the economic recovery and growth.

5. The ICB recommendations will add to the cost of banking operations in the UK, all of which will have some impact on the cost and availability of lending to business.

6. Against a backdrop of major reform to the financial sector, the “when” and “how” details for implementing the ICB’s recommendations need careful examination to avoid damage to the economy.

7. Ring-fencing requirements will make bank products more expensive and harder to access for some businesses, and there could be unintended consequences around the stability benefits.

8. Imposing higher capital requirements on UK banks in isolation will make lending to UK businesses more expensive relative to their international competitors.

9. Measures to boost competition in the banking sector are welcome, and will benefit small businesses as well as retail consumers.

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10. UK businesses and the wider economy depend on a strong and stable banking system to conduct everyday business, such as making payments and taking deposits, but also to provide funds for investment and to help manage the risks they encounter in day-to-day trading. Businesses also benefit from a
universal banking model so that they can easily access the full range of services they need.

11. The costs of the recent banking crisis have had widespread economic impact, and business wants to see reform in the banking sector. In particular, the CBI favours banks being required to hold more capital to withstand losses, having recovery and resolution plans to resolve crisis situations, and more rigorous regulation to identify and tackle emerging problems.

12. Businesses recognise that some of these reforms come at a cost, but these costs must be proportionate to the benefits they deliver in terms of greater stability and competition in the banking sector.

13. With the economy in a fragile state, and bank lending remaining subdued due to depressed demand and constrained supply for parts of the economy, the immediate focus should be on ensuring banks are in a good position to support the recovery, through lending to businesses and consumers. So we urge the Government not to implement any reforms now that would jeopardise that priority.

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14. The ICB proposals will add to the cost of banking operations in a number of ways, which will have a knock-on impact on the cost and availability of lending to business. We set out the detail of this in the sections on ring-fencing and capital reforms below, but in summary:

- The ring-fencing proposals could add to cost in a number of ways:
  
o Through increasing total capital and liquidity requirements on banks, which both restricts and adds to the cost of lending
  
o Making it more expensive, especially for small firms, to access some financial services such as treasury products – including foreign exchange, interest rate and commodity hedging – if those activities sit outside the ring-fence
  
o By banks passing on the costs of ring-fencing, such as loss of diversified earnings, to end customers including business

- The proposals on additional capital – principally for bank activities inside the ring-fence, although measures on primary loss-absorbing capital will impact on non-ring-fenced activities as well – will lead to an increase in the cost of banking.

Against a backdrop of major reform to the financial sector, the “when” and “how” details for implementing the ICB’s recommendations need careful examination to avoid damage to the economy...
15. The CBI believes it is particularly important that the ICB’s suggested approach on the level of flexibility around its ring-fencing proposals and the timing for when the package of reforms will be introduced are maintained.

16. There is already a major programme of international banking reform underway, and much has already changed since 2008. Measures include much tougher capital and liquidity requirements, better recovery and resolution tools or “living wills”, and a tougher and more intrusive regulatory regime.

17. In the UK, for example, banks’ capital buffers are now broadly double what they were in the run-up to the financial crisis, having increased from 4-6% to 9-11% today.

18. All of these will make the banking system more resilient, but the consequence will be to add cost to banking operations. The capital proposals, in particular, will make lending more challenging.

19. The ICB proposals are a substantial set of measures that go beyond this programme of reforms that has been agreed internationally. Reforms that are unilateral and add to the cost of doing business should not be introduced at this point in the economic cycle.

20. The CBI welcomes the ICB’s proposals for a phased introduction on the majority of its proposals. First, because the economy should be more resilient and better placed to absorb additional costs. And second, because the 2019 deadline is consistent with when other major international reforms, particularly the Basel III capital reforms, are due to be completed.

**Ring-fencing requirements will make bank products more expensive and harder to access for some businesses, and there could be unintended consequences around the stability benefits...**

21. The costs of imposing a retail ring-fence on banks will result in some bank products and services becoming more expensive and harder to access for businesses.

22. The ring-fence will increase the total capital and liquidity requirements on banks in total, as capital and liquidity will become “trapped” within each silo of the ring-fenced and non-ring-fenced parts of the bank. This will both restrict and add to the cost of lending, which at least in part will inevitably be passed on to customers.

23. There are some specific prohibitions on what can be inside or outside the ring-fence that could have cost and availability implications for business. These include:

- *The ability of firms to obtain risk management products*
The ICB proposals specifically prohibit “structuring, arranging or executing derivatives transactions, as agent or principal”. This will make it more costly and harder to obtain for businesses, especially smaller firms, to access some important financial services such as exchange rate hedging and other risk management products.

- Restrictions on dealing with non-EEA customers

The ICB also proposes that ring-fenced banks will be prohibited from transacting with entities based outside the European Economic Area (EEA). This has a number of consequences for business. As an example, the following scenarios would not be permitted:

  o A small manufacturing business has an operation in Jersey, and wishes this subsidiary to use the same bank relationship

  o A medium-sized retail business has outlets in a number of overseas territories, including a number in the US and Japan, but wishes to maintain a single banking relationship in the UK

24. There are also a number of potential unintended consequences that the Government should avoid in implementing the ring-fencing proposals, which could undermine the stated objective of delivering greater financial stability. These include:

- A ring-fence could result in increased leverage in the system, as a result of a mis-match of eligible assets and liabilities within the ring-fence

- Moral hazard could increase within the ring-fence, leading to riskier lending practices, driven by a perception that deposits held at the ring-fenced bank will be safe

25. So the CBI urges the Government to undertake a rigorous cost-benefit analysis of the ICB’s ring-fencing proposals to ensure that the costs to the economy are fully understood, and the benefits stand scrutiny, before moving ahead with implementation.

26. The level of flexibility in the design of the ring-fence proposed by the ICB is a step in the right direction, and will go some way to alleviating our earlier concerns expressed at the time of the ICB’s interim report. For example, the proposed design of the ring-fence will allow banks to transact with businesses of all sizes and help prevent distortions in the corporate banking market. It also recognises and allows for different bank business models, which will help to promote competition.

Imposing higher capital requirements on UK banks in isolation will make lending to UK businesses more expensive relative to their international competitors...
27. Requiring banks to hold more and better quality capital is one of the CBI’s preferred measures to help make the banking system more resilient.

28. International reforms, driven by the Basel III proposals and due to be implemented in Europe through the latest Capital Requirements Directive (CRD IV), will significantly raise the levels of capital banks are required to hold to withstand future shocks.

29. The ICB has recommended a package of capital reforms that go beyond the international consensus. These include requirements for higher levels of capital within the ring-fenced bank, a minimum level of primary loss-absorbing capital at the group level, a higher leverage ratio and new proposal to introduce depositor preference. Depending on how they are interpreted and implemented, the new proposals on primary loss-absorbing capital could be particularly significant.

30. Notwithstanding the benefits of enhanced financial stability, capital reforms will lead to an increase in cost. This will impact on business in one or both of the following ways:

- Imposing higher equity capital requirements, coupled with making debt funding riskier for investors, will increase the overall cost of funds for banks. This will ultimately get passed on to customers.

- Banks may look to reduce their levels of lending to stay within the new capital requirements, as raising further capital in the current market environment will be challenging and costly.

31. The CBI’s concern is that if the UK acts in isolation on tougher capital requirements, the cost of lending to UK businesses will increase, putting UK firms at a disadvantage relative to their international competitors.

**Measures to boost competition in the banking sector are welcome, and will benefit small businesses as well as retail consumers...**

32. Business wants choice and diversity in financial products, so the ICB is right to set out measures to inject greater competition in the banking sector. These include proposals on switching, price transparency and competition objectives for the new Financial Conduct Authority (FCA).

33. From a business perspective, we believe the ICB’s competition proposals will be most relevant to small businesses.

34. The ICB’s proposals to improve **switching** are welcome and will help to increase competition for small businesses as well as retail consumers. In particular, the CBI supports the recommendation that banks should improve the process for transferring security, which will help businesses that have borrowing relationships with their existing bank. Although little detail on this
is provided in the ICB report, we believe this is a critical part of enabling higher levels of account switching for small businesses.

35. The ICB makes a number of proposals in relation to greater price transparency for retail products, including business bank accounts. In general, transparency can help small businesses make informed choices, although we believe that providing data on “foregone interest” will only have a limited impact for many businesses.

36. The CBI also supports strengthening the objectives of the new FCA to ensure that there are strong pro-competitive powers and duties embedded within the new approach to financial regulation. We believe that a markets-based competition approach will deliver better outcomes than the new regulator attempting to impose price controls or acting as an economic regulator.

CBI
30 September 2011