Independent Commission on Banking

Final Report
Recommendations

September 2011

ICB Independent Commission on Banking

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Any enquiries regarding this publication should be sent to:
Independent Commission on Banking
Victoria House
Southampton Row
London
WC1B 4AD

This document is also available from our website at
http://bankingcommission.independent.gov.uk/

ISBN 978-1-845-32-829-0

Produced by the Domarn Group, London.

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GLOSSARY AND ANNEXES

List of acronyms

BCA	Business Current Account
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
bp	basis point (1bp = 0.01%)
CBI	Confederation of British Industry
CC	Competition Commission
CCB	Capital Conservation Buffer
CCP	Central Counterparty
CDS	Credit Default Swap
CET1	Common Equity Tier 1
CRD IV	Capital Requirements Directive IV
EC	European Commission
EEA	European Economic Area
EL	Expected Loss
EU	European Union
FCA	Financial Conduct Authority
FDIC	Federal Deposit Insurance Corporation
FPC	Financial Policy Committee
FSA	Financial Services Authority
FSB	Financial Stability Board
FSCS	Financial Services Compensation Scheme
GDP	Gross Domestic Product
G-SIB	Global Systemically Important Bank
HBOS	Halifax Bank of Scotland
HHI	Herfindahl-Hirschman Index
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IPO	Initial Public Offering
IRB	Internal Ratings-Based
LBG	Lloyds Banking Group
LDR	Loan-to-Deposit Ratio
LGD	Loss Given Default
LTV	Loan-to-Value
OFT	Office of Fair Trading
PCA	Personal Current Account
pp	percentage point
PPI	Payment Protection Insurance
PRA	Prudential Regulation Authority
RBS	Royal Bank of Scotland
RRP	Recovery and Resolution Plan
RWA	Risk-Weighted Asset
SIB	Systemically Important Bank
SIFI	Systemically Important Financial Institution
SME	Small and Medium-Sized Enterprise
SRR	Special Resolution Regime
SVR	Standard Variable Rate
TSC	Treasury Select Committee

Executive summary

This *Final Report* sets out the Commission's recommendations on reforms to improve stability and competition in UK banking. It builds on the *Interim Report* published on 11 April 2011 and responses to its consultation on reform options.

Aims of reform

The recommendations in this report aim to create a more stable and competitive basis for UK banking in the longer term. That means much more than greater resilience against future financial crises and removing risks from banks to the public finances. It also means a banking system that is effective and efficient at providing the basic banking services of safeguarding retail deposits, operating secure payments systems, efficiently channelling savings to productive investments, and managing financial risk. To those ends there should be vigorous competition among banks to deliver the services required by well-informed customers.

These goals for UK banking are wholly consistent with maintaining the UK's strength as a pre-eminent centre for banking and finance, and are positive for the competitiveness of the UK economy. They also contribute to financial stability internationally, especially in Europe.

The international reform agenda – notably the Basel process and European Union (EU) initiatives – is making important headway, but needs to be supported and enhanced by national measures. This is especially so 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. Indeed part of the challenge for reform is to reconcile the UK's position as an international financial centre with stable banking in the UK.

Financial stability

More stable banking requires a combination of measures. Macro-prudential regulation by the new Financial Policy Committee should help curb aggregate financial volatility in the UK. But domestic financial shocks, for example related to property markets, cannot be eliminated. Moreover, the UK remains exposed to international financial volatility, in part through the global operations of UK banks.

Improved supervision by the new Prudential Regulation Authority should avoid some shortcomings of regulation exposed by the recent crisis. But information problems mean that supervisory regulation will never be perfect. In any case, it should not be the role of the state to run banks. In a market economy that is for the private sector disciplined by market forces within a robust regulatory framework.

How to make that framework sound? As the *Interim Report* explained, a package of measures is needed that:

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

The Commission's view is that the right policy approach for UK banking stability requires both (i) greater capital and other loss-absorbing capacity; and (ii) structural reform.

Loss-absorbency: principles

Governments in the UK and elsewhere prevented banks from failing in 2008 because the alternative of allowing them to go bankrupt was regarded as intolerable. The financial system was on the point of seizing up. Vital banking services, the continuous provision of which is imperative, would have been disrupted at potentially enormous economic and social cost. Even after the comprehensive government rescues and accompanying monetary expansion, credit provision to the economy has been seriously disrupted and national output remains well below its level of five years ago.

There was a double failure of banks' ability to bear losses. First, they had too little equity capital in relation to the risks they were running. Leverage ratios of assets to equity capital had ballooned to around forty times – twice historically normal levels. This was allowed to happen in part because there was no restriction on leverage, but instead limits on the ratio of capital to 'risk-weighted' assets. But the supposed 'risk weights' turned out to be unreliable measures of risk: they were going down when risk was in fact going up.

Second, when the thin layer of equity capital was eroded, banks' debt proved poor at absorbing losses. Debt holders might have borne substantial losses in insolvency, but fears of the wider consequences of insolvency – not only interruptions to ordinary banking services, but also contagion to other banks and disruption of financial markets more generally – forced governments to make taxpayers bear the contingent liabilities of bank failures. In any case ordinary retail deposits would have had no priority over bank debt in the insolvency process. So the Financial Services Compensation Scheme (FSCS) as deposit insurer would have had to take losses as well.

The risks inevitably associated with banking have to sit somewhere, and it should not be with taxpayers. Nor do ordinary depositors have the incentive (given deposit insurance to guard against runs) or the practical ability to monitor or bear those risks. For the future, then, banks need much more equity capital, and their debt must be capable of absorbing losses on failure, while ordinary depositors are protected.

Under the international agreement known as Basel III, banks will be required to have equity capital of at least 7% of risk-weighted assets by 2019, while risk weights have also been tightened. As a backstop, there is a proposal to limit leverage to thirty-three times. Recent further proposals from the Financial Stability Board and the Basel Committee on Banking Supervision are to increase risk-weighted capital requirements by up to 2.5% for global systemically important banks (G-SIBs), with provision for a further 1% for banks whose systemic importance grows yet more. These increases to capital requirements will not only improve banks' ability to absorb losses, but will also make them less vulnerable to liquidity problems, which are often a symptom of concerns about solvency. Basel III also includes specific proposals requiring banks to hold more liquid assets, to make them better able to withstand any temporary problems in accessing liquidity in the market.

These are important steps but, in the Commission's view, they do not go far enough. First, the analysis discussed in Chapter 4 below indicates that, if capital requirements could be increased across the board internationally, then the best way forward would be to have much higher equity requirements, in order greatly to increase confidence that banks can easily absorb losses while remaining going concerns. The Commission is however conscious that unilateral imposition of a sharply divergent requirement by the UK could trigger undesirable regulatory arbitrage to the detriment of stability. Second, a leverage cap of thirty-three is too lax for systemically important banks, since it means that a loss of only 3% of such banks' assets would wipe out their capital. Third, in contrast with the Basel process, the Commission's focus is on banks with national systemic importance, as well as on ones with global importance. Fourth, the loss-absorbency of debt is unfinished business in the international debate. How to make bank debt loss-absorbent in practice is discussed below, after consideration of the principles and practical application of structural reform proposals.

Structural reform: principles

A number of UK banks combine domestic retail services with global wholesale and investment banking operations. Both sets of activities are economically valuable while both also entail risks – for example, relating to residential property values in the case of retail banking. Their unstructured combination does, however, give rise to public policy concerns, which structural reform proposals – notably forms of separation between retail banking and wholesale/investment banking – seek to address.

First, structural separation should make it easier and less costly to resolve banks that get into trouble. By 'resolution' is meant an orderly process to determine which activities of a failing bank are to be continued and how. Depending on the circumstances, different solutions may be appropriate for different activities. For example, some activities might be wound down, some sold to other market participants, and others formed into a 'bridge bank' under new management, their shareholders and creditors having been wiped out in whole and/or part. Orderliness involves averting contagion, avoiding taxpayer liability, and ensuring the continuous provision of necessary retail banking services – as distinct from entire banks – for which customers have no ready alternatives. Separation would allow better-targeted policies towards banks in difficulty, and would minimise the need for support from the taxpayer. One of the key benefits of separation is that it would make it easier for the authorities to require creditors of failing retail banks, failing wholesale/investment banks, or both, if necessary, to bear losses, instead of the taxpayer.

Second, structural separation should help insulate retail banking from external financial shocks, including by diminishing problems arising from global interconnectedness. This is of particular significance for the UK in view of the large and complex international exposures that UK banks now have. Much of the massive run-up in bank leverage before the crisis was in relation to wholesale/investment banking activities. Separation would guard against the risk that these activities might de-stabilise the supply of vital retail banking services.

Third, structural separation would help sustain the UK's position as a pre-eminent international financial centre while UK banking is made more resilient. The improved stability that structural reform would bring to the UK economy would be positive for investment both in financial services and the wider economy. The proposed form of separation also gives scope for UK retail banking to have safer capital standards than internationally agreed minima, while UK-based wholesale/investment banking operations (so long as they have credible resolution plans, including adequate loss-absorbing debt) are regulated according to international standards. Without separation there would be a dilemma between resilient UK retail banking and internationally competitive wholesale and investment banking.

Moreover, separation accompanied by appropriate transparency should assist the monitoring of banking activities by both market participants and the authorities. Among other things it should allow better targeting of macro-prudential regulation.

Separation has costs however. Banks' direct operational costs might increase. The economy would suffer if separation prevented retail deposits from financing household mortgages and some business investment. Customers needing both retail and investment banking services might find themselves with less convenient banking arrangements. And although global wholesale and investment banking poses risks to UK retail banking, there are times when it might help cushion risks arising within UK retail banking.

In addition, the cost of capital and funding for banks might increase. But insofar as this resulted from separation curtailing the implicit subsidy caused by the prospect of taxpayer support in the event of trouble, that would not be a cost to the economy. Rather, it would be a consequence of risk returning to where it should be – with bank investors, not taxpayers – and so would reflect the aim of removing government support and risk to the public finances.

For these reasons, the Commission regards structural reform as a key component of reforms aimed at enhancing the long-run stability of UK banking. This leads to questions about its design and implementation.

Structural reform: practical recommendations

How should the line be drawn between retail banking and wholesale/investment banking? Should separation be total, so as to ban them from being in the same corporate group? If not, what inter-relationships should be allowed, and how should they be governed and monitored?

The Commission's analysis of the costs and benefits of alternative structural reform options has concluded that the best policy approach is to require retail ring-fencing of UK banks, not total separation. The objective of such a ring-fence would be to isolate those banking activities where continuous provision of service is vital to the economy and to a bank's customers. This would be in order to ensure, first, that such provision could not be threatened by activities that are incidental to it and, second, that such provision could be maintained in the event of the bank's failure without government solvency support. This would require banks' UK retail activities to be carried out in separate subsidiaries. The UK retail subsidiaries would be legally, economically and operationally separate from the rest of the banking groups to which they belonged. They would have distinct governance arrangements, and should have different cultures. The Commission believes that ring-fencing would achieve the principal stability benefits of full separation but at lower cost to the economy.

Scope of ring-fence

Which activities should be **required** to be within the retail ring-fence? The aim of isolating banking services whose continuous provision is imperative and for which customers have no ready alternative implies that the taking of deposits from, and provision of overdrafts to, ordinary individuals and small and medium-sized enterprises (SMEs) should be required to be within the ring-fence.

The aims of insulating UK retail banking from external shocks and of diminishing problems (including for resolvability) of financial interconnectedness imply that a wide range of services should **not be permitted** in the ring-fence. Services should not be provided from within the ring-fence if they are not integral to the provision of payments services to customers in the European Economic Area[1] (EEA) or to intermediation between savers and borrowers within the EEA non-financial sector, or if they directly increase the exposure of the ring-fenced bank to global financial markets, or if they would significantly complicate its resolution or otherwise threaten its objective. So the following activities should not be carried on inside the ring-fence: services to non-EEA customers, services (other than payments services) resulting in exposure to financial customers, 'trading book' activities, services relating to secondary markets activity (including the purchases of loans or securities), and derivatives trading (except as necessary for the retail bank prudently to manage its own risk).

Subject to limits on wholesale funding of retail operations, other banking services – including taking deposits from customers other than individuals and SMEs and lending to large companies outside the financial sector – should be **permitted** (but not required) within the ring-fence.

The margin of flexibility in relation to large corporate banking is desirable. Rigidity would increase the costs of transition from banks' existing business models to the future regime. And it would risk an asset/liability mismatch problem if, for example, retail deposits were prevented from backing lending to large companies. Mismatch could give rise to economic distortion and even to de-stabilising asset price bubbles.

1 The UK's international treaty obligations make the appropriate geographic scope the EEA rather than the UK.

The Commission's view, in sum, is that domestic retail banking services should be inside the ring-fence, global wholesale/investment banking should be outside, and the provision of straightforward banking services to large domestic non-financial companies can be in or out.

The aggregate balance sheet of UK banks is currently over £6 trillion – more than four times annual GDP. On the criteria above, between one sixth and one third of this would be within the retail ring-fence.

Strength of ring-fence

To achieve the purposes of ring-fencing, retail banking activities should have economic independence. This requires, first, that the UK retail subsidiary of a wider banking group should meet regulatory requirements for capital, liquidity, funding and large exposures on a standalone basis. Second, the permitted extent of its relationships with other parts of the group should be no greater than regulators generally allow with third parties, and should be conducted on an arm's length basis.

Effective ring-fencing also requires measures for independent governance to enforce the arm's length relationship. The Commission's view is that the board of the UK retail subsidiary should normally have a majority of independent directors, one of whom is the chair. For the sake of transparency, the subsidiary should make disclosures and reports as if it were an independently listed company. Though corporate culture cannot directly be regulated, the structural and governance arrangements proposed here should consolidate the foundations for long-term customer-oriented UK retail banking.

Together these measures would create a strong fence. There would however be important differences relative to complete separation. First, subject to the standalone capital and liquidity requirements, benefits from the diversification of earnings would be retained for shareholders and (group level) creditors. Among other things, capital could be injected into the UK retail subsidiary by the rest of the group if it needed support. Second, agency arrangements within the group would allow 'one-stop' relationships for customers wanting both retail and investment banking services. Third, expertise and information could be shared across subsidiaries, which would retain any economies of scope in this area. Fourth, some operational infrastructure and branding could continue to be shared.

For these reasons, ring-fencing should have significantly lower economic costs than full separation. The Commission believes that it would secure the principal benefits: a strong ring-fence can guard against contagion risks that might threaten this, and the challenges of ring-fence design are manageable and not materially greater than those of full separation. Aside from these considerations, there are legal impediments to requiring full separation.

Loss-absorbency: practical recommendations

The principles of loss-absorbency discussed earlier – notably the need for much more equity and for debt to be capable of absorbing losses in resolution – can now be applied to the structural reform recommended by the Commission. There are three broad questions. What type of loss-absorbing capacity should be required? How much of it? And where in the banking group should it be held? In most sectors of the economy such questions have purely market-determined answers. The potentially calamitous consequences of uncontrolled bank failures make regulatory baselines necessary for banks.

Equity is the most straightforward and assuredly loss-absorbing form of capital, and there is a strong case for much higher equity requirements across the board internationally. For the UK, taking the international context and the tax regime as given, and having regard to transitional issues and the potential for arbitrage through foreign banks or shadow banks, the Commission recommends that large UK retail banks should have **equity capital of at least 10%** of risk-weighted assets. This exceeds the Basel III minimum, even for G-SIBs, and the backstop leverage cap should be tightened correspondingly.

International standards can apply to the activities of UK banks outside their UK retail subsidiaries so long as they have credible resolution plans including adequate loss-absorbing debt.

As to that, the Commission recommends that the retail and other activities of large UK banking groups should both have **primary loss-absorbing capacity of at least 17%-20%**. Equity and other capital would be part of that (or all if a bank so wished). Primary loss-absorbing capacity also includes long-term unsecured debt that regulators could require to bear losses in resolution (bail-in bonds). If market participants chose, and regulators were satisfied that the instruments were appropriate, primary loss-absorbing capacity could also include contingent capital ('cocos') that (like equity) takes losses before resolution. Including properly loss-absorbing debt alongside equity in this way offers the benefit that debt holders have a particular interest, in a way that equity holders do not, in guarding against downside risk. If primary loss-absorbing capacity is wiped out, regulators should also have the power to impose losses on other creditors in resolution, if necessary.

Within the 17%-20% range there would be regulatory discretion about the amount and type of loss-absorbing capacity. For example, 3% extra equity capital might be required of a UK banking group that was judged insufficiently resolvable to remove all risk to the public finances, while no addition might be needed for a bank with strongly credible recovery and resolution plans.

These levels of loss-absorbency, and of equity in particular, are recommended taking as given that the tax advantage of debt over equity is a feature of the UK tax regime and that international accords on capital do not go materially further than minima already agreed. If there are developments on these fronts, more equity should be required.

The Commission also recommends **depositor preference** for deposits insured by the FSCS. Those deposits – and hence the FSCS (and, in the last resort, the public purse) – would then rank higher than other unsecured debt if it came to insolvency. This prospect would reinforce the credibility of such debt bearing loss in resolution, as would the subordination (as a result of bail-in) of long-term unsecured debt to non-preferred depositors in resolution.

Financial stability reforms work together

The combined effect of the Commission's recommended reforms on structure and loss-absorbency can be explained in relation to the 'too big to fail' problem, i.e. that government is compelled to save big banks for fear of the consequences of not doing so.

First, the degree of insulation that retail ring-fencing provides for vital banking services, for which customers have no ready alternatives, gives them some protection from problems elsewhere in the international financial system, and also makes them easier to sort out if they get into trouble.

Second, greater loss-absorbing capacity – from equity and otherwise – for both retail and wholesale/investment banking means that banks of all kinds can sustain bigger losses without causing serious wider problems, and curtails risks to the public finances if they nevertheless do get into trouble.

Third, greater loss-absorbing capacity facilitates resolution. Ring-fencing, by enhancing the credibility of unsecured debt – both of the ring-fenced bank and of the rest of the bank – taking losses without taxpayer support or insolvency, does the same. So does depositor preference. Solving the 'too big to fail' problem is moreover good for competition. This illustrates the mutually reinforcing nature of the reform package.

All this should curb incentives to run excessive risks in the first place, because creditors (other than insured depositors) have sharper incentives to monitor risk.

Moreover, the combination of simplifying and limiting financial links between banks and making banks more resilient (by increasing loss-absorbency and by ring-fencing) helps limit the spread of contagion through the UK banking system. This reduces the likelihood of a shock triggering a system-wide crisis.

It follows from this that without structural change, substantially higher capital requirements than those recommended here would be necessary to achieve the same degree of expected stability.

Finally, the package is also designed to be complementary to other reforms already underway, and has been targeted on those areas where additional reform is necessary. On this basis, and taking into account the cumulative cost of the Commission's recommendations and other reforms in train, it is clear that the incremental benefits for the economy of these recommendations will exceed their incremental costs, probably by a very large margin.

Risks to the fiscal position

The Commission's terms of reference call for attention to be paid to risks to the fiscal position of the Government. The biggest risk is from the possibility of future crises; the value of the Government stakes in banks is an important but secondary consideration. For the reasons given above, the financial stability reforms recommended in this report should curtail risks to the public finances. The probability of government intervention being needed should be much reduced by greater loss-absorbency and curtailed risk-taking incentives. The form of intervention, if still needed, should involve resolution, not financial rescue. If, in the last resort, public funds had to be deployed, the scale of any such support should be greatly diminished by the proposed reforms.

Recent events elsewhere in Europe have illustrated that, just as banking problems can jeopardise the fiscal position, sovereign debt problems can put banks at risk. This shows starkly the close inter-relationship between the stability of banks and the soundness of public finances, and further strengthens the case for reforms to make the UK banking system more resilient.

UK competitiveness

UK competitiveness also features in the Commission's remit. The recommendations in this report will be positive for UK competitiveness overall by strengthening financial stability. That should also be good for the City's international reputation as a place to do business. The proportion of wholesale and investment banking activity in the City that would be directly affected by the proposed reforms would be relatively small, and the ability of UK banks to compete against foreign banks should be maintained by allowing, subject to important provisos, international regulatory standards to apply to their wholesale/investment banking activities. The proposed capital standards for ring-fenced banks, which have been calibrated partly with an eye to regulatory arbitrage possibilities, should not threaten competitiveness in retail banking either.

Nonetheless, by restoring funding costs to levels that properly reflect risk, the proposed reforms may be contrary to the private interests of wholesale/investment banking operations of some UK banks. But the public interest is another matter. It is best advanced by removing the prospect of government support. The fact that some other countries may implicitly subsidise their wholesale/investment banks does not make it sensible for the UK to do so.

Timescales

The Commission naturally hopes that Government and Parliament will respond positively to its recommendations for financial stability by enacting reform measures soon. Early resolution of policy uncertainty would be best. The Commission believes that banks should be strongly encouraged to implement any operational changes as soon as possible. But, particularly given the additional capital the measures will require, an extended implementation period would be appropriate for what amount in combination to fundamental and far-reaching reforms intended for the longer term. Implementation should however be completed at the latest by the Basel III date of the start of 2019.

Reduced bank leverage is not detrimental to economic growth in the medium term. The inflation of leverage in the past decade led to recession, not growth. Earlier decades saw growth without high leverage. In any case, the Commission's proposals to require banks to have more equity capital and long-term unsecured debt is not so large a shift in the mix of bank funding when viewed in relation to the size of their balance sheets. Banks with more robust capital, together with the creation of the ring-fence, would provide a secure and stable framework for the supply of credit to businesses and households in the UK economy. And improved financial stability would be good for investment in the economy.

Competition

There are long-standing competition issues in UK retail banking. On the supply side, core markets are concentrated – the largest four banks account for 77% of personal current accounts and 85% of SME current accounts. On the demand side, competition between banks on current accounts is muted by difficulties of switching between providers and by lack of transparency about banking services on offer. In short, consumers are often not well placed to make informed choices between effectively competing suppliers of banking services.

The crisis has, moreover, impaired competition. The merger between Lloyds and HBOS – one of the principal challengers to the main incumbents – was not referred to the Competition Commission despite the fact that the Office of Fair Trading had found that the test for referral on competition grounds was met in respect of personal current accounts, banking services to SMEs and mortgages. Other challengers left the market or were absorbed into Santander or other established banks. The 'too big to fail' problem gives large banks a competitive advantage over smaller banks which already face differentially high regulatory capital requirements.

This last problem is to some extent addressed by the Commission's financial stability recommendations, including the higher capital requirements on larger banks. Eliminating the implicit government guarantee is pro-competitive. Furthermore, higher capital requirements guard against competition being directed in part towards unduly risky activities, as was the case in the run-up to the crisis when misaligned incentives led banks to 'compete' by lowering lending standards. The crisis has at the same time created opportunities to improve competition. The Commission's aim is to promote effective competition, in which banks compete to serve customers well rather than exploiting lack of customer awareness or poor regulation.

Beyond its financial stability proposals, in the *Interim Report* the Commission advanced provisional views:

- that the divestiture of Lloyds' assets and liabilities required for EU state aid approval will have a limited effect on competition unless it is substantially enhanced;
- that it may be possible to introduce greatly improved means of switching at reasonable cost, and to improve transparency; and
- that the new Financial Conduct Authority (FCA) should have a clear primary duty to promote effective competition.

Improving prospects for a strong and effective challenger

In the light of further evidence, the Commission confirms its view that the prospects for competition in UK retail banking would be much improved by the creation of a strong and effective new challenger by way of the Lloyds divestiture. (The required RBS divestiture has already taken place.) Since the currently proposed divestiture has important limitations, its substantial enhancement would be desirable. This is not simply a question of the number and quality of divested branches, or of the related share of personal current accounts, which at 4.6% is at the low end of the range associated with effective competitive challenge in the past. The funding position of the divested entity is also important for competitive prospects. In particular, unless remedied, its large funding gap – i.e. high loan-to-deposit ratio – would blunt the incentive of the divested entity to compete effectively as a credit provider, and might raise its funding cost base, thereby weakening its ability to compete generally. The Commission therefore recommends that the Government seek agreement with Lloyds to ensure that the divestiture leads to the emergence of a strong challenger bank.

Improving switching and consumer choice

The consultation on the *Interim Report* has indicated that a greatly improved switching system for personal and business current accounts could be introduced without undue cost. The Commission therefore recommends the early introduction of a redirection service for personal and SME current accounts which, among other things, transfers accounts within seven working days, provides seamless redirection for more than a year, and is free of risk and cost to customers. This should boost confidence in the ease of switching and enhance the competitive pressure exerted on banks through customer choice. The Commission has considered recommending account number portability. For now, it appears that its costs and incremental benefits are uncertain relative to redirection, but that may change in the future. Easier switching would bring benefits only if accompanied by much greater transparency which would allow consumers to make informed choices, and so compel banks to offer products that would meet consumers' needs at competitive prices. Transparency should be improved by requirements on banks to disclose more information about prices, including by displaying interest foregone on annual current account statements, and through the sector regulator acting to make current accounts more easily comparable.

Securing pro-competitive financial regulation

One of the reasons for long-standing problems of competition and consumer choice in banking and financial services more generally has been that competition has not been central to financial regulation. The current reform of the financial regulatory authorities, especially the creation of the FCA, presents an opportunity to change this, which in the Commission's view should be seized. The issues of switching and transparency mentioned above are examples of where the FCA, with strong pro-competitive powers and duties, could make markets work much better for consumers. It could also do so by tackling barriers to the entry and growth of smaller banks.

Statements by Government indicate that the policy goal of a pro-competitive FCA is accepted. The Commission believes, however, that this could be secured more effectively than in the current proposed wording of the duties of the FCA, and recommends that the statement of objectives for the FCA is strengthened accordingly.

The question of reference to the Competition Commission

The *Interim Report* also considered whether there was a case for the relevant authorities to refer any banking markets to the Competition Commission for independent investigation and possible use of its powers to implement remedies under competition law.

Such a reference is not recommended before important current policy questions are resolved, but could well be called for depending how events turn out in the next few years, especially whether:

- a strong and effective challenger has resulted from the Lloyds divestiture;
- ease of switching has been transformed by the early establishment of a robust and risk-free redirection service together with much greater transparency; and
- a strongly pro-competitive FCA has been established and is demonstrating progress to improve transparency and reduce barriers to entry and growth by rivals to incumbent banks.

If one or more of these conditions is not achieved by 2015, a market investigation reference should be actively considered if the OFT has not already made one following its proposed review in 2012 of the personal current account market.

Conclusion

In recent months the macroeconomic and sovereign debt problems consequent upon the financial crisis that began in 2007 have widened and deepened, and levels of stress in bank funding markets have risen again.

These are not reasons for avoiding banking reform. Quite the reverse. The ongoing strain on the economy and financial markets reinforces the importance of improving the resilience of the UK banking system. The reforms proposed in this *Final Report* are aimed at long-term stability. The fact that the economy is currently weak is no reason to be distracted from this goal. It is strongly in the national economic interest to have much sounder banks than before. Postponement of reform would be a mistake, as would failure to provide certainty about its path.

However, it is important that the current economic situation be taken into account in the timetable for implementation of reform. The Commission's view is that setting 2019 as the final deadline for full implementation provides ample time to minimise any transition risks.

Although deliberately composed of moderate elements, the reform package is far-reaching. Together with other reforms in train, it would put the UK banking system of 2019 on an altogether different basis from that of 2007. In many respects, however, it would be restorative of what went before in the recent past – better-capitalised, less leveraged banking more focused on the needs of savers and borrowers in the domestic economy. Banks are at the heart of the financial system and hence of the market economy. The opportunity must be seized to establish a much more secure foundation for the UK banking system of the future.

Chapter 1: Introduction

Background

1.1 The Independent Commission on Banking (the Commission) was established by the Government in June 2010 to consider structural and related non-structural reforms to the UK banking sector to promote financial stability and competition. The Commission was asked to report to the Cabinet Committee on Banking Reform by the end of September 2011. Its members are Sir John Vickers (Chair), Clare Spottiswoode, Martin Taylor, Bill Winters and Martin Wolf.

1.2 In September last year the Commission published an *Issues Paper*,[1] which identified a number of possible options for reform, and served as a call for evidence. The Commission received over 150 responses to the *Issues Paper*.[2] It also consulted with market participants, academics and regulators in the UK and internationally, held hearings with the major banks and other institutions, and held a series of public events around the country.

1.3 In April this year the Commission published an *Interim Report*[3] which set out the provisional views of the Commission on possible reform proposals, and sought views, evidence and analysis in response. Since then, in addition to receiving over 170 submissions in response to the *Interim Report*,[4] the Commission has continued consulting with interested parties, held additional hearings, and has held a number of further public events.

1.4 The financial stability reform options examined in the *Interim Report* focused on measures to increase the ability of banks to absorb losses and on forms of structural separation. It also assessed the likely impact of those reform options on competitiveness. The *Interim Report* also examined reform options aimed at improving competition in UK banking.

1.5 The *Interim Report* stated some Aims and Principles (see Box 1.1) to guide the Commission's work and to be used as the core of an analytical framework against which potential reform options could be assessed. This approach attracted broad support and it has therefore been adopted in making the recommendations in this *Final Report*.

1 The *Issues Paper* is available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2010/07/Issues-Paper-24-September-2010.pdf.
2 Responses to the *Issues Paper* are available at: http://bankingcommission.independent.gov.uk/?page_id=284.
3 The *Interim Report* is available at: http://s3-eu-west-1.amazonaws.com/htcdn/Interim-Report-110411.pdf.
4 Responses to the *Interim Report* are available at: http://bankingcommission.independent.gov.uk/?page_id=835.

Box 1.1: Aims and Principles

Aims

The Commission's recommendations aim to:

1) reduce the probability and impact of systemic **financial crises** in the future;

2) maintain the efficient **flow of credit** to the real economy and the ability of households and businesses to manage their risks and financial needs over time; and

3) preserve the functioning of the **payments system** and guaranteed **capital certainty and liquidity for small savers** including small and medium-sized enterprises (SMEs).

Principles

The Commission's recommendations would achieve these aims, in the context of the wider regulatory reform agenda both in the UK and abroad, by:

A) **curbing incentives for excessive risk-taking** by neutralising subsidies and the unpriced risk of triggering financial crises, and by enabling the market to function more effectively;

B) **reducing the costs of systemic financial crises** through increased resilience of institutions and the financial system as a whole, and through improved resolvability of institutions;

C) **promoting effective competition** in the provision of banking services in the UK;

D) having regard to any **impact on GDP** through the cycle, any **fiscal implications**, and the **competitiveness** of the UK financial and professional services sectors and the wider UK economy; and

E) having regard to the possible impact of recommendations on **non-bank parts of the financial system**, and to the effects of **wider regulatory reforms** in the financial sector.

Outline of this report

1.6 In this *Final Report*, the Commission sets out its recommended reforms for promoting stability and competition in UK banking. The recommendations on financial stability call for both structural reform and enhanced loss-absorbing capacity for UK banks. The recommendations on competition set out reforms for structural change in UK banking markets; for improving switching and consumer choice; and for pro-competitive regulation of financial services.

1.7 The rest of this report is organised as set out below.

PART I – FINANCIAL STABILITY

- Chapter 2 provides an overview of the Commission's recommendations on financial stability.
- Chapter 3 contains the Commission's detailed recommendations on structural reform.
- Chapter 4 contains the Commission's detailed recommendations on loss-absorbency.
- Chapter 5 discusses the economic impact of the Commission's financial stability recommendations, and implementation issues.

PART II – COMPETITION

- Chapter 6 discusses the Commission's approach to competition issues and the relationships between financial stability and competition.
- Chapter 7 sets out the Commission´s assessment of the state of competition in UK banking.
- Chapter 8 sets out the Commission's recommendations to improve competition.

PART III – RECOMMENDATIONS

- Chapter 9 sets out a summary of all the Commission's recommendations.

GLOSSARY AND ANNEXES

- The Glossary contains definitions of financial terms used in this *Final Report*.
- Annex 1 contains a summary of responses to the Commission's *Interim Report*.
- Annex 2 sets out a summary of recent developments in other financial stability and competition reforms.
- Annex 3 explores the economic impact of the Commission's financial stability recommendations.
- Annex 4 responds to critiques that have been made of the competition analysis in the *Interim Report*.

PART I: FINANCIAL STABILITY
Chapter 2: Overview

2.1 The main purpose of this chapter is to set out the Commission's recommendations on how to improve the stability of UK banking by a combination of measures on the structure of banks and their ability to absorb losses. By way of introduction, this Overview recaps the provisional position adopted by the Commission in its *Interim Report* – support for ring-fencing of UK retail banking together with higher capital requirements – and discusses objections to that general approach. Chapters 3 and 4 below specify the Commission's proposals on how the approach should be implemented with respect to ring-fencing and loss-absorbency respectively. Chapter 5 considers the economic impact of the proposals, and discusses implementation and transition issues.

The Commission's approach

2.2 In line with the Aims and Principles outlined in Chapter 1, the *Interim Report* proposed that, in order to reduce the very large costs that financial crises typically impose on the economy,[1] reform is needed 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.

2.3 There are different ways of attempting to achieve these objectives, involving structure and/or capital requirements. Structural options range from *laisser-faire* to requiring retail banking and wholesale/investment banking to be in separate non-affiliated firms. On capital requirements, and loss-absorbency more generally, the central question for the UK is whether, and if so how far, to go beyond the internationally agreed baselines of the 'Basel III' process and related developments at European level.

2.4 On structure the *Interim Report* advanced a general approach based on ring-fencing of vital banking services – fundamental reform but not full separation. On capital the *Interim Report* proposed that:

- international standards should require systemically important banks to have equity of at least 10% of risk-weighted assets (RWAs) plus credibly loss-absorbing debt;

1 These costs are examined in Chapter 5 and Annex 3.

- the above standard should apply to large UK retail banking operations in any case; and
- subject to that safeguard for retail banking, international capital standards could apply to the wholesale/investment business of UK banks so long as they had credible resolution plans (including effective loss-absorbing debt).

This broad policy package reflects the UK's position as an open economy with very large banks extensively involved in global as well as domestic banking.

2.5 The position set out in the *Interim Report* has met with two broad lines of response. Many saw merit in the general approach but called for it to be specified more fully, especially on how ring-fencing would work. Chapter 3 is about that. Others raised objections to the general approach, notably on one or more of the following grounds:

- ring-fencing interferes unduly with efficiency advantages of universal banking;
- ring-fencing does not go far enough because only total separation prevents contagion;
- ring-fencing is impractical and would be circumvented;
- the international community should not go beyond Basel III baselines already agreed;
- in any case the UK should not go beyond whatever standards are agreed internationally; or
- a minimum equity ratio of 10% is much too low, partly because debt cannot be made reliably loss-absorbing in crisis conditions.

Analysis in Chapters 3 and 4 below and Annex 3 addresses these points, as well as various other issues, but some general observations can be made at the outset.

Structure

2.6 In the *Interim Report*, the Commission favoured some degree of structural separation between retail banking and wholesale/investment banking on three main grounds.

2.7 First, it would *make it easier to resolve banks which get into trouble, without the provision of taxpayer support*. Resolution is the process whereby the authorities seek to manage the failure of a bank in a safe and orderly way that minimises any adverse impact on the rest of the financial system and the wider economy. In general, resolution requires the separation of different banking functions. Without *ex ante* separability, which ring-fencing would provide, it is doubtful that this could be done *ex post*. Moreover, resolution needs to achieve different things for different activities: it is vital for the economy and customers that there is continuous provision of some services; for others, the aim is rather to manage the wind-down of those activities, particularly to limit any general loss of confidence in the financial system which might result. It is imperative that both objectives are seen to be achievable without bank creditors or shareholders getting taxpayer bail-outs. Separating activities where objectives differ makes this easier, especially because those services whose continuous provision is essential tend not to be those whose complexity makes resolution difficult.

2.8 Second, it would *insulate vital banking services on which households and small and medium-sized enterprises (SMEs) depend from problems elsewhere in the (global) financial system.* Where there are no limits on what can be on the same balance sheet, the authorities cannot effectively limit contagion. In particular, there are international risks beyond the control of the UK authorities (no matter how well they conduct macro-prudential regulation domestically). So it is sensible to protect vital UK services from those risks. Further, structural reform can reduce the interconnectedness (and hence systemic risk) of the financial system as a whole.

2.9 Third, it would *curtail implicit government guarantees, reducing the risk to the sovereign and making it less likely that banks will run excessive risks in the first place.* Improving resolvability – including of ring-fenced banks – should reduce the expectation of bail-outs. In particular, isolating those services where continuous provision is essential curtails the implicit government guarantee in two ways: it makes clear that in order to maintain those services the government will not need to support the rest of the banking group and it ensures that those services are contained within a resolvable entity – i.e. one in which services can be maintained without solvency support. Reducing risk to the public finances would be important even if they were buoyant; the fact that they are not makes it essential, as events elsewhere in Europe have illustrated. By improving the incentives for creditors to discipline banks, curtailing the implicit government guarantee would also improve the efficiency of the allocation of capital in the economy.

2.10 The *Interim Report* also noted that an important question for the design of any structural reform along these lines would be the treatment of commercial banking – deposit-taking, payment and lending services to mid-sized and large companies.

Efficiency objections

2.11 The first of the general objections to ring-fencing in Paragraph 2.5 is that it would be too costly relative to prospective benefits. Universal banking, the argument goes, brings important efficiency benefits in terms of unfettered intermediation between savers and borrowers, and in terms of diversification of risk, which is reflected in lower capital and funding costs. And it is argued that many customers, such as companies wanting both retail and investment banking services, would face cost and inconvenience in the absence of seamless universal banking.

2.12 These important points have informed the Commission's recommendations on ring-fence design. However, the Commission does not believe that the financial stability benefits relating to resolution, insulation of everyday banking services and curtailment of the implicit government guarantee can be effectively achieved without some measure of structural separation. Some have argued that recovery and resolution plans (RRPs) would be a less costly and equally effective alternative to ring-fencing, but it is increasingly clear that the development of credible RRPs for large banking groups requires structural change. Ring-fencing facilitates the development of such plans – they are complements, not substitutes. (This is discussed in more detail in Chapter 3.) Indeed without structural change, there would be a strong case for requiring considerably higher capital (and other loss-absorbing capacity) than in the package of measures recommended by the Commission. Without structural reform, moreover, the proposed higher equity requirements would apply to the international as well as the domestic retail businesses of the affected banks, which would pose in sharp form the dilemma between safeguarding UK retail banking and competitive international investment banking. Among other things the Commission is seeking to ease that dilemma.

Why not separate completely?

2.13 The second broad objection is the opposite – that only total separation can reliably ensure stability of vital banking services and remove the implicit government guarantee. On this view the true synergy benefits of universal banking – as distinct from unwarranted subsidy to investment banking from the implicit guarantee – are slight, and a price well worth paying for the greater stability that total separation would bring.

2.14 There is force in these arguments too, and the Commission's recommendations below, especially on the 'height' of the ring-fence, take them into account. But the Commission does not accept the conclusion that only total separation will work. First, total separation could have higher economic cost than ring-fencing in terms of efficient intermediation between saving and investment, diversification of risk, and customer synergies. Second, it is not clear that total separation would make for greater financial stability. It would remove a channel of contagion risk from investment banking to retail banking (and *vice versa*), but would preclude support for troubled retail banks from elsewhere in banking groups. Third, total separation is harder to enforce under European Union law inasmuch as (absent competition issues) universal banks in other member states would remain entitled to own UK retail banking operations.

Practicability objections

2.15 The third broad category of objections to ring-fencing relates to practicability. This is best addressed once the proposed ring-fence design has been described. Suffice it to say at this point that the Commission is satisfied that its recommended approach is workable. Indeed, practicability is a benefit of ring-fencing – as simpler entities, ring-fenced banks would be easier to monitor, supervise and manage than universal banks, other things being equal.

Loss-absorbency

2.16 In the *Interim Report* the Commission argued that banks should have greater loss-absorbing capacity as well as simpler and safer structures. Banks need to hold more equity relative to their assets, and creditors, not taxpayers, should bear losses if necessary. Beyond loss-absorption, that would make it easier and less costly to sort out banks that still get into trouble, and all this would help discipline risk-taking in the first place.

2.17 In particular, the Commission saw the Basel III baseline agreed internationally as insufficient, albeit a major improvement on the past, and noted that further international work was in train, in particular on capital requirements for systemically important banks (SIBs) and on resolution of complex institutions, which itself requires adequate loss-absorbing capacity. Much of Chapter 4 below is devoted to analysis of the appropriate amounts and types of loss-absorbing capacity to require, and where in banking structures it should be held, on which the Commission has received many submissions. Some wider points can usefully be made now, however.

The Basel III baseline

2.18 The first of the three broad objections in Paragraph 2.5 to the position adopted in the *Interim Report* relating to loss-absorbency is that there is no need to go beyond the Basel III baseline requirements. Proponents of this view point to the cumulative enhancement of capital and liquidity requirements in the Basel III standards. This includes higher quality as well as quantity of required capital, tighter risk weights, the proposed backstop minimum leverage ratio of 3%,[2] and liquidity rules. They argue, further, that equity capital is costly to the economy, and that requiring more of it risks de-leveraging to an extent that would seriously damage growth.

2.19 The Commission rejects this view. The crisis exposed banks as having woefully thin capital support. Massive enhancement is needed, especially for SIBs. This is well recognised by the international community, as shown by the proposals published in July by the Financial Stability Board and the Basel Committee on Banking Supervision on loss-absorbency surcharges for global systemically important banks (G-SIBs).[3] It proposes that these 'G-SIB surcharges' will range from 1%-2.5% (with scope for a further 1%) of equity, on top of the previously agreed 7% baseline, reflecting the potential impact of an institution's failure on the global financial system and the wider economy. This is seen, moreover, as a minimum level above which national jurisdictions may wish, and are free, to go. All of these requirements (other than the

2 A bank's 'leverage ratio' and 'leverage' are the inverse of each other. So a minimum leverage ratio of 3% implies maximum leverage of 100/3=33.

3 BCBS, 2011, *Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement*. Available at: http://www.bis.org/publ/bcbs201.htm.

leverage ratio) apply to RWAs, which are typically around half of total assets – so the Basel III equity baseline of 7% of RWAs represents 3%-4% of actual bank assets.

2.20 As to the cost of equity capital and effects on growth, the Commission's conclusion from various cost-benefit analyses is that there is a powerful case for the *global* minimum equity requirement being a good deal higher than 10% of RWAs, and for it to be accompanied by a minimum leverage ratio well above 3%. Much of the higher cost of equity to private parties relates to tax effects, which is a private, not social, cost and in principle could be offset by tax reform. In sum, the Commission believes that the Basel baseline is by some margin too low.

The 'super-equivalence' objection

2.21 A separate line of objection to the position on loss-absorbency in the *Interim Report* is that, wherever the international debate ends up, there should not be higher ('super-equivalent') standards for UK banks, because that would put them at a competitive disadvantage and, by triggering geographic arbitrage, might be detrimental to stability in the UK.

2.22 On this the Commission draws a distinction between retail banking, where markets tend to be national in scope, and wholesale/investment banking, where they tend to be global. One of the reasons for ring-fencing is to allow international standards to apply to the wholesale/investment banking business of UK banks, subject to major caveats on their resolvability, while higher standards apply to UK retail banking. Aside from the question of super-equivalence, wholesale/investment banking businesses of UK banks may find themselves competing against international competitors who continue to benefit from an implicit government guarantee. The fact that other countries choose to provide such subsidies to their wholesale/investment banking business does not mean that the UK should do so, particularly given the damaging incentives that such subsidies create.

2.23 The super-equivalence objection is much weaker in relation to retail banking but, in part because of European Economic Area (EEA) bank branching freedoms, it is not altogether without force. It follows that there is scope for the UK to go significantly beyond international standards in respect of retail banking, but some limit on how far it could sensibly go. (A separate question, discussed below, is whether the European Commission's proposed capital requirements directive would constrain the UK in this regard. It ought not to.)

Why not impose much higher standards?

2.24 The final objection to consider is the opposite of those discussed above – that the UK should impose much higher standards than those proposed internationally, even with the G-SIB surcharge added. As will be apparent from above, the Commission has considerable sympathy with this point of view, and its recommendations on loss-absorbency have been informed by it. For example, the Commission's recommendations would give scope for requiring a 13% equity-to-RWAs ratio on large retail banks, plus additional capital and long-term unsecured debt. However, for the following reasons, the Commission is not recommending still higher equity requirements.

2.25 First, cost-benefit analyses and the historical experience of bank losses indicate that the incremental stability benefits of higher capital requirements diminish as they increase, whereas estimated growth effects do not. Estimates of the trade-off between stability and growth, at least with the tax system as it is, indicate that 20% would be at the high end of the range of estimated optimal equity-to-RWAs ratios, even if it could be applied across the board. Second, geographic arbitrage possibilities do constrain UK policy beyond some point, as just discussed. Third, imposing much higher capital requirements on banks may result in some activities that can be more safely carried out within the banking sector migrating to non-banks. Fourth, a constraint is imposed by the need to avoid the transition to higher capital requirements resulting in banks shrinking their balance sheets too quickly. Further, the Commission believes that, while equity is the simplest and surest form of loss-absorbing capacity, there is an important role for other types of loss-absorbing capacity such as long-term unsecured debt. Various elements of the Commission's overall reform package are designed to ensure that debt would indeed bear loss effectively in times of stress. Moreover, because debt investors are more sensitive to downside risk than shareholders, they would have a stronger incentive to discipline banks to curb risk-taking.

An overview of the reform package

2.26 The Commission believes that the best way forward is a far-reaching but practicable combination of approaches, comprising ring-fencing of vital banking services and increased loss-absorbency.

2.27 Accordingly, the Commission recommends that a high ring-fence be placed around vital retail banking activities in the UK. In summary, such ring-fenced banks should:

- contain all deposits from individuals and SMEs, along with any overdrafts supplied to them;
- not be allowed to engage in trading or other investment banking activities, provide services to financial companies, or services to customers outside the EEA;
- within these constraints, be allowed to take deposits from larger companies and provide non-financial larger companies with other intermediation services such as simple loans; and
- where they form part of a wider corporate group, have independent governance, be legally separate and operationally separable, and have economic links to the rest of the group no more substantial than those with third parties – but be

allowed to pay dividends as long as they maintain adequate capital levels, which will preserve diversification benefits.

2.28 Alongside the ring-fence, the Commission recommends that banks be made much more loss-absorbing than they were in the past. In summary, this requires that:

- large ring-fenced banks should maintain equity of at least 10% of RWAs;
- all banks should maintain a leverage ratio of at least 3% (calibrated against 'Tier 1' capital),[4] tightened correspondingly to 4.06% for ring-fenced banks required to have an equity ratio of at least 10%;
- the authorities should take bail-in powers which allow them to impose losses on 'bail-in bonds' – long-term unsecured debt available to absorb losses in resolution – and other unsecured liabilities;
- insured depositors should rank ahead of all other unsecured creditors in insolvency;
- large ring-fenced banks and all G-SIBs headquartered in the UK with a G-SIB surcharge of 2.5% should maintain regulatory capital and bail-in bonds amounting to at least 17% of RWAs; and
- a further loss-absorbing buffer (that can be required to be capital or bail-in bonds) of up to 3% of RWAs should be required of these banks if the supervisor has concerns about their ability to be resolved without cost to the taxpayer.

2.29 One objection to the ring-fencing recommendation is that some prominent casualties of the crisis of 2007-8 were not universal banks, particularly Lehman Brothers and Northern Rock. However, the package of reforms set out above would have addressed each of the failures – each in a different way. The Commission's recommendations on bail-in and minimum levels of loss-absorbency for systemically important banks, alongside other reforms already underway (for instance in relation to trading of derivatives) would directly improve the resolvability of investment banks. Further, ring-fencing curbs incentives for excessive risk-taking within universal banks by improving resolvability, and insulates retail banking against contagion from disorderly collapses of investment banks. The Commission's loss-absorbency recommendations would also reduce the risk of another Northern Rock, as will changes already in train to supervision, liquidity regulation and the tools available to the authorities in managing retail bank failures. Box 2.1 below considers in more detail how the Commission's package of reforms might have addressed the failure of a number of banks in the recent crisis.

4 'Tier 1' capital is a slightly broader definition of capital than just equity (for more details see Box 4.2 in Chapter 4).

Box 2.1: How would the reforms have addressed bank failures during the recent crisis?

The Commission's recommendations, together with the other reforms that have been instigated following the recent crisis, would create a much more stable financial system. While intended as systemic reforms for the future, it is still useful to consider how they might have affected the failures of HBOS, Lehman Brothers, Northern Rock and RBS. This is addressed in Table 2.1.

Table 2.1: Impact of reforms on HBOS, Lehman Brothers, Northern Rock and RBS

Reform	HBOS	Lehman Brothers	Northern Rock	RBS
Capital	✓✓	✓✓	✓✓	✓✓✓
Liquidity	✓✓✓	✓✓✓	✓✓✓	✓✓
Loss-absorbing debt	✓✓	✓✓✓	✓✓	✓✓✓
Ring-fence	✓✓	✓✓	✓	✓✓✓
Other resolution	✓	✓	✓	✓
Derivatives (CCPs)		✓✓✓		✓✓
Other reforms	✓✓	✓✓	✓✓	✓✓

The incremental impact of the Commission's recommendations may be summarised as follows.

- Capital: more capital – especially for large ring-fenced banks – would have reduced the probability of bank failure, and of the need for a taxpayer bail-out if failure still ensued.
- Liquidity: stricter liquidity constraints – both for ring-fenced and non-ring-fenced banks – would have reduced the likelihood that solvency concerns led to bank failure.
- Loss-absorbing debt: bail-in powers, depositor preference and loss-absorbing debt (plus equity) of 17%-20% of RWAs would have provided more discipline on risk-taking by bank management and resulted in a larger buffer to prevent taxpayer bail-outs.
- Ring-fence: a ring-fence would have facilitated the above, insulated the domestic banking system from global shocks, restricted the activities conducted within it and made it easier to resolve a failing bank – again making a taxpayer bail-out much less likely.

A more detailed analysis of why these institutions failed and how these reforms – had they been in place – may have reduced the probability and impact of failure is outlined below.

Box 2.1: How would the reforms have addressed bank failures during the recent crisis? (continued)

HBOS

Why did it fail?

At end-2007, 56% of its funding was wholesale (more than half of which was short-term) and it had a very thin layer of equity capital: less than 6% of RWAs and only 2.7% of assets. Increasingly unable to replace maturing wholesale funding, it was acquired by Lloyds TSB in early 2009.

How might the reforms have helped?

Liquidity reforms would have made it more resilient to a liquidity crisis. The ring-fence would have complemented this with wholesale funding restrictions, as well as restricting the activities of its treasury function and requiring more equity. Macro-prudential tools could have constrained the property boom to which it became particularly exposed. Even if it had still run into trouble, more capital, bail-in powers, loss-absorbency of 17%-20% of RWAs and the ability to separate the ring-fenced bank from the rest of the group would have given the authorities many more options to resolve it, rather than injecting £20bn of taxpayer funds into Lloyds TSB/HBOS.

Lehman Brothers

Why did it fail?

It was heavily exposed to US sub-prime mortgages and over 30 times leveraged – a combination which led creditors to stop providing funds as large losses began to materialise. When in late 2008 it ran out of liquid assets to sell to meet this withdrawal of funds, it filed for bankruptcy.

How might the reforms have helped?

Reforms to improve regulatory co-operation, the regulation of shadow banks and liquidity would have reduced the risks it posed. Greater use of central counterparties for derivatives would have limited contagion. If required in the US, bail-in and minimum loss-absorbency of 17%-20% of RWAs would have restricted the impact of losses and the consequential liquidity run. In the UK, the ring-fence would have insulated vital banking services of universal banks from contagion through their global banking and markets operations. (Measures have also been put in place to reduce delays in returning client assets – a feature of the Lehman Brothers insolvency in the UK.)

Northern Rock[1]

Why did it fail?

In June 2007, following balance sheet growth of >20% p.a., only 23% of its funding was from retail deposits, with the majority being wholesale funding (e.g. securitisations, covered bonds).
As wholesale funding markets froze in autumn 2007, the Bank of England provided emergency liquidity assistance before it was taken into public ownership in 2008.

Box 2.1: How would the reforms have addressed bank failures during the recent crisis? (continued)

How might the reforms have helped?

Liquidity reforms and more intrusive supervision would have restricted significantly its ability to pursue a strategy of rapid growth financed through wholesale funding. The ring-fence would have complemented this with wholesale funding restrictions and by requiring greater equity capital. Macro-prudential tools would also have leant against the rapid growth in credit provision that was central to its strategy. More capital, bail-in powers, loss-absorbency of 17%-20% of RWAs and the existence of the UK Special Resolution Regime would have given the authorities many more options to resolve it in the event that it still failed.

RBS

Why did it fail?

It bought most of ABN AMRO under a largely debt-financed deal which left it with limited equity at end-2007: 4% of RWAs (1.2% of assets).[2] It suffered large losses from proprietary trading, structured credit, derivatives and write-downs of goodwill from recent acquisitions. It raised £12bn of new equity from existing shareholders in 2008 but this proved insufficient. The Government injected a further £45bn of equity and insured some assets against extreme losses.

How might the reforms have helped?

Capital reforms, most notably greater emphasis on equity, use of a leverage ratio, and a recalibration of risk weights, would have made it more robust – it would not have been able to buy ABN AMRO without raising substantial new equity and it would have had fewer incentives to take significant risk in trading and derivatives. The ring-fence would have isolated its EEA banking operations from its global markets activities where most of its losses arose. Together with more loss-absorbent debt, this would have given the authorities credible alternative options to injecting £45bn of taxpayer funds into the group – e.g. isolating the ring-fenced bank for sale or temporary public ownership and an orderly wind-down of the rest of the group at no public cost.

[1] For a lucid analysis of the Northern Rock story, see Shin, H.S., 2009, Reflections on Northern Rock: The bank run that heralded the global financial crisis, *Journal of Economic Perspectives,* 23(1), pp.101-119.

[2] Ratios based on *pro forma* figures (excluding assets and liabilities not to be retained by RBS).

Chapter 3: Retail ring-fence

3.1 Chapter 2 provided an overview of the Commission's financial stability recommendations, explaining why structural reform of the banking sector is necessary. This chapter sets out details of the Commission's recommendation for a retail ring-fence and compares it to alternative structural reforms. Chapter 5 and Annex 3 consider in more detail the economic impact, benefits and costs of introducing a retail ring-fence.

Purpose of the ring-fence

3.2 In essence, ring-fenced banks would take retail deposits, provide payments services, and supply credit to households and businesses. A ring-fence could take a variety of forms. An efficiently designed ring-fence would introduce restrictions where and only where they are necessary to achieve its purpose and objectives.

3.3 Following from the arguments presented in Chapter 2, the Commission recommends that the following purpose and objectives should be adopted for the ring-fence.

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.*

3.4 A ring-fence of this kind would also have the benefit that ring-fenced banks would be more straightforward than some existing banking structures and thus easier to manage, monitor and regulate. Further, macro-prudential regulation could be more precisely targeted on ring-fenced banks than on existing banking structures.

3.5 In the design of a retail ring-fence there are two key areas to consider:

- which activities must or could take place within ring-fenced banks and which must or could take place within wholesale/investment banks or other financial institutions. This can be thought of as the 'location' of the fence; and

- the degree of separation between ring-fenced banks and wholesale/investment banks within the same corporate group. This can be thought of as the 'height' of the fence.

3.6 To specify the retail ring-fence proposal the Commission has developed a set of 'ring-fence principles' which summarise how a ring-fence should be introduced. If specified in terms of the products in existence at the time of reform, activity splits can fail to keep pace with financial innovation.[1] To counter this, the ring-fence principles are designed to identify the features of financial services that should determine their treatment and thus provide a guide for the operation of the ring-fence when new products arise. These principles are not in a format which would be appropriate for legislation or regulatory rules. But they aim to provide clarity on the Commission's intentions while recognising that the development of detailed rules is not part of its remit.

3.7 The location of the fence is specified in three principles which describe: the services which should only take place within ring-fenced banks ('mandated services'); the services which should not take place within ring-fenced banks ('prohibited services'); and activities ancillary to the provision of non-prohibited services ('ancillary activities'). The height of the fence is specified in two principles which describe the legal, operational and economic links which should be permitted between a ring-fenced bank and any wider corporate group of which it is part. The rest of this chapter considers each principle in turn. The full set of ring-fence principles can be found in Chapter 9.

Location of the ring-fence

Principle 1: Mandated services

3.8 Which services *must be* provided by ring-fenced banks? For resolution purposes, it is important to isolate those services where continuous provision is critical to the economy. This occurs when interruption to a service would have a high economic cost and where the customers concerned do not have a ready alternative provider. When a service has these characteristics, governments often feel compelled to ensure the service continues even if the provider fails. It is thus imperative that the authorities have a way to ensure continuity of provision without bailing out the creditors of the provider concerned. In banking, the consequences of service disruption are most severe where customers are dependent on a service to meet their day-to-day need for

1 Notably the Glass-Steagall Act, which prevented deposit-taking banks from underwriting or dealing in equity or securities, was undermined in part by the development of derivatives.

money – the key services are thus deposits and overdrafts.[2] The customers who largely do not have an alternative provider and cannot reasonably be expected to plan for a disruption to their service are individuals and small and medium-sized organisations (SMEs).[3] Note that the isolation of such services is not simply designed to ensure that the government need only support a smaller entity. Rather, isolation should be done in a way which allows the authorities to have confidence that they do not need to protect creditors of any bank to ensure continuity of such critical services.

3.9 A view put forward by some respondents to the *Interim Report*[4] was that, in addition, credit provision to individuals and SMEs must be within ring-fenced banks (referred to in this chapter as 'retail credit'). As shown in the recent crisis, aggregate contraction in the credit supply has high economic costs. Mandating that all credit provision to individuals and SMEs should be within ring-fenced banks would prevent non-banks from providing this credit. This would come at a high cost in normal times – significantly reducing the supply of credit and competition among credit providers.[5]

3.10 An alternative option would be to insist that the only *banks* which could provide credit should be ring-fenced banks. However, the benefits of this are not clear-cut. First, it would be a somewhat arbitrary rule introducing unhelpful distortions – given that continuous provision from banks is not in itself more important than continuous provision from non-banks for the same product. Second, the provision of long-term credit by one bank only can be interrupted without overly negative consequences. For instance, provided there is a supply of new mortgages from alternative providers, it is not particularly damaging for an individual if the supplier of their mortgage fails. The failure of a credit provider is not costless – the loss of information about and relationships with borrowers can cause significant disruption particularly in the SME sector – but it is in isolation tolerable. In general then, credit provision is different in nature from products which customers rely on to be able to make everyday payments.[6] A significant portion of the economy's credit supply should be stable and resilient to shocks but it need not all be continuously provided.

3.11 Naturally, if a large volume of deposits were placed within ring-fenced banks then a significant proportion of the credit supply would be expected to follow.[7] Banks need assets to match their liabilities. So while the Commission does not believe that credit

2 I.e. those credit facilities that are an extension of the customer's core banking accounts.
3 The acronym 'SMEs' is used in this chapter for convenience to encompass all kinds of small and medium-sized organisations, not just companies.
4 For example, Lloyds Banking Group (LBG) suggested that certain retail banking credit products, including mortgages, should be provided only from ring-fenced banks. (LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking.* Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Lloyds.pdf).
5 On the importance of non-bank providers see, for example, Annex 1, Federation of Small Businesses, 2011, *Response to the Independent Commission on Banking Interim Report*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Federation-of-Small-Businesses.pdf.
6 Indeed, the importance of monitoring the aggregate supply of credit in the economy has been reflected in the post-crisis focus on greater macro-prudential regulation.
7 Assuming, of course, that ring-fenced banks are not prevented from providing credit – an issue considered in Paragraphs 3.20-3.24.

provision need be mandated, it is expected that under its proposals a large proportion of the credit supply to individuals and SMEs would come from ring-fenced banks. As a result the ring-fence would play an important role in improving the stability of the aggregate credit supply. First, a significant proportion of credit supply to the UK would be insulated from shocks elsewhere in the financial system. Second, the ring-fence would reduce interconnectedness within the financial system and thus would reduce the probability of multiple failures at one time – the situation which can be so damaging for credit supply.

3.12 If these expectations were not realised, and large portions of retail credit supply were provided by non-ring-fenced banks, this is an area which should be reviewed and activity restrictions tightened if appropriate. For example, if within a group containing ring-fenced banks and non-ring-fenced banks large corporate services were being provided from ring-fenced banks while standard retail services were being provided elsewhere in the group this could be an indication that the spirit of the ring-fence principles was being breached. Indeed, it would be important for the authorities to monitor the evolution of the banking system as a whole in response to a retail ring-fence, especially the migration of traditional retail banking services to non-ring-fenced banks or outside the banking system as a whole. With any regulation, there is a risk that activities migrate outside the regulated sector and in doing so become less controlled but no less economically important. Equally, some genuine migration of risk away from the banking sector can be positive for its stability.

3.13 Thus, the first ring-fence principle is:

Mandated services. *Only ring-fenced banks*[8] *should be granted permission by the UK regulator*[9] *to provide mandated services. Mandated services should be those banking services where:*

a) even a temporary interruption[10] *to the provision of service resulting from the failure of a bank has significant economic costs; and*

b) customers are not well equipped to plan for such an interruption.

Mandated services currently comprise the taking of deposits from, and the provision of overdrafts to, individuals[11] *and small and medium-sized organisations.*[12]

8 'Ring-fenced banks' includes building societies and these societies would still need to follow the ring-fence rules.
9 Note that branches with entitlement to conduct activities in the UK under European law are not considered to be 'granted permission' for the purposes of these principles.
10 A temporary interruption means broadly an interruption lasting anything up to seven days. For some services, even interruptions of a shorter period can have significant economic costs and such services would also satisfy this criterion.
11 Except for the limited number of private banking customers for whom these two criteria do not hold.
12 All organisations (including companies, charities and partnerships) which meet the size requirements set out in the Companies Act except the limited number of small or medium-sized financial organisations for whom the two conditions outlined do not hold. At present, the Companies Act 2006 defines, subject to limited exclusions, medium-sized companies as those satisfying two or more of the following requirements: a turnover of less than £25.9mn; a balance sheet of less than £12.9mn; and employees of fewer than 250.

3.14 This principle also determines the scope of the Commission's ring-fencing proposal. The requirement to comply with the ring-fence principles should apply to anyone carrying on a banking business as a distinct legal entity with permission from the UK regulator. Thus it would include any standalone UK bank, any UK bank which is part of a wider banking group headquartered in the UK, and any UK bank which is a subsidiary of a wider banking group headquartered overseas. Mandated services could also be provided in the UK by branches of foreign banks, although any significant banks based outside the European Economic Area (EEA) wishing to carry out mandated services in the UK should generally be required to establish a UK subsidiary.[13] No other organisation could provide mandated services in the UK. In this sense, the word 'bank' when used in relation to the ring-fence has a broad meaning encompassing all types of deposit-takers, in particular including building societies. The ring-fence requirements would not apply to the foreign subsidiaries of UK-headquartered banking groups unless they were subsidiaries of a ring-fenced bank.

3.15 One question is whether banks below a certain size (say total assets of less than £20bn) should be exempted from being required to follow the ring-fencing rules. The risks of unrestricted universal banking are in general greater for larger banks. The impact of failure, and thus the importance of resolution and of reducing contagion, is greater the more customers and creditors are affected. Any fixed costs associated with ring-fencing would be proportionately greater for smaller banks. However, complex small banks could still pose significant resolution challenges, an exemption could confuse consumers, and the risk of contagion from financial markets to the retail banking *system* would remain if there were a large number of small banks operating below some *de minimis* limit. At present the latter risk looks unlikely to materialise. Equally, the impact of ring-fencing on small banks would be minimal – the vast majority of small banks would be unaffected by the ring-fence because they conduct only services which would be permitted within ring-fenced banks, or they do not conduct any mandated services. In addition, any exemption below a certain size might create a competitive distortion, as universal banks might have a disincentive to grow beyond that level. On balance, the Commission is not persuaded of the need for any *de minimis* exemption from the ring-fence principles.

3.16 An alternative proposal would be for mandated services to be only the taking of insured deposits, with individuals and SMEs free to place uninsured deposits in non-ring-fenced banks. However, this would allow a significant proportion of services where continuity is important to migrate outside ring-fenced banks. In any case, the structure of deposit insurance[14] does not permit individuals and SMEs to make only uninsured deposits in non-ring-fenced banks: a company outside the ring-fence which took deposits would need to be separately authorised even if it was part of

13 The implications of branching from EEA firms are considered in Paragraph 3.68.
14 A matter governed by European law.

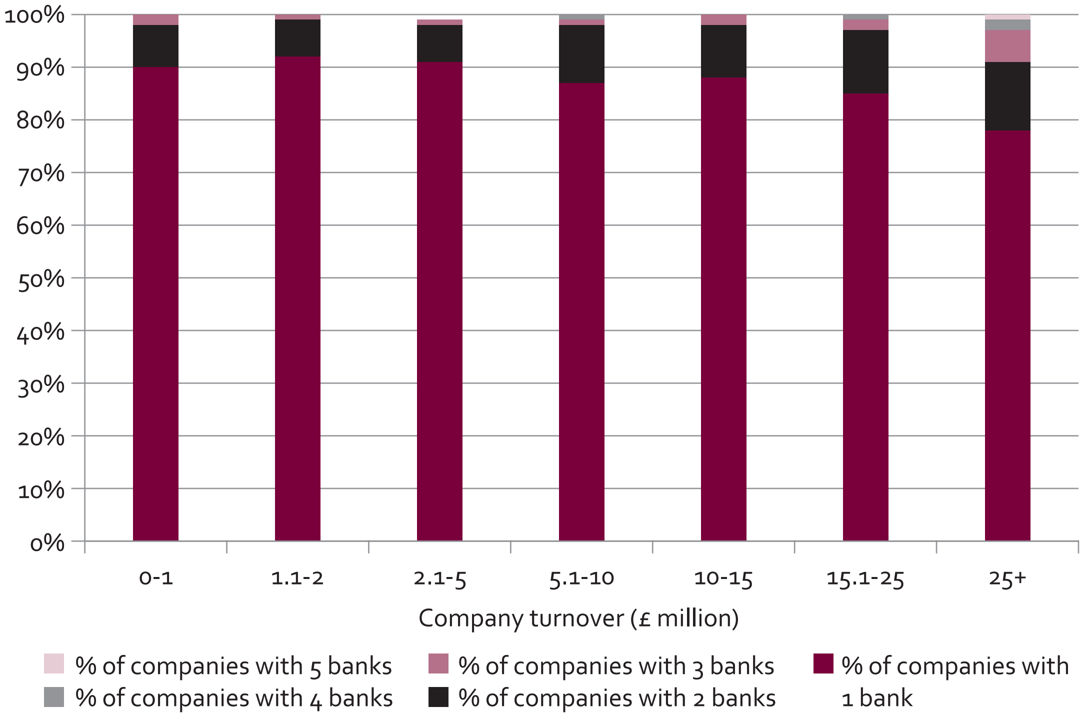
the same wider corporate group; and as a result, deposits made with it would be insured.[15]

3.17 A small number of individuals are well equipped to plan for an interruption to their banking services and so do not meet the principle's second criterion. In particular, very high net worth private banking customers are likely to use more than one bank, should have sufficient resources to assess the safety of their bank, and should be able to make use of alternatives if one of their banks failed. If such customers want to place deposits outside ring-fenced banks they should be permitted to do so. However, to guard against attempts to use this exception to conduct general retail banking outside the ring-fenced bank, the authorities should place stringent limits on its use on the basis of customer type and awareness. In line with the assessments commonly made of private banking customers to qualify for this exemption customers should, at a minimum, have adequate knowledge and experience of financial matters and have substantial liquid assets.[16] They should also be required to certify that they understand that their deposit is being placed outside the ring-fenced bank.

3.18 The Companies Act defines SMEs as satisfying two or more of the following requirements: a turnover of less than £25.9mn; a balance sheet of less than £12.9mn; and fewer than 250 employees.[17] In practice, different banks use different definitions of company size and type to assign customers to their retail, commercial or investment banking divisions and often make exceptions according to particular customer needs. The definition used for the ring-fence should be one under which the vast majority of organisations qualifying as SMEs meet the criteria outlined in the first ring-fence principle. The evidence on business multi-banking (see Figure 3.1) shows that businesses with a turnover of less than £25mn usually do not have an alternative banking provider. Therefore, it is appropriate for only ring-fenced banks to be able to take the deposits of all companies classified as SMEs under the Companies Act. The deposits of similar sized organisations, including charities and partnerships, should also only be placed with ring-fenced banks. Note that even the majority of businesses with a turnover of over £25mn do not tend to multi-bank – an important consideration when determining whether such businesses should be *allowed* to bank with the ring-fenced bank (see Paragraph 3.29 onwards). The limited number of small or medium-sized financial companies who are equipped to plan for disruption to their services could be treated in a similar way to private banking customers and their deposits need not be included in the definition of mandated services.

15 An additional complication is that reforms have been proposed which would extend coverage of the Financial Services Compensation Scheme (FSCS) to non-financial corporate customers of all sizes (see European Commission, July 2010, *Proposal for a Directive on Deposit Guarantee Scheme*. Available at: http://ec.europa.eu/internal_market/bank/docs/guarantee/20100712_proposal_en.pdf). Even if these proposals come into force it is likely that the vast majority (>95%) of FSCS-insured deposits would, in practice, be held within ring-fenced banks.
16 The authorities should judge the appropriate precise levels for these factors based on the principles and objectives of the ring-fence. Existing regulatory definitions might provide an appropriate basis for this exemption.
17 Strictly, this is the definition of medium-sized companies provided in the Companies Act. Here, 'SMEs' is intended to capture all those companies defined as small or medium in the Companies Act.

Figure 3.1: Extent of multi-banking by turnover of company[18]



Source: Commission analysis of data from the Charterhouse Research UK Business Banking Survey 2010, based on more than 16,000 interviews with businesses conducted between January and December 2010 covering businesses with turnover up to £1bn.

Principle 2: Prohibited services

3.19 Which services *must not be* provided by ring-fenced banks? This involves a balance between the costs associated with losing synergies and the benefits of improving financial stability through separation. The Commission received a wide variety of proposals for services which ring-fenced banks should be prohibited from providing. The key areas of debate are:

- Should ring-fenced banks be able freely to provide credit to individuals and SMEs?
- Should any wholesale or investment banking activities be permitted in ring-fenced banks?
- Should the provision of any commercial banking services to large companies and other organisations be permitted in ring-fenced banks? If so, which ones?

18 Figures have been rounded to the nearest percentage point and so not all columns sum to 100%. The category '£0-1mn' includes start-up businesses and companies not in business for a year.

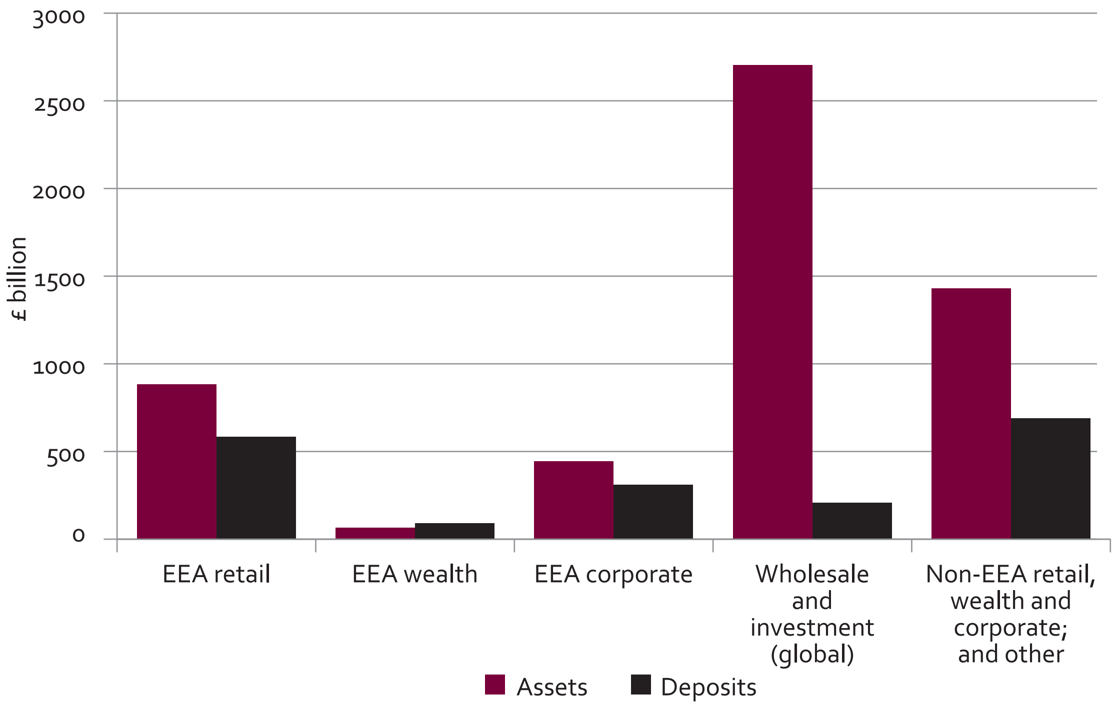
After outlining the size of different parts of the banking sector in Box 3.1, this section considers each of these questions in turn and against the objectives of the ring-fence. It then outlines in detail the division between retail and wholesale/investment banking which the Commission believes is most appropriate.

Box 3.1: The relative size of different activities within the UK banking sector

Before examining the issues surrounding the location of the fence in detail, it is useful briefly to consider the relative size of different activities within the UK banking sector. This can be done either through an analysis of the balance sheets of UK banks, or through an analysis of the monetary data regarding the deposits and borrowing of different sectors of the economy.

Figure 3.2 breaks down the balance sheets of the four largest UK banking groups at the end of 2010 between European and non-European activity and, within Europe, into the activities of different divisions. The assets of these banks make up over 80% of the assets of all UK banks and building societies.

Figure 3.2: Assets and deposits in the four largest UK banks at the end of 2010, by division (£bn)[1]

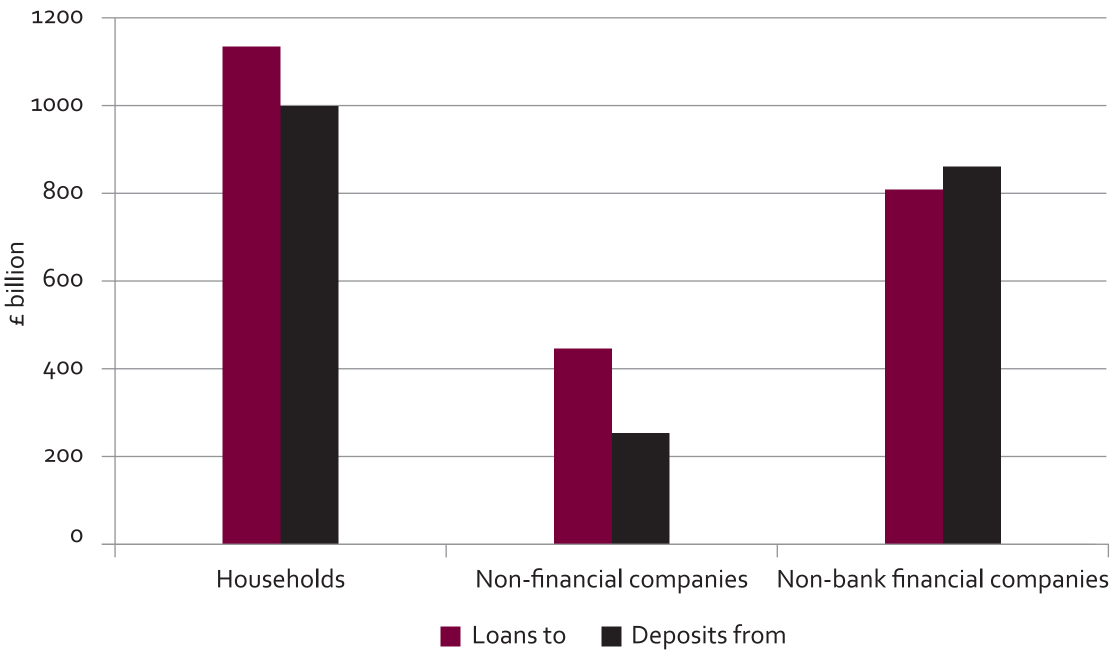


Source: Company accounts, Commission estimates.

Figure 3.3 shows for all UK banks the amount held in sterling deposits from, and the amount of sterling loans to, different sectors of the UK economy.

Box 3.1: The relative size of different activities within the UK banking sector (continued)

Figure 3.3: Sterling lending by and deposits in all UK banks to/from UK households, companies and non-bank financial institutions at the end of 2010 (£bn)[2]



Source: Bank of England, Commission estimates.

For households (which would broadly incorporate the retail and wealth divisions of banks) and companies (roughly corresponding to the corporate divisions of banks) the two figures show similar patterns for activities within the EEA with both sectors borrowing more than they deposit. Variations in the absolute amounts between the two figures are to be expected given that the second figure is for all banks but only sterling activity within the UK, while the first is for only four banks but estimates their activities in the whole of Europe and regardless of currency. The size of assets in the wholesale and investment banking divisions of the four largest UK banks is around 50% of their total assets. Much of this does not appear in Figure 3.3 because it may be global activity, and includes significant foreign currency activity, activities other than direct lending and some interbank activity.

[1] 'Other' includes assets (EEA and non-EEA) identified by banks as 'non-core' or in wind down, assets associated with insurance divisions and other group items not allocated between divisions. The banks included in this data are Barclays, HSBC, Lloyds Banking Group and Royal Bank of Scotland. The figure is based on the divisional disclosures provided in company accounts. Assumptions have been made about splits within divisions where necessary.

[2] Data is taken from the Bank of England's sectoral analysis of M4 and M4 lending. 'Households' corresponds to the Bank of England's definition of the 'household sector'; 'non-financial companies' corresponds to 'private non-financial corporations'; and 'non-bank financial companies' to 'other financial corporations'. Details of theses definition are available at: http://www.bankofengland.co.uk/mfsd/iadb/notesiadb/m4_sectoral.htm.

Should credit provision to individuals and SMEs be prohibited?

3.20 Proponents of a different kind of structural reform known as 'narrow banking'[19] argue that the function of taking deposits and providing payments services to individuals and SMEs is so critical to the economy that it should not be combined with risky assets. Under a strict form of narrow banking the only assets allowed to be held against such deposits would be safe, liquid assets.[20] Since lending to the private sector necessarily involves risk, such banks would not be able to use the funding from deposits to make loans to individuals and SMEs. Should ring-fenced banks be allowed to make such loans?

3.21 If ring-fenced banks were not able to perform their core economic function of intermediating between deposits and loans, the economic costs would be very high.[21] If all current retail deposits were placed in narrow banks, around £1tn of deposits which currently support credit provision in the economy would no longer be able to do so. Alternative sources of credit could arise – for example if narrow banks could invest only in short-term UK sovereign debt ('gilts') the current investors in gilts would need other assets to invest in, since the stock of gilts would be more than taken up by the demand from narrow banks. Thus, those investors might become direct lenders. Such a system would be less efficient, given that the synergies within banks would be removed, leading to increased costs for customers. Either way, narrow banking would mean that ring-fenced banks could not be a source of stable credit supply during times of stress. Instead, the supply of credit would move entirely to a less regulated sector.

3.22 Limited purpose banking[22] offers an alternative solution, under which the role of financial intermediaries is to bring together savers and borrowers but risk is eliminated from the intermediary because it does not hold the loan on its books. All of the risk of the loan is passed onto the investors in the intermediary (or fund), so that effectively all debt is securitised. However, limited purpose banking would severely constrain two key functions of the financial system. First, it would constrain banks' ability to produce liquidity through the creation of liabilities (deposits) with shorter maturities than their assets. The existence of such deposits allows households and firms to settle payments easily. Second, banks would no longer be incentivised to monitor their borrowers, and it would be more difficult to modify loan agreements. These activities help to maximise the economic value of bank loans.

19 For example see Kay, J., 2009, *Narrow Banking: The Reform of Banking Regulation*, Centre for the Study of Financial Innovation. Available at: http://www.johnkay.com/2009/09/15/narrow-banking.

20 The example of such assets normally given is sovereign debt instruments, although it is clear in the current financial environment that even these are not risk-free.

21 A number of prominent economic analyses consider the reasons for the existence of financial intermediaries – i.e. why lending is not simply done directly through markets and why it is useful to have institutions which both take deposits and make loans. The existence of such financial intermediaries is frequently thought to be associated with an asymmetry of information between lenders and depositors. In particular, the delegated monitoring theory says that institutions which both take deposits and make loans economise on the costs of monitoring borrowers (Diamond, D.W., 1984, Financial intermediation and delegated monitoring, *Review of Economic Studies,* 51(3), pp.393-414).

22 Kotlikoff, L., 2010, *Jimmy Stewart is Dead: Ending the World's Ongoing Financial Plague with Limited Purpose Banking,* Hoboken: John Wiley & Sons Inc.

3.23 The ring-fence proposal shares the recognition that continuous provision of deposit-taking services is important to the economy, but not the conclusion that the providers of such services must therefore be made virtually riskless. The role banks play in intermediation is an important one, and lending necessarily involves risk. So some risk of failure should be tolerated but it must be possible for the authorities to ensure continuous provision of vital services without taxpayer support for the creditors of a failed provider. Equally, the importance of intermediation means that it should not be combined with other risky activities which are not an inherent part of intermediation.

3.24 The debate about narrow banking provides two important insights into the appropriate design of a retail ring-fence:

- services which are not integral to the direct intermediation of funds or the provision of payments services should not be provided by ring-fenced banks since they introduce unnecessary risk and complicate the resolution of a failed bank, increasing the likelihood that the bank would be bailed out; and

- in order to minimise the costs of structural reform proposals, it is important not to constrain, without any flexibility, both sides of a bank's balance sheet. Doing so could create an inefficient mismatch between assets and liabilities.

Should wholesale and investment banking activities be prohibited?

3.25 Under the Volcker rule, a form of which has been introduced in the US,[23] banks are not allowed to engage in proprietary trading, and investments in hedge funds and private equity firms are restricted. The Volcker rule is a form of full separation in that it prevents common ownership of banks and entities which conduct such activities. One UK bank has suggested that the activity split within the Volcker rule could form the basis for a ring-fence.[24] Under this proposal, the only prohibited activities would be those not allowed by the Volcker rule – all other forms of wholesale/investment banking could continue to take place within ring-fenced banks.

3.26 In part the Volcker rule aims to remove from certain activities the benefit of implicit and explicit government support for the banking system. Those activities prohibited by the Volcker rule should be prohibited from ring-fenced banks. Proprietary trading, in particular, is not a necessary part of intermediation in the real economy and so should not be conducted in the same entity as the mandated services. It introduces risks to the mandated services which are not necessary for economic efficiency.

3.27 However, prohibiting only those activities caught by the Volcker rule would not achieve all of the objectives of ring-fencing. First, a number of other wholesale/investment banking activities make it harder, for example due to the complexity of

23 See Financial Stability Oversight Council, 2011, *Study and Recommendations on Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds*. Available at: http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf.
24 See RBS, 2011, *Response to Interim Report*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/RBS_response_ICB_Interim_Report_public_final_v2.pdf.

unwinding them, for the authorities to maintain continuous provision of service without taxpayer support. As a result, most of the efforts to improve the resolvability of universal banks involve requiring that all investment banking activities must be separable from the rest of the bank. Second, to reduce the ring-fenced bank's interconnectedness with the financial system and the correlation of its performance with that of financial markets, it should not conduct trading or other activities which give rise primarily to market risk or counterparty credit risk. The high degree of interconnectedness is a key cause of the fragility of the financial system as a whole.[25] It increases 'systemic risk' – the risk that multiple banks will fail at the same time, and the kind of risk which can give rise to aggregate credit crunches, and has in the past led to taxpayer support for banks. Third, a ring-fenced bank could effectively conduct its key economic role of intermediation within the real economy without engaging in wholesale/investment banking, as is clear from the existence of successful banks which do this today. Fourth, removing the complexity of some wholesale/investment banking would make it easier for ring-fenced banks to be managed, monitored and supervised. Alongside the curtailment of government guarantees, this would reduce the probability as well as the impact of failure.

3.28 Some argue that by removing difficult to resolve wholesale/investment banking activities from ring-fenced banks, the problem is transferred elsewhere but not solved. The consequences of the collapse of Lehman Brothers, it is said, demonstrated that even standalone investment banks cannot be allowed to fail and thus, in a world of ring-fencing, governments would continue to bail out non-ring-fenced banks. However, this argument fails to recognise the other reforms in train internationally in response to the collapse of Lehman Brothers – including greater use of central counterparties – and proposals included in Chapter 4 of this report to ensure that creditors are appropriately exposed to losses. Furthermore, the ring-fence would mean that UK retail banking services would in future be materially less exposed to collapses like that of Lehman Brothers, or to the volatility this created.[26]

Should accepting deposits from large companies be prohibited?

3.29 On the issue of commercial banking services for large companies and other organisations,[27] it is useful to consider deposits and loans separately. On deposits, there are reasons to believe that permitting ring-fenced banks to take such deposits would be beneficial:

- all sizes and types of organisations require payments services and the provision of these services is an important part of the role of banks. While some large organisations can plan for disruption to their services – and thus their deposits need not be mandated within ring-fenced banks – a large number do not multi-bank and may suffer significantly from such disruption;

25 See Annex 3 for a more detailed discussion.
26 See Box 2.1 for further discussion.
27 Including charities, partnerships and public authorities.

area restriction, an overdraft facility, at least 20 free withdrawals per month, no introductory credit interest rate and a minimum investment of no more than £300. Total cost includes the cost of arranged overdrafts, unarranged overdrafts and interest foregone. Figures are deflated by the GDP deflator and expressed in 2005 prices.

x The sample is all UK PCA providers from 2000-2010, excluding PCA providers which had a market share below 1%, and excluding years in which banks merged, so only organic growth is represented. Each data point shows market share for each bank at the beginning of each year, against that bank's change in market share over the course of that year. Source: Commission analysis of GfK NOP FRS, 5 months ending September 2000-2010, main current accounts (21396-24789), new main current accounts (1061-1487).

xi Standard PCAs in Figure A4.11 are ones that offer free banking, no monthly charges, have no age restriction, no minimum income, no area restriction, an overdraft facility, at least 20 free withdrawals per month, no introductory credit interest rate and a minimum investment of no more than £300. Total cost includes the cost of arranged overdrafts, unarranged overdrafts and interest foregone. Interest rates that apply to deposits of £1000 have been used to prevent the tiering of rates from having an effect. Figures are deflated by the GDP deflator and expressed in 2005 prices. Based upon Commission analysis of Defaqto data.

xii Standard PCAs in Figure A4.12 are ones that offer free banking, no monthly charges, have no age restriction, no minimum income, no area restriction, an overdraft facility, at least 20 free withdrawals per month, no introductory credit interest rate and a minimum investment of no more than £300. Total cost includes the cost of arranged overdrafts, unarranged overdrafts and interest foregone. Interest rates that apply to deposits of £1000 have been used to prevent the tiering of rates from having an effect. Figures are deflated by the GDP deflator and expressed in 2005 prices. Based upon Commission analysis of Defaqto data.

xiii Standard PCAs in Figure A4.13 are ones that offer free banking, no monthly charges, have no age restriction, no minimum income, no area restriction, an overdraft facility, at least 20 free withdrawals per month, no introductory credit interest rate and a minimum investment of no more than £300. Total cost includes the cost of arranged overdrafts, unarranged overdrafts and interest foregone. Interest rates that apply to deposits of £1000 have been used to prevent the tiering of rates from having an effect. Figures are deflated by the GDP deflator and expressed in 2005 prices. Based upon Commission analysis of Defaqto data.

xiv Standard PCAs in Figure A4.14 are ones that offer free banking, no monthly charges, have no age restriction, no minimum income, no area restriction, an overdraft facility, at least 20 free withdrawals per month, no introductory credit interest rate and a minimum investment of no more than £300. Total cost includes the cost of arranged overdrafts, unarranged overdrafts and interest foregone. Interest rates that apply to deposits of £1000 have been used to prevent the tiering of rates from having an effect. Figures are deflated by the GDP deflator and expressed in 2005 prices. Based upon Commission analysis of Defaqto data.

xv Numbers do not sum due to rounding. Those surveyed who responded 'other' or 'do not know' were attributed to each of the categories above in proportion to the existing size of the categories. Source: Commission analysis of GfK NOP FRS, 5 months ending September 2000-2010, current accounts (25923-34655).

xvi Type A SME customer is one that has a turnover of c.£900k, deposit balances of just under £70k, high levels of automated and manual transactions, and has medium levels of cash usage. The cost to SMEs includes the cost of interest foregone but does not include the cost of overdrafts which are often set by negotiation. Deposit rate used was the rate paid on balances of £25,000. Only accounts that could be used by firms of the six types were included and only instant access accounts that allowed branch access were compared. Based upon Commission analysis of Moneyfacts data.

xvii Type B SME customer is one that has a turnover of £100k, deposit balances of between £5k-£10k, low levels of automated and manual transactions, and high levels of cash usage. The cost to SMEs includes the cost of interest foregone but does not include the cost of overdrafts which are often set by negotiation. Deposit rate used was the rate paid on balances of £5,000. Only accounts that could be used by firms of the six types were included and only instant access accounts that allowed branch access were compared. Based upon Commission analysis of Moneyfacts data.

xviii Type C SME customer is one that has a turnover of £250k, deposit balances just over £10k and some use of automated and manual transactions (no cash usage). The cost to SMEs includes the cost of interest foregone but does not include the cost of overdrafts which are often set by negotiation. Deposit rate used was the rate paid on balances of £10,000. Only accounts that could be used by firms of the six types were included and only instant access accounts that allowed branch access were compared. Based upon Commission analysis of Moneyfacts data.

ISBN 978-1-845-32-829-0
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