ICB Independent Commission on Banking

Final Report
Recommendations

September 2011

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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.

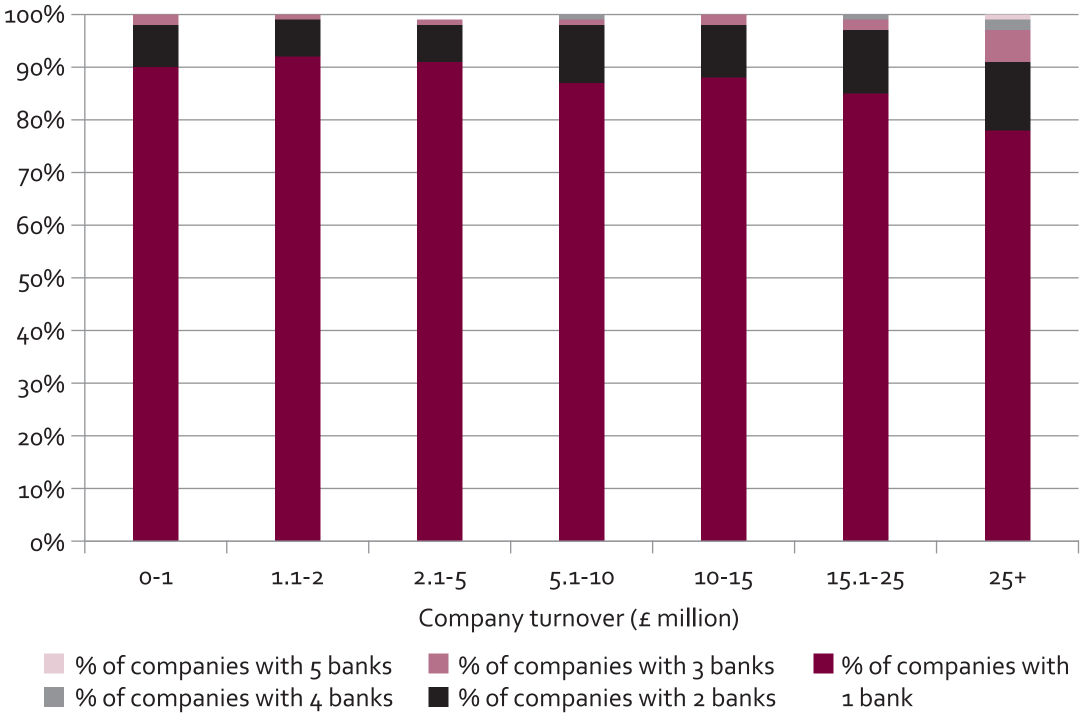
the same wider corporate group; and as a result, deposits made with it would be insured.[15]

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.

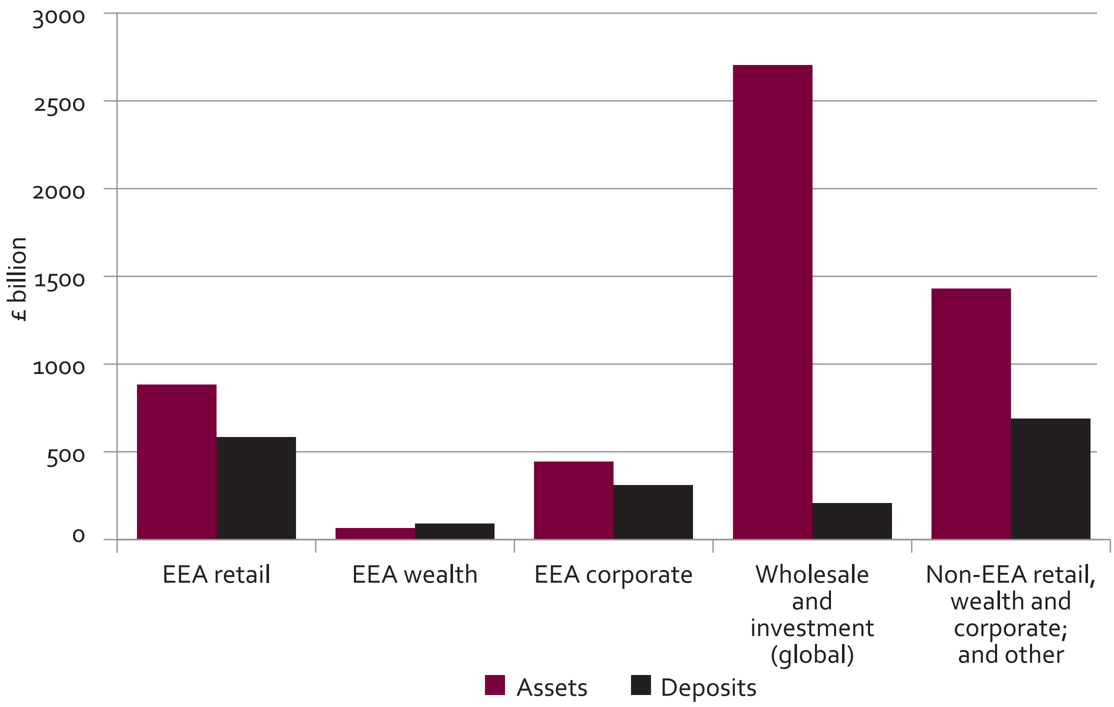
After outlining the size of different parts of the banking sector in Box 3.1, this section considers each of these questions in turn and against the objectives of the ring-fence. It then outlines in detail the division between retail and wholesale/investment banking which the Commission believes is most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

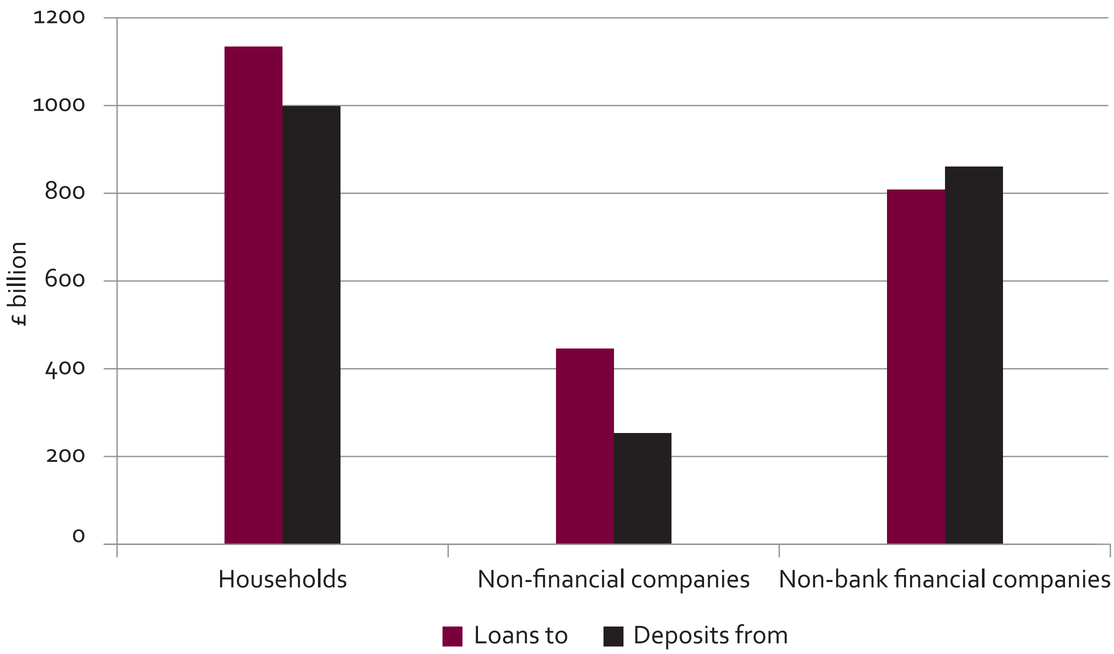


Source: Company accounts, Commission estimates.

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.

- arguably, if large organisations were *prevented* from depositing with ring-fenced banks there would be strong political pressure at times of stress to ensure continuity of service provision for other types of bank;[28]
- allowing some non-retail deposit funding into the ring-fenced bank would, in combination with the Commission's proposals for depositor preference and bail-in, improve the resolvability of the ring-fenced bank as these liabilities increase loss-absorbing capacity; and
- some diversity of funding base may be positive for the stability of the ring-fenced bank.

3.30 There are also some practical difficulties with the idea that deposits should be restricted according to size or type of organisation. A bank ordinarily engages in monitoring and evaluation of the nature of the companies it lends to, but the requirement that it continuously do this for its depositors would impose additional costs. For example, a restriction on deposits according to size of company would require a bank to instruct a company to withdraw its deposits if the company's turnover increased above a certain level. Responses to the *Interim Report* highlighted the concerns of corporate customers about such consequences. For example, the Confederation of British Industry (CBI) said "many businesses of all sizes may be concerned about being forced to bank outside the ring-fence... this could be a concern, particularly, for a growing business which is moved outside the ring-fence arbitrarily because it reached a certain size".[29]

3.31 However, some have argued that there are significant risks and costs associated with allowing a ring-fenced bank to take large corporate deposits. It is said that allowing ring-fenced banks to take corporate deposits would increase the instability of the rest of the financial system because at times of stress such deposits would run from other banks and into ring-fenced banks.[30] But corporate deposits ran from weaker banks in the last crisis – in the absence of a ring-fence. Corporate deposits have a tendency to run in times of stress, but this tendency appears with or without a ring-fence and the design of a ring-fence cannot eliminate it. If corporate depositors were prevented from running to ring-fenced banks they would run to other types of banks – but they would still wish to withdraw their money from any bank they were concerned about, and they would have the ability to do so. The principal way to address run risk is by stronger liquidity and capital requirements, including the proposals outlined in Chapter 4.

28 Indeed, it could be argued that there would be political pressure to provide continuity of service for large corporate deposits in any case and this could lead to bail-outs of non-ring-fenced banks. However, large corporate depositors can and should ensure that their banking arrangements are secure. This is an important source of market discipline and ring-fencing should make it politically easier to ensure such discipline is imposed in future.
29 See Page 7, CBI, 2011, *CBI Response to the Independent Commission on Banking Interim Report.* Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Confederation-of-British-Industry.pdf.
30 This risk was highlighted in 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.

3.32 It is argued by some banks that permitting ring-fenced banks to take corporate deposits would significantly increase the private costs for those banks, although other banks have argued the opposite.[31] Certain forms of investment banking are claimed to have strong synergies with the taking of corporate deposits. Some say that it would not be possible to maintain these synergies if ring-fenced banks were allowed to take corporate deposits. Of course, an investment bank could still offer to take corporate deposits and ring-fenced banks would not be obliged to do so. The proponents of this argument say, however, that if some ring-fenced banks offered deposit-taking services for large organisations then all these customers would choose to place their deposits with those banks (and none would place them with investment banks). It is not clear that this would be the case, given the wide variety of business models with which large organisations currently choose to place their deposits. But if it is true, then the introduction of a narrower ring-fence[32] would not mitigate the costs since large companies cannot be forced to deposit with UK investment banks. Rather, they might switch to foreign banks if prevented from placing their deposits with UK ring-fenced banks.

3.33 But the importance of this argument depends on why it is supposed that large companies would choose to place their deposits with ring-fenced banks. If they would do so because they have a preference for having their deposits backed by retail assets then market forces should be allowed to determine the most efficient system in light of this choice. However, if they would do so because of a belief that ring-fenced banks would benefit from strengthened implicit government guarantees then this would be an unhelpful distortion. Some respondents to the *Interim Report* said that the ring-fence would not remove government guarantees from ring-fenced banks. For example, the CBI said "there will be a perception that deposits held at the ring-fenced bank will be safe, even above the limit of the deposit protection scheme or outside its scope".[33]

3.34 The Commission rejects the idea that the debt of ring-fenced banks would be implicitly guaranteed. Ring-fenced banks would be simpler, less connected and easier to resolve without taxpayer support than existing universal banks. A key benefit of ring-fencing is that continuity of service could be achieved without the provision of taxpayer support. Banks similar to ring-fenced banks are frequently resolved by the US authorities and losses are, where necessary, imposed on unsecured creditors and uninsured depositors. One market analyst report recognised this, commenting, "in our opinion the senior debt of these retail ring-fenced entities will have a much lower

31 They might all be correct – different ring-fences could have different impacts depending upon the business model concerned.
32 I.e. one in which the taking of corporate deposits was prohibited.
33 See Page 4, CBI, 2011, *CBI Response to the Independent Commission on Banking Interim Report.* Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Confederation-of-British-Industry.pdf. However, this view was disputed by others (see Pringle, R. and Sandeman, H., 2011, *Response to the ICB's Consultation Questions and Comments on the Purpose and Design of a UK Banking Ring-fence.* Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Pringle-Robert-and-Sandeman-Hugh.pdf).

level of systemic support".[34] In particular, if a company chose to place its deposits with a ring-fenced bank it would be exposed to losses in the event of that bank's failure. The Commission's proposals outlined in Chapter 4, for additional powers to impose losses on debt holders and to give insured deposits priority in the event of failure, further reduce implicit guarantees for all parts of the banking sector. Indeed, given these proposals, a corporate deposit would bear losses before retail depositors, meaning that they would suffer a higher proportion of any losses which did occur if they deposited in a ring-fenced bank rather than a non-ring-fenced bank.

Should lending to large companies be prohibited?

3.35 Turning to the asset side of the balance sheet, some arguments point towards the inclusion of lending to large organisations within ring-fenced banks. Intermediation between retail deposits and larger organisations can be an important source of finance for the latter.[35] Constraining the ability of banks to intermediate to any size of organisation would also limit diversification within ring-fenced banks. Earlier, the risks of creating a mismatch between assets and liabilities were considered – allowing ring-fenced banks to take deposits from large organisations but not to lend to them could create such a mismatch and, *in extremis*, generate bubbles in retail assets such as mortgages. If a wide range of deposits could be placed with ring-fenced banks and such banks were only allowed to invest them in a small range of asset classes then this could artificially increase the demand for these assets and hence inflate their values. Thus, where loans to large organisations do not threaten the objectives of the ring-fence there are strong reasons to allow ring-fenced banks to offer them.

3.36 So which, if any, types of loans to large organisations are consistent with the objectives of the ring-fence? The size of the organisation lent to is not in itself a key factor in influencing resolvability or contagion. A bank which issues loans to a domestic manufacturing company is no easier to resolve, or necessarily more connected to the global financial system, according to whether that company is large or small. Other factors are a much better basis for identifying services which could damage the objectives of the ring-fence:

- the country in which the activity takes place; and
- whether the organisation is financial or non-financial in nature.

3.37 Geography is important, since cross-border issues are a key obstacle to resolution and exposures by all banks to a wide variety of geographies increase the risk of problems in one country spreading to another. Some respondents to the *Interim Report* proposed geographic subsidiarisation as an alternative to ring-fencing – in other

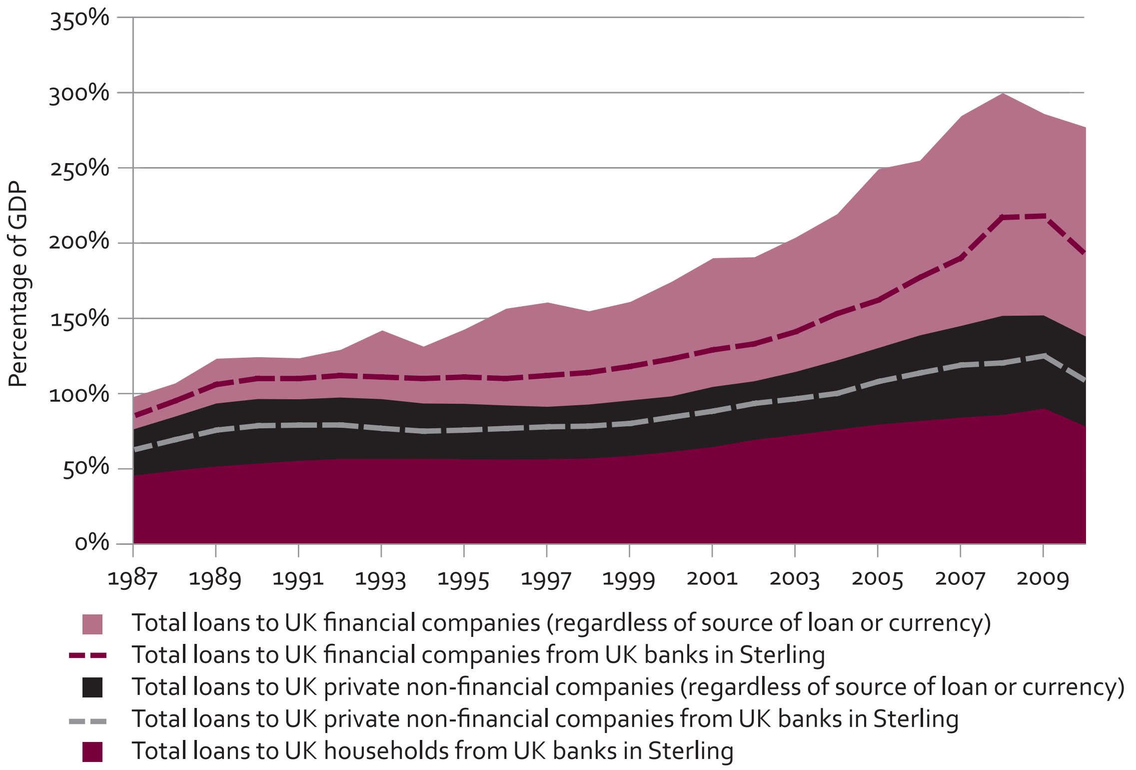
34 Page 1, J.P. Morgan, 2011, *UK Bank Ring-Fencing Proposals Survey*.
35 This was highlighted by the Association of Corporate Treasurers (ACT) in their response to the *Interim Report*. "We see the mobilisation of individual deposits to provide loans to businesses of all sizes as a key social benefit from banking. Accordingly, we believe that retail banks should be able to take deposits from and make loans etc. available to large companies." (Page 2, ACT, 2011, *Comments in Response to the Interim Report*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Association-of-Corporate-Treasurers.pdf).

words, they felt that the only activities which should be prohibited from ring-fenced banks are those conducted outside the UK.[36] However, such a proposal does not address the risks created by permitting ring-fenced banks to conduct wholesale/investment banking activities. Indeed, such activities are inextricably linked to financial markets all around the world and so geographic subsidiarisation alone would not insulate ring-fenced banks from problems elsewhere in the world. It is difficult to divide wholesale/investment banking geographically and such businesses appear to enjoy synergies from operating globally.[37] A further drawback is that the authorities could apply any such requirement consistently only at the level of the EEA, and not at the UK level.[38] Particularly given the presence of the City of London within the UK, a restriction based purely on the location of the activity would effectively allow all European banking activities and a sizeable portion of global wholesale/investment banking activity to take place within ring-fenced banks.

3.38 The type of organisation lent to also plays a critical part in determining whether the ring-fence achieves its objectives, and an important distinction can be drawn between financial and non-financial organisations. Lending to financial organisations, which might themselves conduct a whole range of prohibited services, could undermine the purpose of the ring-fence both directly and indirectly. In a direct sense, the ring-fence would achieve little if ring-fenced banks could simply collect retail deposits on the one hand and lend to wholesale/investment banks on the other. Without restrictions, a key mechanism by which banks could avoid the intended effect of a ring-fence would be the creation of a financial company which is funded by a ring-fenced bank and which conducts prohibited services. Moreover, lending to financial organisations would increase the exposure of ring-fenced banks to financial markets – even if not through a deliberate avoidance mechanism. In general, interconnectedness within the financial system is a key factor in generating systemic risk and can increase the reluctance of authorities to impose losses on creditors. Figure 3.4 illustrates the importance of the distinction between financial and non-financial companies for the size of ring-fenced banks, with lending to non-bank financial companies alone amounting to 140% of UK GDP in 2010. Between 1998 and 2008, sterling loans from UK banks to households and private non-financial companies relative to GDP rose 50% and 60% respectively, while loans to financial companies grew by over 200%.

36 See HSBC, 2011, *Independent Commission Banking Interim Report*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/HSBC-Response-to-ICB-Interim-Report_Redacted-Version1.pdf.
37 The greater tendency to establish geographical subsidiaries in retail banking, as opposed to wholesale/investment banking, is considered in Fiechter, J., Ötker-Robe, I., Ilyina, A., Hsu, M., Santos, A. and Surti, J., 2011, Subsidiaries or branches: does one size fit all?, *IMF Staff Discussion Note*. Available at: http://www.imf.org/external/pubs/ft/sdn/2011/sdn1104.pdf.
38 Member states are entitled to consider on a case-by-case basis whether it is appropriate for a domestic bank to operate in other European countries (as a branch) but it would appear incompatible with the Banking Consolidation Directive (which governs the business of credit institutions) to impose a blanket ban preventing all UK banks from operating elsewhere in the EEA.

Figure 3.4: Total loans to different sectors of the economy as a proportion of GDP[39]



Source: Commission analysis, Bank of England, Office for National Statistics Blue Book.

Design details and definitions

3.39 Thus, the second ring-fence principle is:

Prohibited services. *Ring-fenced banks should be prohibited from providing certain services. Prohibited services should be those banking services which meet any of the following criteria:*

a) make it significantly harder and/or more costly to resolve the ring-fenced bank;

b) directly increase the exposure of the ring-fenced bank to global financial markets;

c) involve the ring-fenced bank taking risk and are not integral to the provision of payments services to customers, or the direct intermediation of funds between savers and borrowers within the non-financial sector; or

39 The data for this chart are available from the Office for National Statistics at: http://www.statistics.gov.uk/downloads/theme_economy/bluebook2010.pdf and from the Bank of England at: http://www.bankofengland.co.uk/statistics/bankstats/current/index.htm#1. Note that 'financial companies' corresponds to 'other financial companies' which does not include banks. The chart shows the cumulative position and each dotted line is shown relative to the solid area below it.

d) in any other way threaten the objectives of the ring-fence.

As a result prohibited services should include (though need not be limited to):

a) any service which is not provided to customers within the EEA;

b) any service which results in an exposure to a non-ring-fenced bank or a non-bank financial organisation,[40] except those associated with the provision of payments services where the regulator has deemed this appropriate;[41]

c) any service which would result in a trading book asset;

d) any service which would result in a requirement to hold regulatory capital against market risk;[42]

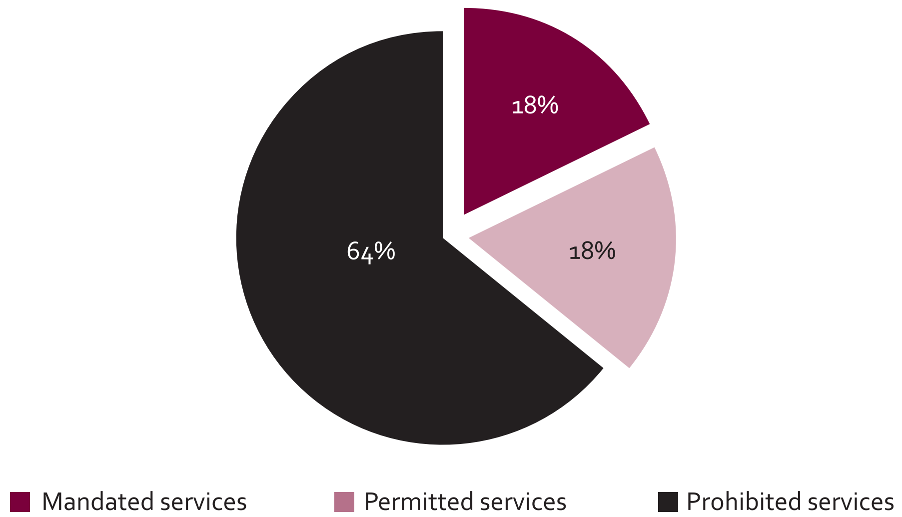
e) the purchase or origination of derivatives or other contracts which would result in a requirement to hold regulatory capital against counterparty credit risk; and

f) services relating to secondary markets activity including the purchase of loans or securities.

3.40 Broadly, this principle would mean that the majority of the retail and commercial banking divisions of current UK banks *could* be placed in ring-fenced banks, but the wholesale/investment banking divisions could not. At present most, but not all, financial companies are served out of the wholesale/investment banking divisions. Some of the lending to large organisations currently performed in the wholesale/investment banking divisions would be permitted within ring-fenced banks. As shown in Figure 3.5, based on the balance sheets of UK banks at the end of 2010 this construction of a retail ring-fence could lead to around £1.1tn-£2.3tn of assets being held within UK ring-fenced banks, or around 75%-160% of current UK GDP. This is between a sixth and a third of the total assets of the UK banking sector of over £6tn.

40 This prohibition does not include any organisations in the same corporate group as the ring-fenced banks. Intra-group exposures are constrained, and only constrained, by Principle 5 'economic links' (see Paragraph 3.85).
41 Transactions with other ring-fenced banks are not prohibited by virtue of these principles.
42 Where market risk is defined as per the Basel Committee on Banking Supervision capital standards.

Figure 3.5: Estimates of the proportion of the assets of UK banks at the end of 2010 associated with mandated, permitted and prohibited services[43]



Source: Commission estimates, company accounts 2010, Bank of England, European Central Bank, Office for National Statistics.

3.41 Figure 3.6 provides a list of illustrative examples of services which a ring-fenced bank could not provide, and those which it could provide. Box 3.2 considers some related proposals made by respondents to the *Interim Report* for defining prohibited activities.

3.42 Principle 2 should be used by the authorities when considering whether a service is one it is appropriate for a ring-fenced bank to provide. This consideration should be based on the implications for the objectives of the ring-fence and the intention outlined in the principles rather than the specifics of particular definitions. If, for example, an instrument was devised which had the effect of increasing the exposure of the ring-fenced bank to market risk but which strictly avoided the need to hold regulatory capital against market risk then such an instrument should be prohibited. The existing process by which banks must seek regulatory permission to conduct specific activities would continue in parallel.

43 This provides only a broad estimate given that much of the data required is not publicly available. The actual outcome could vary materially from the one shown, not least since the size of each portion would naturally change over time.

Figure 3.6: Illustration of the location of the ring-fence[44]

Mandated in a ring-fenced bank

Taking deposits from and providing overdrafts to individuals and SMEs.

Permitted in a ring-fenced bank

Taking deposits from and providing payments services to any customer within the EEA, including providing current accounts, savings accounts and those investment products which do not give rise to the ring-fenced bank being required to hold regulatory capital against market risk.

Services of the following kinds to individuals and non-financial companies of any size within the EEA:

- Lending to consumers and businesses on a secured and unsecured basis, including mortgages and credit cards.
- Trade finance and project finance.
- Advising on and selling products from non-ring-fenced banks, where no exposures arise for the ring-fenced bank as a result.

Prohibited in a ring-fenced bank

Any services outside the EEA or any services, other than deposit-taking and payments services, to financial institutions.

Also, any services to any customer involving activities of the following kinds:

- Structuring, arranging or executing derivatives transactions, as agent or principal.
- Investing in stock, corporate debt securities, convertible/exchangeable securities, convertible bonds, partnership interests, mutual funds, exchange traded funds, etc.[1]
- Originating, trading, lending, or making markets in securities (including debt securities, equity securities, derivatives, and asset-backed obligations). However, ring-fenced banks can originate and retain portions of own-label securitisations.[2]
- Underwriting the sale of debt and equity securities, including private placements.

1 A ring-fenced bank may hold equity which has arisen as a result of an exchange for corporate loans originally issued by the bank and acquired as part of a work out process.

2 The ring-fenced bank should of course be required to hold appropriate capital against such retentions.

44 This figure is an illustration of how the principles would apply to existing banking services. The principles should be used as the key guide to the Commission's intentions, however.

3.43 As an illustration of how this principle would operate, consider the following examples of current market products.

- Risk management – a ring-fenced bank could offer some products which help customers to manage risk. For example, a ring-fenced bank could offer fixed rate mortgages which protect customers from movements in interest rates. The ring-fenced bank could also offer other risk management services, provided it did so in a way which did not give rise to exposures which required the ring-fenced bank to hold regulatory capital against market risk, did not take on assets that would qualify for trading book treatment, and that the services were sufficiently simple that they did not threaten resolvability. The most straightforward way this could be done would be for the ring-fenced bank to act as an agent, for example in arranging a hedge between a customer and a third party.

- Underwriting the issuance of debt securities would be prohibited. In this case, rather than making a loan to a company, the bank is facilitating investment from market participants directly to the company. Even though it must be prepared to take the debt onto its books in order to carry out the underwriting, the purpose is to facilitate a market transaction, rather than to intermediate directly between savers and borrowers.

Box 3.2: IFRS 9 and regulatory capital definitions of banking and trading books

One bank proposed that ring-fenced banks should be permitted to hold any assets which can be accounted for on an amortised cost basis, under the rules known as 'IFRS 9'.[1] This means any asset would need to pass two tests:

- business model test – the objective of the entity's business model is to hold the financial asset to collect the contractual cash flows (rather than to sell the instrument prior to its contractual maturity to realise its fair value changes); and
- cash flow characteristics test – the contractual terms of the financial asset give rise to cash flows that are solely payments of principal and interest on the principal outstanding.

Similarly, another bank[2] proposed that ring-fenced banks should be permitted to hold any assets which are treated as banking book, rather than trading book, for regulatory capital purposes. The trading book is set out in the relevant EU Directive[3] as "all positions in financial instruments and commodities held either with trading intent or in order to hedge other elements of the trading book and which are either free of any restrictive covenants on their tradability or able to be hedged." As a result, it is not defined based on the nature of the instruments themselves, but rather the intentions of the institution holding them, as "evidenced on the basis of the strategies, policies and procedures set up by the institution to manage the position or portfolio".

These definitions are welcome suggestions and provide useful ways of assessing assets that should be prohibited from being in ring-fenced banks. It would seem more practical to base the ring-fence on a definition with which *regulators* are already familiar. Services giving rise to assets that are held in the trading book should be prohibited from ring-fenced banks.

Although such definitions are already used they nonetheless require qualitative judgement in determining the treatment of particular activities because they are based on the intentions of the relevant bank. Indeed, there would be significant risks in basing the ring-fence solely on these accounting and regulatory definitions, which were not designed for this purpose. They could change over time – some changes are currently in train. Most importantly, these definitions would permit ring-fenced banks to conduct some activities that threaten the objectives of the ring-fence, such as loans to financial corporations, or complex debt instruments. Nor would they confine the geographical scope of bank activities to the EEA. The further rules outlined in Paragraph 3.39 are therefore required to meet the objectives of the ring-fence.

[1] See Annex B of HSBC, 2011, *Independent Commission Banking Interim Report*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/HSBC-Response-to-ICB-Interim-Report_Redacted-Version1.pdf.

[2] 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.

[3] *Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the Capital Adequacy of Investment Firms and Credit Institutions.*

3.44 The geographical scope of ring-fenced banks is determined by the requirement that they could only provide services within the EEA. This would mean that ring-fenced banks would be permitted to serve individuals within the EEA, whether permanent residents or visitors (e.g. students). Similarly they could serve companies incorporated within the EEA, or with substantial business in the EEA, provided that the transaction also took place within the EEA and was subject to the law of an EEA member state. However, they should not be permitted to serve non-EEA customers: for example, providing mortgages to American homeowners, or a loan to an Australian energy company with no base, or subsidiary, in the EEA. The ring-fence itself imposes no restrictions on the ability of ring-fenced banks either to fund themselves or to make loans in foreign currencies.

3.45 The distinction between financial and non-financial companies is an important one. Under the proposed principle, ring-fenced banks would be prohibited from providing services, other than payments services, to any bank which is not a ring-fenced bank[45] and to all other non-bank financial companies. Non-bank financial companies should be defined in line with the intention to prohibit exposures which would, directly or indirectly, undermine the purpose and objectives of the ring-fence. Thus, 'financial' companies should include those entities which either provide, or engage in for their own account, prohibited services, or those which are strongly connected to or correlated with financial markets. For example, insurance companies, pension funds, securities firms, broker-dealers, underwriters, asset managers, hedge funds and other investment funds should all be considered financial companies for this purpose. So should companies whose principal activity is to acquire holdings in such firms or in banks.[46] A number of existing definitions of 'financial' companies exist (described further in Box 3.3) and could be used as a basis.

3.46 The purpose of the distinction between financial and non-financial companies is to reduce the exposure of ring-fenced banks to failures elsewhere in the financial system. These restrictions need not be applied symmetrically as not all financial companies play the same role in the economy, or face the same liquidity risks, as banks. In particular, the Commission sees no reason to limit the ability of financial companies such as insurance companies and pension funds to invest in ring-fenced banks and such restrictions could, through limiting funding for the banking sector, have significant costs.[47]

3.47 The distinction between financial and non-financial companies applies only to the provision of services. A ring-fenced bank could become exposed to non-ring-fenced banks and non-bank financial organisations as part of its ancillary activities – discussed next. The proposed ring-fence principles also place no particular constraints on transactions between different ring-fenced banks.

45 Banks here mean institutions which accept deposits, known as 'credit institutions' in European law.
46 Central banks should not count as financial organisations for these purposes.
47 Regulations of the banking and insurance sectors are necessarily different, though greater examination of how they interact would be beneficial.

Box 3.3: Existing definitions of financial institutions

The distinction between financial and non-financial companies is one which is important in existing and proposed regulation. For example, the Basel Committee on Banking Supervision (BCBS) proposals for liquidity regulation treat exposures to financial companies differently from exposures to non-financial companies.[1] The precise definition of financial companies is left for national regulators.

In existing European law the term 'financial institution' is defined somewhat narrowly in that it excludes, for example, insurance companies. A more appropriate starting point for those entities which should be considered 'financial' for the purposes of the ring-fence would be those whose deposits are proposed to be excluded from deposit insurance under the Deposit Guarantee Scheme Directive.[2] As well as those which count directly as financial institutions, this includes investment firms, insurance undertakings, collective investment undertakings, pension and retirement funds.

An alternative basis for the distinction exists in those used for national statistics. In this context, financial institutions are "all corporations and quasi-corporations which are principally engaged in financial intermediation and/or in auxiliary financial activities". Financial intermediation is in turn defined as "the activity in which an institutional unit acquires financial assets and liabilities on its own account by engaging in financial transactions in the market".[3]

Neither of these definitions could be copied exactly for the retail ring-fence and in order to implement the Commission's proposals the authorities would need to develop a bespoke definition in line with the objectives described in Paragraph 3.45. For example, such definitions tend to include companies such as small companies which provide only financial advice where there would not be significant additional risk in allowing ring-fenced banks to provide services to such companies. The existing definitions do show, however, that the division can be drawn.

[1] BCBS, 2010, *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring*. Available at: http://www.bis.org/publ/bcbs188.pdf.

[2] European Commission, 2010, *Proposal for a Directive on Deposit Guarantee Schemes*. Available at: http://ec.europa.eu/internal_market/bank/docs/guarantee/comm_pdf_com_2010_0368_proposition_de_directive_en.pdf.

[3] For a full explanation of the statistical definition see: http://circa.europa.eu/irc/dsis/nfaccount/info/data/esa95/en/een00074.htm.

3.48 Further, payments services should be exempted from this general prohibition as long as specific regulatory approval is granted. Banks often provide payments services for other banks because those banks' UK operations are too small to make direct membership of the relevant payments system cost-effective.[48] They also provide payments services for other financial organisations, to support operational payments needs (paying staff etc.) and core business activities, like trading and markets. This

48 A payments system is the shared part of an end-to-end process that offers an account-based transfer service between two final customers and (usually) between two different banks (e.g. CHAPS and Bacs). The implications of payments system membership for competition are considered in Chapter 8 and the oversight role suggested there should, if a ring-fence is implemented, encompass the interaction between ring-fencing rules, competition and payments system membership.

involves both taking deposits and extending credit lines (often unsecured to facilitate payments intraday). These services are at the heart of liquidity provision around the financial system, but they could create counterparty credit risk for ring-fenced banks. Given the importance of the provision of payments services, ring-fenced banks ought to be permitted to settle payments for other banks and financial organisations, but with strong safeguards to mitigate these risks. Where possible banks should become direct members of the payments systems they use. Where ring-fenced banks settle payments on behalf of other banks or financial companies, prudential limits should be imposed on the resulting exposures to those companies, including collateral requirements and limits on the size of potential exposures (including intraday and overnight, secured and unsecured).

3.49 While the exemption for payments services is an important one,[49] it should be monitored particularly carefully given the risk that it could be used to circumvent the general restrictions on lending to financial organisations. It would be expected that the overdrafts and other exposures which would be permitted within the payments services exemption are those of a temporary, 'settlement', nature. The exemption should not give rise to a long-term loan.

Principle 3: Ancillary activities

3.50 There are a number of activities which ring-fenced banks would need to do in order to deliver effectively those services which they would be permitted to provide. In particular, they would have to be able to manage their balance sheet against the variety of risks that arise in the course of their business, manage their liquidity and raise funding. In banks, these needs are typically achieved through the 'treasury function'.

3.51 In some circumstances, the treasury function of a ring-fenced bank would need to engage in activities which would be prohibited if offered as a service to customers. For example, a ring-fenced bank would need to be able to hedge its own interest rate risk even if it should not be allowed to sell that hedge as a service. An effective treasury function could also involve exposures to financial companies which would otherwise be prohibited. In general, it would be damaging for financial stability to hamper the effective operations of the treasury function. Nonetheless, since this requires exemptions from the general activity restrictions placed on ring-fenced banks, the potential risk that these could be exploited must be carefully considered.

3.52 First, ring-fenced banks should be able to engage in effective risk management. This would include purchasing, perhaps from non-ring-fenced banks, risk management products such as derivatives. Precedents in other industries demonstrate that a clear and robust boundary could be drawn between products used for risk management and those used for service provision. Some examples are outlined in Box 3.4. Broadly, the use of products can be restricted by purpose, scope or a combination of the two.

49 Note that the exemption is also intended to cover exposures between banks arising from the provision of payments services to non-financial customers.

Purpose restrictions enable usage only for a certain purpose, for example restricting the purchase of derivatives only where they offset risks arising in the course of the institution's normal business. Scope restrictions limit the mix and/or type of products used.

Box 3.4: Risk management functions in other sectors

Building societies

Building societies are subject to purpose and scope restrictions on the use of risk management products. Under the Building Societies Act 1997, societies are restricted from entering into transactions that involve derivatives, except where these reflect a legitimate hedging activity. They cannot take speculative positions. Scope is restricted, for example, by limiting potential exposures to certain instruments (such as call-only options). This is governed under more detailed regulatory rules in the Financial Services Authority's (FSA's) *Building Societies Sourcebook*, which sets limits on what societies can and cannot do in managing their liquidity, funding and risk.

Insurance companies

Insurance companies also face purpose and scope restrictions. Risk management products, including derivatives, can only be used for efficient portfolio management and the reduction of risk. Scope restrictions are imposed through regulations that specify that insurance companies must cover derivatives positions, in order to be able to meet in full any call made on maturing contracts.

Utilities

In most utilities trading is banned and treasury units cannot be profit centres. There are generally no scope restrictions on risk management products, although there are often gearing ratios and requirements to cover interest rate risk in licences. Risk management products, including derivative instruments, can only be used where they are part of a clear hedging strategy.

3.53 The precedent in building society legislation appears to provide a particularly good basis for the risk management functions of ring-fenced banks. Building society regulations have operated effectively for a long time. A number of former building societies failed in the crisis or were taken over as a result of poor business models, sometimes associated with their treasury-related activities. However, evidence to the Commission suggested that problems that occurred in the treasury function only did so following the lifting of the relevant restrictions after demutualisation.[50] In principle a ring-fenced bank should be able to undertake its necessary risk management within the building society regulatory framework, although the types of permitted instruments might need some extending given the wider range of services which may be provided by ring-fenced banks.

3.54 Second, consider the management of liquidity. Within a bank, the treasury function maintains an appropriately sized pool of liquid assets so that it can be confident of

50 In particular, Nationwide said in a letter to the Commission "the problems caused by the treasury activities of Abbey National and Halifax occurred only after they were demutualised".

meeting its obligations to pay out depositors and other creditors. Regulations dictate the minimum size of this pool and the type of assets which can be in it. Clearly, ring-fenced banks should be permitted to purchase liquid assets and any necessary restrictions on the quality of these assets (to avoid liquidity management becoming an avoidance mechanism for the trading of financial securities) could be based on existing liquidity regulations.

3.55 Furthermore, the short-term fluctuations in the net cash position of a bank are managed through the interbank market. Banks lend to and deposit with each other, generally on a short-term basis, in order to balance the effects of transactions between their customers. Thus, a ring-fenced bank could, as part of its management of liquidity risk, become exposed to other non-ring-fenced banks. While much liquidity management does not require exposure to other banks[51] and there would be no (new) restrictions on exposures between ring-fenced banks, the interbank market plays a central role in the financial system. In particular, in the event that in aggregate ring-fenced banks experienced a temporary influx of deposits, providing them with an ability to deposit with other kinds of banks would ease any risk that ring-fencing could exacerbate the effects of such fluctuations. Again, safeguards would be needed to mitigate any risk that liquidity management is used as a surreptitious way to lend money to wholesale/investment banks as a primary activity. Treating all such exposures as subject to third party exposure limits, even when they occur within corporate groups, is a key safeguard discussed in detail in Paragraphs 3.80-3.84. In addition, the size and profitability of a bank's liquidity management function should be monitored to ensure that it, and the resulting exposures to non-ring-fenced banks, are properly limited to the role of a treasury function and not becoming a primary activity. Overall, total exposures, including collateralised exposures, between a ring-fenced bank and any non-ring-fenced bank should be monitored and subjected to backstop safeguard limits.[52]

3.56 A bank's treasury function also raises wholesale funding – i.e. raising debt or taking deposits from sources other than individuals and small businesses.[53] Over-reliance on short-term wholesale funding quickened the failures of a number of UK banks during the crisis, and arguably caused them. As a result regulation in this area has been tightened and would act as a significant constraint on a ring-fenced bank's ability to fund from short-term wholesale sources.[54] Properly controlled wholesale funding could improve the diversity of a ring-fenced bank's funding base and finance its growth. On balance, a ring-fenced bank should be allowed to raise wholesale funding, but in addition to existing regulations backstop limits should be placed on the

51 A bank can simply, for example, invest in high quality liquid assets.
52 One appropriate such safeguard would be a limit on gross secured exposures in line with that proposed later for intra-group limits (see Paragraph 3.87).
53 The taking of wholesale deposits is not strictly part of a bank's treasury function, but it is a form of wholesale funding which is considered in general terms here.
54 As discussed later it would be important that liquidity regulations applied on a 'solo basis'. In other words, ring-fenced banks should be required to comply with them as standalone entities. Application only to a whole banking group (or some subset of the group containing entities other than ring-fenced banks) would undermine the objectives of the ring-fence.

absolute level of wholesale funding permitted. A cap on the absolute level would act as a check against attempts to arbitrage more complex regulations. Again, similar provisions exist in the Building Societies Act although the level set there (50%) may not be appropriate for all ring-fenced banks. The limit should be calibrated so that it is non-binding for a bank as of today but guards against de-stabilising wholesale-funded growth in the future.

3.57 Thus, the third ring-fence principle is:

Ancillary activities. *The only activities which a ring-fenced bank should be permitted to engage in are: the provision of services which are not prohibited; and those ancillary activities necessary for the efficient provision of such services. Ancillary activities should be permitted only to the extent they are required for this provision, and not as standalone lines of business.*

Ancillary activities would include, for example, employing staff and owning or procuring the necessary operational infrastructure. In particular, a ring-fenced bank should be permitted to conduct financial activities beyond the provision of non-prohibited services to the extent that these are strictly required for the purposes of its treasury function – i.e. for risk management, liquidity management, or in order to raise funding for the provision of non-prohibited services. In conducting ancillary activities a ring-fenced bank may transact with and become exposed to non-ring-fenced banks and non-bank financial organisations.

Backstop limits should be placed on the proportion of a ring-fenced bank's funding which is permitted to be wholesale funding and on its total exposures, secured and unsecured, to non-ring-fenced banks and other non-bank financial companies.

Height of the ring-fence

3.58 Principles 1, 2 and 3 describe the location of the ring-fence. The height of the ring-fence concerns the extent to which ring-fenced banks could be linked to other kinds of entities within any wider corporate group to which they belong. There are three key questions:

- Should a ring-fenced bank be allowed to be in the same corporate group as other companies, including those conducting prohibited activities, at all?
- If so, what legal and operational links should be permitted between a ring-fenced bank and its wider corporate group?
- What economic links should be permitted between a ring-fenced bank and its wider corporate group?

Why not full separation?

3.59 Some respondents to the *Interim Report* argued strongly that one link which must be eliminated is common ownership by one corporate entity of retail and wholesale/investment banks.[55] Restricting common ownership would be appropriate if, but only if, it was necessary to secure the benefits of structural reform, or it would not come at significant additional cost.

3.60 Two key arguments are made for full separation.

- First, it is argued that common ownership increases contagion from the rest of the financial system to retail banks through increased reputational links. In particular, banking groups tend to live or die together – as evidenced by the extent to which banking groups have in the past provided support to subsidiaries even when they have had no legal obligation to do so. Because banks rely so heavily on confidence in order to operate, it is said to be unlikely that a retail bank could carry on operating as normal in the event of failure or significant losses in another part of its corporate group. So problems elsewhere in the group could cause the retail bank to fail.

- Second, it is argued that it is not possible to implement effective rules governing economic links between banks unless they are in separate corporate groups. In particular, common ownership creates incentives for management to attempt to maximise economic links and it is difficult for rules and supervision to counter such incentives. Some claim that ring-fencing would be much more complicated than full separation.

3.61 There is strong evidence that reputational links are indeed important in banking.[56] However, this means that full separation has risks as well as benefits. Reputational links mean that it is likely that a ring-fenced bank would if possible be saved from failure by the rest of its corporate group if it got into difficulty.[57] When domestic retail banking is suffering losses but the rest of the banking system is doing well, more retail banks would fail under full separation than under ring-fencing. The risk that the rest of the group could bring down a ring-fenced bank could be managed by insisting that the ring-fenced bank is not dependent for its solvency, liquidity or continued operations on the rest of the group (rules which would achieve this are discussed in detail below). Reputational contagion might nonetheless mean that the authorities would be required to resolve the ring-fenced bank if the wider corporate group were to fail – but there would be no cost to the taxpayer of doing this for a solvent bank with a reasonable stock of high quality liquid assets.

55 For example, see Global Policy Institute, 2011, *Response to Consultation Questions from the ICB Interim Report*. Available at:
http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Global-Policy-Institute.pdf.
56 Partly as a result of reputational concerns a number of banks went beyond their legal obligations in supporting or consolidating off-balance sheet conduits during the recent crisis.
57 Through the injection of additional capital.

3.62 In general, it is not clear that ring-fencing rules need be much more complex than those for full separation. In either case, for separation truly to limit contagion, rules need to consider the relationship between retail banks and the rest of the financial system, and the division between mandated and prohibited services needs to be defined.

3.63 The incentives of management are critical. As discussed in more detail later, independent governance is essential for ensuring that those who manage a ring-fenced bank have appropriate incentives to act in the interests of that bank. There are precedents, notably in the utilities sector, which show that governance arrangements for a subsidiary can be suitably independent from its wider corporate group. Thus, while the incentives of management must be aligned with the objectives of the ring-fence, this could be achieved without a ban on common ownership.

3.64 So, on benefits, the arguments for full separation demonstrate that at a minimum:

- retail banks should not be dependent for their solvency, liquidity or continued operations on a wider corporate group; and
- the boards of retail banks should be suitably independent from any wider corporate group.

However, once these conditions are in place there is not a strong case for a ban on common ownership. In particular, such a ban would in some situations increase the probability of retail bank failure.

3.65 On costs,[58] there are a number of factors which would lead full separation to be more expensive than ring-fencing. This is principally because ring-fencing preserves those diversification benefits which arise from the ability to move excess capital – i.e. capital not needed to meet regulatory requirements – between different parts of a corporate group. Banks and analysts say that diversification lowers the funding costs for universal banks because the risks faced are less than perfectly correlated. In principle, investors should be able to replicate this benefit through their portfolios and so no great funding cost benefit should accrue, but the very high costs associated with bank insolvency, among other things, may limit this possibility in practice, especially when banks run with low capital levels (and so bankruptcy is a less-than-remote possibility). Chapter 5 and Annex 3 discuss the possible value of such diversification benefits in more detail – average analyst estimates suggest they could be as much as £4bn annually but the empirical evidence is mixed.

3.66 In addition, there are other synergies which ring-fencing would preserve but which full separation would not. There may be a valuable benefit to some customers of being able to purchase from a single banking group a range of services which would straddle the divide between retail banking and wholesale/investment banking. Within banking groups, there need not be restrictions on the sharing of information and

58 The costs of the Commission's proposals are considered in detail in Chapter 5 and Annex 3.

expertise[59] and it may be possible to preserve a greater degree of operational synergies than under full separation.

3.67 The Commission has received from banks rather little quantitative evidence on the magnitude of claimed diversification benefits or customer synergies. It is particularly difficult to separate the two effects which might lower the funding costs of universal banks: an implicit government guarantee and diversification benefits. Rating agencies' historical methodologies ascribed material benefits to diversification though Standard & Poor's have indicated their intention to ascribe lower benefits to diversification between retail banking and wholesale/investment banking than before the crisis. The advantage of ring-fencing is that it is targeted at curtailing government guarantees while allowing the retention of some diversification benefits. If the latter benefits are in fact weak then some banking groups might choose to separate completely if required to apply a retail ring-fence.

3.68 In addition, full separation would give rise to legal obstacles which are not applicable to ring-fencing because European law places particular constraints on the degree to which ownership of companies can be controlled. Member states can object to the change of ownership of a bank only on certain grounds, and it is far from clear that these would enable the authorities to prevent the acquisition of a UK-incorporated retail bank by a European universal or wholesale/investment bank. Some say that ring-fencing would also be difficult to enforce in the context of European law because the ring-fencing restrictions would not apply to European banks operating in the UK as a branch (rather than subsidiary). It is said that, as a result, banks could avoid a ring-fence by relocating to another member state and branching back into the UK. However, there would be major legal, reputational and practical impediments to such a proposition. For example, in order for depositors to be transferred to a new legal entity either the individual consent of each depositor would be required or a statutory process would need to approve the transfer. It is true that branches of European banks would be able to offer services to UK customers also offered by ring-fenced banks. However, in doing so they would not have any particular competitive advantage as a result of ring-fencing since, as outlined in Chapter 5, most costs of ring-fencing accrue to the rest of the group. At present, UK retail banks without any investment banking activities in the same subsidiary are able to compete with those which do combine the activities.

3.69 Ring-fencing therefore has a further advantage over full separation in that it could be robustly implemented within the current EU framework.[60] While it might be possible to secure changes to the relevant EU law, there seems little reason to pursue this difficult and uncertain course given that the merits of the economic arguments do not clearly favour full separation.

59 Beyond the existing restrictions on information sharing designed to address conflicts of interest.
60 See Box 5.1 for consideration of the implications of draft European legislative proposals for the Commission's recommendations.

3.70 Based on this assessment, the Commission considers that the right approach is not to require full separation, but instead to impose through ring-fencing the degree of separation required to secure the benefits, and then to leave it to the market to determine whether common ownership remains efficient with the new constraints in place.

Principle 4: Legal and operational links

3.71 At a minimum, ring-fenced banks should be separate legal entities. The authorities' resolution powers apply in the first instance on a legal entity basis. Without this first step, it would be very difficult for regulators to impose constraints on, or for market participants to monitor, the economic links between activities. The retail entity should also be operationally *separable* from the other entities within its banking group to ensure that it would be able to continue providing services irrespective of the financial health of the rest of the group. Without this, contagion would not have been properly constrained and separate resolution of the ring-fenced bank and the rest of the group would remain problematic.

3.72 Some respondents to the *Interim Report* were sceptical that any form of structural change was necessary in order to achieve the objectives of the retail ring-fence.[61] In particular, the development of an advanced plan for the recovery and resolution of a bank – known as 'recovery and resolution plans' or 'RRPs' – is sometimes said to be an alternative to ring-fencing that does not require legal entity changes but which could secure its resolvability benefits. It is said that such plans, particularly alongside a greater ability to absorb losses (the subject of Chapter 4), render ring-fencing unnecessary.

3.73 However, it is misleading to consider RRPs and ring-fencing as alternatives rather than complements. It is far from clear that a credible RRP could be developed without changes to legal structure. For example, the Financial Stability Board commented in its recent consultation on resolution that, "the complexity and integrated nature of many firms' group structures and operations ... make rapid and orderly resolutions of these institutions under current regimes virtually impossible".[62] Similarly, the FSA's consultation on the same topic identified the co-mingling of activities within legal entities and financial dependencies within banking groups as key barriers to resolution.[63] Second, the possibility of a retail ring-fence, over and above the development of RRPs, already appears to have significantly strengthened the assessment by some market participants that banks will not receive taxpayer support – an essential step if incentives for excessive risk-taking are to be curbed *ex ante*. For

61 See, for example the responses from Standard Chartered and the British Bankers' Association. (Standard Chartered, 2011, *Response to the Interim Report.* Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Standard-Chartered.pdf. British Bankers' Association, 2011, *Interim Report: Consultation on Reform Options.* Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/BBA.pdf.)
62 Page 10, Financial Stability Board, 2011, *Effective Resolution of Systemically Important Financial Institutions*. Available at: http://www.financialstabilityboard.org/publications/r_110719.pdf.
63 FSA, 2011, *CP11/16: Recovery and Resolution Plans.* Available at: http://www.fsa.gov.uk/pubs/cp/cp11_16.pdf.

example, Moody's said, "the ring-fencing proposals would likely lead to a further reduction in our assumptions of systemic support".[64] Of course, ring-fenced banks and the banking groups of which they are part should be required to produce an RRP.

3.74 Thus, the fourth ring-fence principle is:

Legal and operational links. *Where a ring-fenced bank is part of a wider corporate group, the authorities should have confidence that they can isolate it from the rest of the group in a matter of days and continue the provision of its services without providing solvency support.*

As a result:

a) ring-fenced banks should be separate legal entities – i.e. any UK regulated legal entity which offers mandated services should only also provide services which are not prohibited and conduct ancillary activities;

b) any financial organisation owned or partly owned by a ring-fenced bank should conduct only activities permitted within a ring-fenced bank. This organisation's balance sheet should contain only assets and liabilities arising from these services and activities;

c) the wider corporate group should be required to put in place arrangements to ensure that the ring-fenced bank has continuous access to all of the operations, staff, data and services required to continue its activities, irrespective of the financial health of the rest of the group;[65] *and*

d) the ring-fenced bank should either be a direct member of all the payments systems that it uses or should use another ring-fenced bank as an agent.

3.75 A variety of models have been proposed which could meet the operational separability required by (c) above:

- all of the relevant infrastructure could be supplied independently of the ring-fenced bank – either from a third party, or from the rest of the group, with appropriate service level agreements in place. Set out correctly, this would enable the ring-fenced bank to continue operating in the event of failure of other parts of the group. However, it is important that if this were to occur, the supplier of the operational infrastructure would remain financially viable, and therefore able to service the ring-fenced bank even if its other income streams suddenly

64 Moodys, 2011, *UK Treasury Support for Ring-fencing Proposals is Credit Negative for Banks*. Available at: http://www.moodys.com/research/Moodys-UK-Treasury-support-for-ring-fencing-proposals-is-credit?lang=en&cy=global&docid=PR_220985.
65 For example, the ring-fenced bank could directly own all the relevant infrastructure, or the infrastructure could be placed in a subsidiary which was bankruptcy-remote from the rest of the group.

ceased. It is not clear this can be achieved purely through the use of service level agreements;

- operational subsidiarisation would go further and also involve placing into a separate subsidiary the critical infrastructure needed for a bank to continue operating. By keeping the operational capabilities of the group separate from its financial functions it would insulate them from the failure of any part of a banking group; or

- alternatively, the ring-fenced bank could directly own its entire operational infrastructure. This would have the benefit of complete *ex ante* operational separability, but could be costly, with elements of system and data duplication.

3.76 As there are a number of plausible methods to achieve operational separability of a ring-fenced bank from the rest of its group, the Commission does not see a need to prescribe a specific operational model for ring-fenced banks. Similarly, the operational infrastructure associated with the provision of payments services need not be directly owned by ring-fenced banks provided arrangements are in place which meet the requirement for operational separability.

3.77 One bank has argued that operational subsidiarisation alone would render a ring-fence of financial activities unnecessary.[66] The Commission believes that operational subsidiarisation could prove a very effective means of securing operational separability. But operational separability alone, because it leaves all the financial assets and liabilities on the same balance sheet, cannot plausibly secure the resolvability, insulation and reduced implicit guarantee benefits of separating retail from wholesale/investment banking – it is necessary but not sufficient. The authorities do have powers to separate financial assets and liabilities[67] but these are subject to important constraints[68] which, alongside the sheer practical difficulties associated with segregating a large and complex balance sheet quickly, in practice limit the feasibility of doing so. In a crisis, the process involved must be one which the authorities can exercise with confidence. Further, operational subsidiarisation would do nothing to secure the *ex ante* benefits of ring-fencing – curtailing implicit government guarantees and improving the ease with which ring-fenced banks can be monitored, managed and supervised.

3.78 The fourth principle would not prevent a banking group from offering a 'one-stop shop' for customers who required services both from the ring-fenced bank and the rest of the group. One entity could sell products as an agent for other entities in the group. For example, the ring-fenced bank could sell to its customers complex risk management products originated in the non-ring-fenced bank where the associated

66 See Barclays, 2011, *Response to the Interim Report*. Available at:
http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Barclays.pdf.
67 Within the Special Resolution Regime.
68 In particular, the inability to break master netting agreements and the necessity that no creditor can be left worse off than under liquidation.

market risk remains with the latter. Similar arrangements are common at present in the insurance sector. Banks are required to place their insurance activities in a separate subsidiary but frequently sell the insurance products through their retail banking network.

3.79 The principle also places no additional restrictions on the sharing of information and expertise within banking groups. In particular, information about individual customers could be shared. The availability of private information about a customer's financial position can sometimes allow a bank to offer better rates than other lenders. Such synergies would still be available under ring-fencing.

Principle 5: Economic links

3.80 If a ring-fenced bank was part of a wider corporate group, this group would often include other banks and financial organisations. Thus, central to whether a ring-fenced bank would be successfully isolated from the global financial system are its economic links to the rest of the group. If either part of the banking group was dependent for its solvency or liquidity on the financial health of the other, then problems could still spread quickly between them and throughout the system.

3.81 Some sort of safeguard on economic ties would clearly be necessary for the ring-fence to be effective – without this, in the limit, a ring-fenced bank could simply have one large loan to the rest of the group. Indeed, there was a high degree of consensus among respondents that a relatively high fence is required to secure the benefits of the ring-fence. Even some of those banks who were not in favour of a ring-fence in principle generally agreed that, if one were to be implemented, significant constraints on economic links with the rest of the group would logically be required.

3.82 There were some differences of view among respondents to the *Interim Report* on the precise level at which such safeguards should be set. One benchmark is that a ring-fenced bank and the rest of the group should treat each other as third parties, and be regulated as such. Some respondents argued that economic links between a ring-fenced bank and the rest of the group should be treated somewhat more leniently than third party relationships, because within corporate groups there is a greater understanding of the risks being taken and a shared reputation could make it in the interests of the ring-fenced bank to support the rest of the group. Others argued for more lenient treatment for lending *from* the rest of the group *to* a ring-fenced bank as this would ensure there was no constraint on the ability of the rest of the group to support the ring-fenced bank if it got into difficulty. On the other hand, some respondents suggested that intra-group relationships should be more constrained than those between third parties. This would guard against possible private incentives for groups to engage in more intra-group relationships than was in the interests of a ring-fenced bank.

3.83 There are examples in existing regulation that provide for more lenient as well as stricter limits on intra-group exposures. For example, current regulations in the UK allow large exposure limits for entities in the same group that are more generous than for third parties. On the other hand, US regulations governing transactions between insured banks and their affiliates are often more strict than those governing exposures to third parties.[69]

Box 3.5: US regulation of transactions within banking groups

While it is sometimes said that structural reform is not being considered outside the UK, restrictions on transactions within banking groups already exist elsewhere including in the US. In the US, national banks are chartered and primarily regulated by the Office of the Comptroller of the Currency (OCC). The OCC limits national banks to engaging in activities that are "part of, or incidental to, the business of banking".[1] The OCC publishes a list of these permissible activities, which it sees as evolving with the business of banking. Any activity that is not explicitly permitted by the OCC cannot take place within a national bank. However, affiliated non-bank companies within the same corporate group can undertake some of these prohibited financial activities.

In order to insulate a bank from its non-bank affiliates, sections 23A and 23B of the Federal Reserve Act and the Federal Reserve's Regulation W restrict transactions between a bank and its affiliates. A bank is limited to extending a maximum of 10% of its capital to any one affiliate and a maximum of 20% of its capital to all affiliates. This compares to 15%-25% and 50% respectively for exposures to third parties. The Dodd-Frank Act enhances sections 23A and 23B to widen the range of affiliate transactions that fall within these capital limits (a notable deficiency in the regulations in recent years being the exclusion of derivatives from the quantitative exposure limits) and further requires that collateral must be maintained on a mark-to-market basis for credit transactions.

While the range of activities permitted in a US national bank is much broader than those proposed for UK ring-fenced banks, there are clear parallels in principle between the two in limiting activities to certain subsidiaries within a corporate group. The limits on transactions between a US national bank and its affiliates can also be compared to the similar limits proposed to be placed on a UK ring-fenced bank.

The US experience in operating various forms of this model over almost 80 years offers many useful insights into how activities can be separated within a banking group, and different subsidiaries insulated from each other.

[1] Page 3, OCC, 2011, *Activities Permissible for a National Bank*, *Cumulative*. Available at: http://www.occ.gov/publications/publications-by-type/other-publications-reports/_pdf/bankact.pdf.

3.84 The Commission's view is that regulations which limit intra-group relationships to the same level as general third party relationships[70] strike the right balance and have the further advantage of being a clear benchmark which could be judged against the prices charged and terms imposed by actual third parties for similar services. While

69 See Box 3.5 for details of US legislation on intra-group transactions.

70 Note that the restrictions outlined in Paragraph 3.39 on providing *services* to financial companies are not intended to prevent ring-fenced banks from being exposed to other banks or financial companies within the same group. Rather, the relevant constraint on intra-group exposures is by way of third-party limits.

exposures within groups could give rise to contagion risk from prohibited activities to a ring-fenced bank, a low level of such exposures is necessary to allow banking groups to operate efficiently and exploit synergies. The safeguards proposed here would constrain such exposures to ensure they did not represent a risk transfer from wholesale/investment banking to retail banking. Placing stricter regulatory limits within groups than are in place between third parties generally would be hard to police effectively since loans could be routed through a third party in order to achieve more generous regulatory treatment.

3.85 The final ring-fence principle is:[71]

Economic links. *Where a ring-fenced bank is part of a wider corporate group, its relationships with entities in that group should be conducted on a third party basis and it should not be dependent for its solvency or liquidity on the continued financial health of the rest of the corporate group. This should be ensured through both regulation and sufficiently independent governance.*

Thus, where a ring-fenced bank is part of a wider corporate group:

a) its relationships with any entities within the same group which are not ring-fenced banks should be treated for regulatory purposes no more favourably than third party relationships;[72]

b) all transactions (including secured lending and asset sales) with other parts of the group should be conducted on a commercial and arm's length basis[73] *in line with sound and appropriate risk management practices;*

c) where third party arm's length relationships are not ensured through the application of existing regulation, additional rules should be considered;

d) assets should only be sold to and from the ring-fenced bank and other entities within the group at market value. The ring-fenced bank should not acquire any assets from other entities within the group unless such assets could have resulted from the provision of non-prohibited services;

e) the ring-fenced bank should meet regulatory requirements, including those for capital, large exposures, liquidity and funding, on a solo basis;

71 The implications of proposed changes to European law for this ring-fence principle are considered in Box 5.1.
72 Where there is more than one ring-fenced bank within the same corporate group there need not be any restrictions on transactions between them. 'Sub-consolidation' of regulatory requirements across ring-fenced banks would also be acceptable.
73 I.e. transactions should be valued as if they had been carried out between unrelated parties, each acting in his own best interest.

f) dividend payments and other capital transfers should only be made after the board of the ring-fenced bank is satisfied that the ring-fenced bank has sufficient financial resources to do so. In addition, any such payments which would cause the ring-fenced bank to breach any kind of capital requirement, including requirements to hold buffers above minimum requirements, should not be permitted without explicit regulatory approval;

g) the board of the ring-fenced bank should be independent. The precise degree of independence appropriate would depend on the proportion of the banking group's assets outside the ring-fenced bank. Except in cases where the vast majority of the group's assets were within the ring-fenced bank, the majority of directors should be independent non-executives of whom:

i. one is the Chair; and

ii. no more than one sits on the board of the parent or another part of the group;

h) a ring-fenced bank should make, on a solo basis, all disclosures which are required by the regulator of the wider corporate group and/or its other relevant substantial subsidiaries, and those which would be required if the ring-fenced bank were independently listed on the London Stock Exchange; and

i) the boards of the ring-fenced bank and of its parent company should have a duty to maintain the integrity of the ring-fence, and to ensure the ring-fence principles are followed at all times.

3.86 Neither this nor the preceding principles impose any particular constraints on the ownership structure of ring-fenced banks. Banking groups could choose to operate with what is known as a 'holding company' or a ring-fenced bank could have a parent which is an 'operating company'. Under a holding company structure, a group is headed by one entity which does not itself conduct any business but simply owns a series of other businesses and co-ordinates their strategies. This structure is common for banking groups in the US. Alternatively, a ring-fenced bank could be directly owned by another bank or financial company (including those who provide prohibited services), provided that the principles were followed. A ring-fenced bank could not, however, be the parent of (or have any equity holdings in) any entity except other ring-fenced banks.

3.87 For a third party arm's length relationship to be implemented effectively, regulations should generally apply to any transactions between a ring-fenced bank and the rest of the group as they would apply to third parties. New regulations might also be required for transactions which are not regulated among third parties. As a result of this principle the specific regulations which should apply to a ring-fenced bank and its relationship with the rest of the group include:

- exposures from the ring-fenced bank to the rest of the group, and *vice versa*, should be subject to the same large exposure limits as third parties, and no waivers should be granted. At present, a bank's aggregate exposures to a single third party can be no more than 25% of its capital resources (after certain deductions from capital);[74]

- additional limits should be placed around the level of total secured exposures between the ring-fenced bank and the rest of the group and the quality of collateral securing these exposures. At present, firms' collateralised exposures do not count against their large exposure limits.[75] Without further restriction this could lead to large intra-group exposures undermining the objectives of a ring-fence. Secured exposures (gross of the value of the collateral) between the ring-fenced bank and the rest of the group should be no more than twice the level of third party unsecured limits and should include only assets of the highest quality;[76]

- the ring-fenced bank should not provide any form of unlimited guarantee, indemnity or similar commitment to the rest of the corporate group. Limited guarantees, and any other joint liabilities,[77] should be captured within the third party exposure limits;

- limits should be placed on the total intraday exposures permitted between ring-fenced banks and the rest of the corporate group;

- the ring-fenced bank should not be party to agreements which contain cross-default clauses, or similar arrangements which are triggered by the default of entities in the rest of the corporate group unless it can satisfy the regulator that such clauses do not undermine the objectives of the ring-fence;

- the ring-fenced bank should not receive a disproportionate amount of any wholesale funding from the rest of the group;

- asset sales or swaps between the ring-fenced bank and the rest of the group should be on a commercial and arm's length basis;[78] and

- ring-fenced banks should be required to disclose all intra-group transactions and exposures on a regular basis and to demonstrate that these are taking place on a commercial and arm's length basis.

74 Chapter 10, FSA, *Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU)*. Available at: http://fsahandbook.info/FSA/html/handbook/BIPRU/10.
75 Provided certain standards are met around the quality of collateral used.
76 For example, only assets which qualify as 'level 1' (highest quality) under proposed international liquidity regulation (see Box A2.1 for further details).
77 Including those arising from master netting agreements.
78 Commerciality should be judged according to whether the terms are similar to comparable transactions with counterparties not in the same corporate group. Arm's length means that transactions should be valued as if they had been carried out between unrelated parties, each acting in his own best interest.

The general intention of these suggestions is that no type of intra-group exposure should be unconstrained. Rather, they should all be captured by either the unsecured third party limit or the new secured limit proposed.

3.88 There are some limited but important circumstances in which, as the law currently stands, a ring-fenced bank could be involuntarily obliged to bear costs incurred elsewhere in the group. Two such involuntary obligations are liabilities for value added tax (VAT) and any pension deficits. Under current tax law, companies under common control may form a VAT group in order to be treated as a single taxable person for VAT purposes.[79] This simplifies internal accounting but leaves all members of the VAT group jointly and severally liable for the VAT liabilities of the group. In a similar way, under current pensions regulation, ring-fenced banks may be liable for funding any deficit in group-wide pension schemes.[80] In implementing the ring-fence, the authorities should remove these involuntary obligations as applied to ring-fenced banks, or ensure that their impact is mitigated.

3.89 Particular attention should be paid to assets being sold to or from a ring-fenced bank to the rest of the corporate group. Asset sales must be on a third party basis – i.e. at market values – to avoid them being a mechanism for transferring subsidies from one entity to another through inflated purchase prices or discounted sale prices. The asset sales must not result in the ring-fenced bank acquiring assets which it would not otherwise be permitted to hold. Also, the business arrangements between ring-fenced banks and the rest of the group should be on third party terms such that, for example, the ring-fenced bank should not provide services to the rest of the group at unreasonably discounted rates and should not be required to give preference to an entity within the group when purchasing risk-management products.

3.90 It is difficult for regulations to work effectively if they are operating against the grain of corporate culture. So, alongside financial restrictions, the governance of a ring-fenced bank should reflect and encourage an appropriate relationship with the rest of the group. The Treasury Select Committee's report on the Commission's work[81] and a number of respondents to the *Interim Report* highlighted the importance of the separation of governance arrangements between the ring-fenced bank and the rest of the group.

3.91 Where ring-fenced entities exist within the utilities sector, independent boards are a standard requirement and have played an important role in protecting vital services. For example, evidence suggests that board independence was crucial to the survival

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79 'Common control' means control as defined for the purpose of a 'holding company' under the Companies Act 1985.

80 It was such an involuntary obligation that forced the charitable Wedgwood Museum Trust into administration following the failure of the broader Wedgwood group (see: http://www.museumsassociation.org/museums-journal/news/26042010-wedgwood-museum-trust-in-administration).

81 House of Commons Treasury Committee, 2011, *Independent Commission on Banking, Nineteenth Report of the Session 2010-12*. Available at: http://www.parliament.uk/documents/commons-committees/treasury/CRC%20HC%201069%20-%20Nineteenth%20Report%20-%20ICB.pdf.

of Wessex Water despite the collapse of its parent, Enron.[82] On the other hand, the parent needs to be able to communicate effectively with the ring-fenced bank and to deliver group strategy. The Commission's proposals for board composition are designed to balance these factors. On the board of the ring-fenced bank, there should be a majority of directors who are independent non-executives with minimal cross-over between these directors and members of the group board. However, the appropriate degree of independence depends upon the proportion of the banking group's assets which are outside the ring-fenced bank. Specifically, some degree of flexibility might be appropriate where a ring-fenced bank forms a very large part of the overall group. The directors of both the ring-fenced bank and the group as a whole should be responsible for complying with the spirit, as well as the letter, of the ring-fence. A duty to secure this outcome could be implemented through the existing approved persons regime.[83]

3.92 It is to be expected that a ring-fenced bank would pay dividends to its parent company. These should not be constrained in normal times since, as well as investors in the holding company needing access to profits of the ring-fenced bank, the ability to move excess capital around a banking group is the main way in which a bank holding company can retain diversification benefits from owning both retail and wholesale/investment banks. However, in times of stress it is also a potential way in which the ring-fenced bank could be weakened by the rest of the group. The ring-fenced bank must not pay dividends where doing so could threaten its own viability. This should be ensured both through regulation and through governance. Regulatory approval should be required for the payment of dividends if after such a payment the ring-fenced bank would not be meeting all relevant capital requirements including buffers. These buffer requirements should include those discussed in Chapter 4 of this report, and those considered necessary by the regulator for individual banks as a result of the idiosyncratic risks they face or in order to ensure they could survive a stressed economic environment.[84] Regardless of and in addition to this significant regulatory constraint, the board of the ring-fenced bank should be responsible for ensuring that no inappropriate dividends are paid.

3.93 In addition, the workings of the ring-fence should be clear and visible to market participants so that the benefits for market discipline, and better monitoring of the activities of banks *ex ante,* would be realised. Appropriate disclosures would allow regulators and the market to assess the health of ring-fenced banks and their compliance with the ring-fence principles. Thus, a ring-fenced bank should make the same disclosures as would be required if it were a separately listed company.

82 See Byatt, I., 2005, Managing water for the future: the case of England and Wales, in Trottier, J. and Slack, P. eds., *Managing Water Resources Past and Present*, Oxford: OUP.
83 The approved persons regime applies to individuals holding certain functions in most businesses regulated by the FSA. The regime aims to ensure that only individuals who are fit and proper can carry out specified functions in banks and imposes personal obligations on them in relation to the business' compliance with regulatory requirements. For more information, see: http://www.fsa.gov.uk/Pages/Doing/Regulated/Approved/persons/index.shtml.
84 I.e. in technical terms those requirements arising under Pillar 2 or from regulatory stress tests.

3.94 While corporate culture cannot be directly regulated, these measures should assist in building a separate, consumer-focused culture in UK retail banking, and a distinctive identity within the ring-fenced bank. Some respondents to the *Interim Report* argued that structural reform would be beneficial for the supply of credit to SMEs.[85]

The structure of banking groups

3.95 In summary, how then would a ring-fence in line with the principles proposed affect the structure of banks? At present, while banks are highly regulated, within the UK there are very few restrictions on how they choose to structure themselves. Large universal banks are a complex web of legal entities and intra-group relationships. They tend to operate both retail and wholesale/investment banking from one legal entity or a combination of closely connected entities with limited restrictions on transactions between them. Problems are liable to spread quickly from one part of the financial system to another and the authorities face the unacceptable choice between supporting bank creditors or allowing vital services to the economy to be interrupted. An expectation of government bail-outs means the price of bank funding does not reflect the risks that banks run.

3.96 The ring-fence recommended, alongside the other measures outlined in this report, would change this situation markedly. It would prevent the unrestricted mixture of financial activities legally, operationally and economically. Where there is a strong public interest in the continuous provision of services the authorities would be in a position to ensure such provision without supporting bank creditors. Such services would be provided from legal entities whose activities are significantly constrained and which are relatively straightforward to manage, monitor and supervise. The restrictions would allow ring-fenced banks to carry out their key economic functions efficiently and effectively, while insulating them from the risks posed by the global financial system. The ring-fenced banks would have their own financial resources and no greater financial exposure to the rest of the group than those generally allowed in relation to third parties. This insulation from the rest of the financial system would reduce their susceptibility to failing just when they are most important to the economy – when financial markets and other financial institutions are weakest. Such banks would be the major providers of credit to households and SMEs, and so would act as a more stable source of credit at such times.

3.97 But where it is not damaging to the objectives of the ring-fence, flexibility in bank structures would remain. First, there are some services which could be provided either

85 In their response to the *Interim Report* Will Hutton and Paul Nightingale argued that tough ring-fencing will correct incentives which currently make SME lending unattractive (Nightingale, P. and Hutton, W., 2011, *The Discouraged Economy: A Submission from The Work Foundation to the Independent Commission on Banking*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Hutton-Will-and-Nightingale-Paul.pdf). Similarly the Federation of Small Businesses supported the introduction of a retail ring-fence partly on the grounds that it would concentrate the retail sections of banks on their relationships with small businesses (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).

from within a ring-fenced bank or elsewhere. Non-banks could continue to be important sources of credit for all customers. Corporate banking could be conducted in different places within different banking groups – either inside or outside the ring-fence. Second, ring-fenced banks could be part of a wider corporate group. This would lower the costs relative to full separation – particularly given that dividends could be paid from the ring-fenced bank to the rest of the group, retaining the benefits arising from diversification of earnings. Customers who required services from both a ring-fenced bank and a non-ring-fenced bank could continue to get all their services from one banking group. Information and expertise could continue to be shared within banking groups.

3.98 Some say that even if such an outcome is desirable, it is simply too complicated to implement. This chapter has outlined how it could be achieved. Bank regulation necessarily involves a degree of complexity, and additional regulatory resource would be needed to regulate the ring-fence effectively, but there are no insurmountable difficulties to imposing structural reform. Divisions between services to financial and non-financial companies, customers within the EEA and outside, and between the intermediation of savings and borrowings and trading on financial markets could all be drawn, and indeed are in many cases already drawn for the purposes of regulation, accounting and other law. Precedents in other countries and other sectors show that activity restrictions, and restrictions on dealings between members of a group, can be made to work. In particular, with strong corporate governance successful ring-fences can exist within corporate groups.

3.99 The separation of different banking functions would make it easier for the authorities to ensure continuity of vital services without the provision of solvency support. It would insulate such services from shocks in the global financial markets, improve the discipline imposed on banks by the market, and make banks easier to sort out if they got into trouble. Nevertheless, without further measures the risks to the economy from the failure of a large bank would remain too high. The next chapter considers proposals to mitigate such risks further by making banks much better able to absorb losses. Chapter 5 then considers the economic impact of the proposed reform package as a whole.

Chapter 4: Loss-absorbency

Introduction

4.1 The recent financial crisis revealed banks in the UK and elsewhere to be severely under-capitalised. Relatively small declines in the value of their assets threatened insolvency. Fearful of the consequences of allowing systemically important banks to fail, governments bailed them out. Shareholders in some of the largest banks – having enjoyed strong returns in the years running up to the crisis – suffered losses, and some were wiped out. But bank creditors escaped largely unscathed, and many employees in wholesale and investment banking were very well paid throughout. In addition to direct capital injections, the taxpayer also took on enormous contingent liabilities.

4.2 Besides the question of fairness, this distribution of risk and reward is potentially de-stabilising. It creates incentives for banks to take further risk (ultimately borne by the taxpayer) for the chance of greater reward (for the banks' shareholders, creditors and employees). In particular, for as long as systemically important banks cannot be allowed to go into insolvency, creditors who can only take losses in insolvency will not exert effective discipline on banks to curb excessive risk-taking.

4.3 It is not only bank insolvency that is problematic. As the crisis approached, banks had not sufficiently protected themselves against the risks they were taking. So as losses started to erode their safety buffers, banks that were ill-prepared had ever fewer resources to absorb further losses that might come through. In an attempt to reduce risk, banks sought to shrink their balance sheets, and so cut lending. The resulting contraction in the supply of credit has been significantly more costly to the economy than the amount spent bailing out banks.

4.4 So reform is needed to make banks better able to absorb losses. They need to be made less likely to fail, and better able to cope with losses short of failure. If they do fail, they need to be able to do so safely, avoiding the consequences of disorderly bank failure. This chapter addresses these issues and sets out the Commission's recommendations on them.

4.5 This chapter is set out in five sections, as follows.

- Overview – this section expands on some of the problems identified above, introducing some concepts and terminology that will be used in the remainder of the chapter.

- Should banks have much more equity? – this section considers whether the best response is to require banks to have much more equity.

- Loss-absorbing debt – this section looks at how the loss-absorbency of debt can be increased (including by making other debt bear losses ahead of ordinary deposits).

- How much loss-absorbing capacity do banks need? – this section addresses the question of how much loss-absorbing capacity banks should be required to have.

- Recommendations – this section sets out the Commission's recommendations for improving banks' loss-absorbing capacity.

Later on, Chapter 5 and Annex 3 consider in more detail the economic impact, benefits and costs of the Commission's recommendations to increase loss-absorbing capacity.

Overview

4.6 The recommendations on loss-absorbency set out below necessarily engage with technical issues. The basic themes that regulation seeks to address can however be viewed in straightforward terms. To that end, this section discusses how the bearing of risk, reward and loss depends on banks' capital structures, and *vice versa*. It includes a brief consideration of a number of important concepts which will be considered in more practical detail later in the chapter.

Bank funding

4.7 A bank funds itself by issuing shares (equity) and incurring debt (for example, by taking customer deposits and issuing bonds). These are collectively the bank's liabilities. A bank uses the funds it raises to make loans and investments. These are its assets. A bank makes a profit by earning a higher rate of interest on its assets than it pays on its debt.

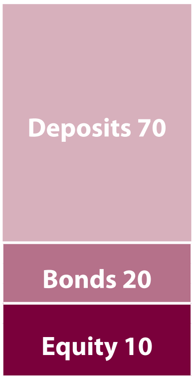
Leverage

4.8 A bank's leverage is the ratio of assets to equity. As with any company, the value of a bank's equity equals the value of its assets less the value of all the other (non-equity) liabilities. This means that the higher a bank's leverage, the more sensitive the value of its equity is to rises or falls in the value of its assets. This is illustrated in Box 4.1.

4.9 Bank B is twice as leveraged as Bank A. Does this provide an efficiency advantage, by 'economising' on equity? Other things being equal, it does not. If the assets held by the two banks are the same, the total risk borne by the investors – i.e. all the shareholders and the creditors (depositors and bondholders) – is the same in each case, and so Banks A and B should have the same aggregate funding cost in the market.

Box 4.1: The impact of higher leverage on return on equity

Bank A



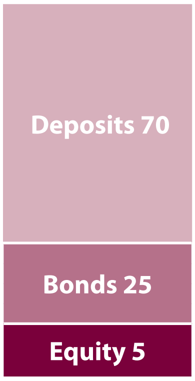
Bank A has 100 assets, funded by 70 deposits, 20 bonds and 10 equity.

Leverage is 100/10 = 10

If the value of the assets rises to 101, the equity gains 1 in value.

Return on equity: 1/10 =10%

Bank B



Bank B has 100 assets, funded by 70 deposits, 25 bonds and 5 equity.

Leverage is 100/5 = 20

If the value of the assets rises to 101, the equity gains 1 in value.

Return on equity: 1/5 =20%

Higher leverage magnifies returns *and* losses on equity. The equity of a highly leveraged bank would be wiped out by a smaller shock than would wipe out the equity of a less leveraged one.

Implicit government support

4.10 However, other things are not equal. First, greater leverage increases the chance of the bank becoming insolvent. The insolvency of banks tends to be costly and disruptive not only to private parties but also to the rest of the financial system and society more generally – especially if several banks hit trouble at once, as in a systemic crisis. A major disruption to the payments system could have a catastrophic social and economic impact. Interruptions in the supply of bank lending to borrowers will constrain investment, reducing both demand and supply capacity, and hence GDP. Private incentives do not reflect the wider economic and social costs of bankruptcy, and so will produce an equity buffer that is smaller than the socially optimal level.

4.11 Moreover, in a crisis, the government may feel compelled to prevent the insolvency of a systemically important bank by injecting public funds into it. If government support is anticipated, higher leverage will not increase creditors' perception of risk as much as it should. The cost of bank debt will not properly reflect the risks involved, and there will be private incentives (at contingent public expense) to take on too much risk in the first place. This is the 'moral hazard' problem. Implicit government support incentivises higher leverage. Key employees of the bank might well have substantial shareholdings, and/or bonuses linked directly or indirectly to returns on equity, in which case their incentives also encourage leverage.

Differential tax treatment of debt and equity

4.12 Second, in the UK and elsewhere, debt finance gets more favourable tax treatment than equity. So issuing debt instead of equity does in a sense 'economise' – on tax bills. This is not a saving for the economy as a whole, and for the Exchequer it is a loss.

Shareholder reluctance to issue more equity

4.13 Third, consider a highly leveraged bank that is contemplating raising more equity. If it does so, existing shareholders will bear the cost of being diluted by the issue of new stock, but much of the benefit will be enjoyed by existing creditors because the equity cushion protecting them from loss will be greater. Furthermore, raising equity in such circumstances can signal to prospective investors that the prospects of the firm are not good. These factors may bias existing shareholders (and employees with aligned incentives) away from issuing more equity, and so create an incentive for the bank to remain highly leveraged.[1]

4.14 So banks' shareholders (and some employees) have an incentive to economise on equity in a way that is not aligned with the interests of wider society. It follows from the above that this incentive arises in two ways. First, the social costs of bank insolvency are greater than the private costs. Second, as a consequence of this banks benefit from an implicit guarantee; this makes debt cheaper than it should be, further incentivising leverage.

Loss-absorbing debt

4.15 If debt only bears losses in insolvency and systemically important banks cannot be allowed to go into insolvency, debt holders have little incentive to discipline banks – the moral hazard problem discussed above. In order to address this issue, a process is needed whereby debt can bear losses if equity is wiped out, without requiring disorderly failure. Further, debt must be able to bear losses without unacceptable side effects such as triggering a run on the bank, or causing disruption in the wider wholesale funding market. This is more readily achieved for debt that is long-term and if it has been clear to everyone all along that such debt is liable to bear losses ahead of other (non-capital) liabilities, including ordinary deposits. (Below, 'bail-in bonds' is the term used to describe such debt.) Debt can bear losses simply by being written down. Alternatively, the write-down can be accompanied by the issue of shares to the debt holder – the debt is 'converted' into equity.

Resolution

4.16 A process of the kind outlined above also requires there to be an efficient mechanism whereby the authorities can quickly sort out a failing bank and ensure that losses are borne as necessary by investors, while avoiding the disruption that may result from a disorderly bank insolvency – in short, a mechanism for *resolution*. Loss-absorbing debt is essential to resolution. The two are complements.

1 This is the 'debt overhang' problem.

Recovery

4.17 While resolution is generally better than insolvency,[2] ideally problems are sorted out before resolution becomes necessary. If a struggling bank possesses and can execute a recovery plan to rebuild equity, resolution can be averted. This might be done by, for example, asset sales, restricting dividends and bonuses, or by issuing new equity. Loss-absorbing debt that is designed to absorb loss not only before insolvency, but also before resolution – 'contingent capital' – may also feature in a bank's recovery plan.

Capital requirements

4.18 For the reasons indicated above, there is a strong public interest in banks, especially systemically important ones, having more equity and loss-absorbing debt than they would choose themselves. This raises important questions for the regulation of banks' liability structures. How much equity should they have? What type of, and how much, loss-absorbing debt should they have? The answers to these questions provided by the international 'Basel III' agreement on minimum capital standards are outlined in Box 4.2.[3]

4.19 Of course these questions are much more complicated than in the basic example discussed above, in which the sources of bank capital and funding were simplified to be equity, bonds and deposits. In practice there is a wide variety of types of capital and funding, which regulatory rules must encompass.

Asset risk weights

4.20 The asset side of bank balance sheets is also complex. Depending on the activities that banks may undertake, asset classes include mortgages, business loans, trading positions, derivatives exposures, and so on. The Basel III rules recognise that capital requirements should relate to the riskiness of a bank's asset portfolio as well as its size. Relatively safe assets, such as short-term bonds issued by a stable government with strong public finances do not need as much capital backing as riskier assets. The Basel III rules utilise 'risk weights' in an attempt to address this; a bank's 'risk-weighted assets' (RWAs) are a measure of its total assets weighted for risk. Risk-weighting has merit in principle but inevitable imperfections in practice. For example, the low risk weights attributed to some sovereign bonds have clearly been inconsistent with the market's view of the likelihood of their default. So there is a strong case for capping total (unweighted) leverage too, as a backstop. (The Basel III rules include a proposal for leverage ratios to be monitored, with a view to a binding minimum leverage ratio being put in place from 2018. See Box 4.2.)

2 Note that if the wider social and economic impact of a bank going into insolvency is considered tolerable, the authorities may still determine that the best way to resolve a failing bank is to put it into insolvency.
3 For detail on the Basel III agreement see Basel Committee on Banking Supervision, 2010, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems*. Available at: http://www.bis.org/publ/bcbs189.htm.

Box 4.2: Basel III capital requirements

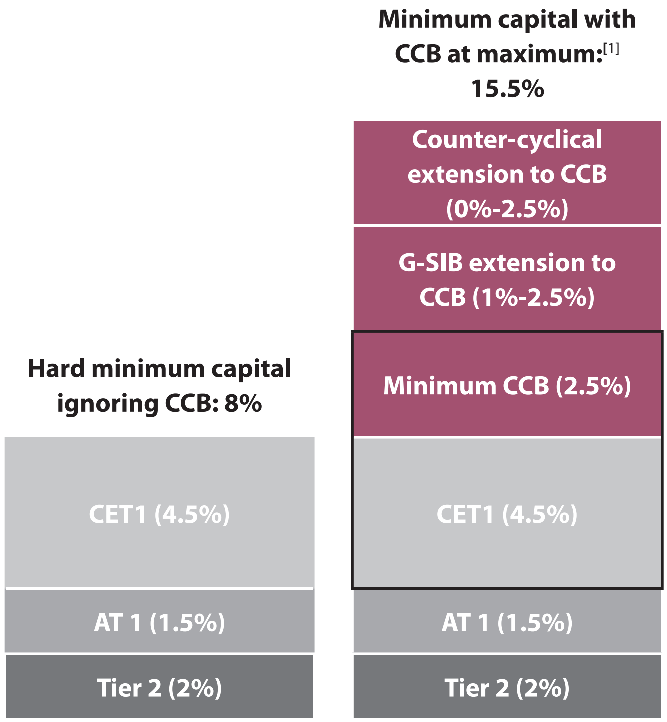
This box summarises the Basel III rules on capital. Banks have until 2019 to meet fully these new rules. The rules define three types of capital, described in Table 4.1.

Table 4.1: Three types of capital under Basel III

Type of capital	Description of typical instruments	Quality of capital
Common Equity Tier 1 (CET1)	Common equity, retained earnings	Best
Additional Tier 1 (AT1) (Tier 1 = CET1 + AT1)	Preference shares, perpetual subordinated debt	Second best
Tier 2 (Total capital = Tier 1 + Tier 2)	Subordinated debt with remaining term > 5 years	Third best

Banks must hold minimum total capital equal to at least 8% of risk-weighted assets (RWAs). At least 4.5% must be CET1 – the 'hard' minimum CET1 requirement – and at least 6% must be Tier 1 capital. The rules also introduce a CET1 'capital conservation buffer' (CCB). This must be at least 2.5% of RWAs, but can be extended in two ways (see Figure 4.1). The CET1 hard minimum together with the minimum CCB gives the Basel III CET1 baseline of 7% of RWAs (outlined in bold in Figure 4.1). Note that these requirements are not yet in force – they will be implemented in the UK through European legislation known as 'CRD IV' (see Box 5.1 in Chapter 5 for more detail).

Figure 4.1: Capital requirements



The size of the CCB

- Minimum CCB of 2.5%.
- CCB extended by 'G-SIB surcharge' of 1%-2.5%[1] for global systemically important banks (G-SIBs) (under consultation).
- CCB also extended by 'counter-cyclical buffer' of up to 2.5%.[2]

If a bank's CET1-to-RWAs ratio falls into the CCB, dividend and bonus restrictions are imposed. A bank becomes non-viable if it breaches the hard minimum requirement.

Box 4.2: Basel III capital requirements (continued)

These capital rules are expressed relative to RWAs. If risk weights are not set correctly, banks could end up holding too little capital. To guard against this, Basel III also proposes that banks' leverage ratios (measured as Tier 1 capital to *unweighted* assets) be monitored against a benchmark of 3%, with a binding minimum requirement to be introduced in 2018.

[1] The proposed G-SIB surcharge can go up to 3.5%. No G-SIB is initially expected to have a 3.5% surcharge.

[2] The counter-cyclical capital buffer is designed to require banks to build up a loss-absorbing buffer in the good times that can be run down in a downturn. It can be set above 2.5% within national jurisdictions.

Liquidity requirements

4.21 The focus of this chapter is on capital requirements, which are designed to ensure that a bank has sufficient resources to cope with losses on its assets. But a bank's viability is threatened not only by declining asset values. Banks conduct 'maturity transformation' by financing long-term assets (such as mortgages) with shorter-term liabilities (such as deposits). Because of the maturity mismatch between assets and liabilities, even a solvent bank can fail if there is a large-scale withdrawal of deposits. The Basel III rules therefore also introduce liquidity requirements that limit the mismatch between the maturity of a bank's assets and liabilities by requiring banks to hold enough assets that can be sold easily to meet demands for a withdrawal of funding in a crisis. Increased loss-absorbing capacity complements liquidity regulation by improving the credibility of a banks' solvency and so reducing the probability of a liquidity crisis. It also increases the confidence with which a central bank can provide liquidity support.

Building societies

4.22 Building societies undertake similar activities to those of retail and commercial banks (and indeed would be subject to the retail ring-fence), but are owned by their members – savers and borrowers – instead of by external shareholders. This means that building societies are not able to boost their equity levels by issuing shares to external investors.[4] The majority of their capital is accordingly in the form of retained profits. However, it is as important that building societies have adequate loss-absorbing capacity as it is for banks. So the recommendations set out by the Commission in this chapter should apply to building societies as well as to banks.

4 Note, however, that the development of equity-like instruments for building societies (and other mutuals) is contemplated in a recent proposal from the European Commission (EC) on the prudential regulation of financial institutions. See Article 25 of EC, 2011, *Proposal for a Regulation of the European Parliament and of the Council on Prudential Requirements for Credit Institutions and Investment Firms.* Available at: http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm.

From basic principles to practical recommendations

4.23 Although the rest of this chapter is in more technical terms than the discussion in this section, the basic themes and principles illustrated here carry over to the more complex reality that the Commission's recommendations address.

Should banks have much more equity?

4.24 Banks need to be better able to absorb losses than was the case in the recent crisis. There is no disagreement on this point. More loss-absorbing capacity is needed both to make banks more resilient to shocks (and so reduce the likelihood that they will fail), and to make them easier to deal with when they do fail. Loss-absorbing capacity can therefore be divided into two broad types, depending on whether it absorbs losses before or after a bank is put into resolution (sometimes referred to as 'going concern' and 'gone concern' loss-absorbing capacity, respectively). Box 4.3 illustrates how different types of loss-absorbing capacity can be categorised in this way.

4.25 Box 4.3 shows that equity is the only form of loss-absorbing capacity that works both pre- and post-resolution.[5] In particular, it is the only form of loss-absorbing capacity that certainly absorbs losses before a bank fails. Contingent capital may be of some value in this regard, but this is not yet proven. Because the value of a bank's equity equals the value of its assets less the value of its (non-equity) liabilities, if asset values fall, equity absorbs losses smoothly. Equity holders know that it is risky. Further, equity is perpetual. A bank does not have to re-finance its equity funding periodically, as it does its debt funding (although it may need to add to it from time to time). So equity cannot 'run' in the way that other liabilities – in particular, deposits and short-term funding – can.

4.26 For these reasons, and others,[6] equity is by far and away the best form of loss-absorbing capacity. Again, there is consensus on this point, and this is reflected in the significant increases in the minimum amount of equity that banks are required to have under the Basel III rules (see Box 4.2).[7] Some argue, though, that while these proposals to increase minimum equity levels are welcome, they do not go far enough. Because higher equity levels enhance financial stability, the argument can indeed be made for going much further than the Basel III baseline of a minimum equity-to-RWAs ratio of 7%.

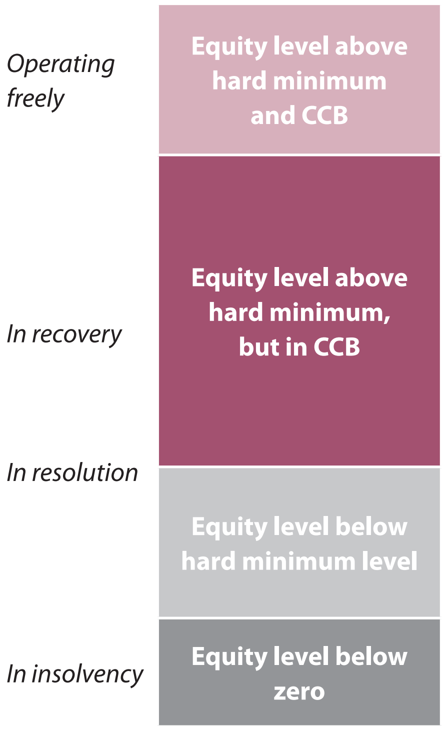
4.27 A number of objections are made to this argument. The claim is made that increasing banks' equity requirements forces them to hold additional resources idle as protective buffers, instead of using them to finance productive investment – but higher equity requirements do no such thing. This confuses the liability with the asset side of the balance sheet. Higher equity requirements simply require banks to use less debt and more equity funding.

5 'Post-resolution' loss-absorbing capacity is available to absorb loss once a bank is *in* resolution.
6 For example, more equity mitigates the debt overhang problem discussed at Paragraph 4.13.
7 Under the previous (Basel II) rules banks were only required to have equity equal to 2% of RWAs, 'equity' was more loosely defined and asset risk weights were often lower.

Box 4.3: Pre-resolution and post-resolution loss-absorbing capacity

Under Basel III, a bank's minimum equity ratio is made up of two parts – the 'hard' minimum requirement (4.5% of RWAs), and the CCB above the hard minimum (see Box 4.2 for more detail). If a bank's equity level falls into its CCB, restrictions will be imposed on dividends and bonuses. A breach of the hard minimum requirement would make a bank non-viable. Loss-absorbing capacity can be divided into two types, depending on whether it absorbs losses before resolution ('pre-resolution loss-absorbing capacity') or only once the bank enters resolution ('post-resolution loss-absorbing capacity').[1] Figure 4.2 shows how different types of loss-absorbing capacity work pre- and post-resolution.

Figure 4.2: When different types of loss-absorbing capacity work



With equity above both the hard minimum level and the CCB, the bank operates freely. Losses fall on **equity**.

If the bank falls into the CCB, some restrictions will be imposed on discretionary distributions such as dividends and bonuses, but the bank can otherwise operate normally. The bank is in 'recovery'. Losses fall on **equity**. If the bank has any **contingent capital**, this may also suffer losses (through write-down or conversion).

If a bank is put into resolution, losses fall first on **equity**; after the equity is wiped out further losses fall on **loss-absorbing debt** including non-equity capital. The resolution authorities may write down or convert loss-absorbing debt sufficiently to 'create' new equity,[2] so the bank is re-capitalised. They will also have other options (which will include putting the bank into an insolvency process).

Equity absorbs losses in all states. Contingent capital issued by the bank, if any, is likely to absorb losses once the level of equity has fallen some way into the CCB (but before it falls below the hard minimum level). Other loss-absorbing debt takes losses in resolution.

When a bank suffers losses, it may seek to reduce its assets – and so restrict lending – in order to bring its equity ratio back to where it was before the losses hit. The more pre-resolution loss-absorbing capacity a bank has, the less it will have to cut back its assets in order to regain its original equity position. Pre-resolution loss-absorbing capacity is therefore particularly important as it mitigates any adverse impact on the wider economy of bank losses.

[1] These are sometimes referred to as 'going concern' and 'gone concern' loss-absorbing capacity. In this report they are referred to as 'pre-resolution' and 'post-resolution' loss-absorbing capacity to reflect the fact that the purpose of resolution will often be to keep (at least some of) a bank's business operating.

[2] Put simply, a bank's equity is the amount by which the value of its assets exceeds its non-equity liabilities. So if loss-absorbing debt is written down, non-equity liabilities fall – and so equity is created.

4.28 Another objection is that equity is more expensive for banks than debt. The argument is made that making banks switch some of their funding from debt to equity increases their average cost of funding. This would be passed on to bank borrowers in the form of more expensive loans, reducing the level of investment and so imposing a cost on the wider economy by limiting growth. This analysis overlooks the fact that a bank with more equity would be safer, and so investors – both debt and equity – should accept lower returns, as they are exposed to less risk.[8] A further argument as to why equity is more expensive than debt is that debt gets a tax subsidy. But the loss of these tax benefits to *banks* would not represent a net cost to the *economy*.

4.29 Moreover, any increase in banks' funding costs from higher minimum equity requirements would not be borne solely by borrowers – it would be likely to be shared with shareholders and employees. So it is not clear how much a bank's average cost of funding would increase with more equity funding, nor how much of any such increase would be passed on to borrowers.

4.30 This raises the question of where the balance should be struck between the benefit of enhanced financial stability from higher equity requirements, and the possible impact on the economy of more expensive bank lending. In order to address this issue, in the *Interim Report* the Commission analysed a number of recent studies that have attempted to measure the costs and benefits of higher levels of equity as a proportion of RWAs.[9] This analysis (summarised in Annex 3) shows that the studies give a range of estimates for the optimal ratio of equity to RWAs of 7% to 20%. Box 4.4 sets out an example of what the impact on a bank's average cost of funding might be as a result of moving from one end of this range to the other.

4.31 On the basis of this range of 7% to 20%, and taking into account a number of other factors set out therein, the proposal put forward by the Commission in the *Interim Report* was that all systemically important banks should have a minimum equity-to-RWAs ratio of at least 10%.[10] Acknowledging that the wholesale/investment banking markets in which UK banks compete are international, the Commission proposed that the operations of UK banks in these markets should not be required to have more equity than that agreed at international level (subject to those operations having credible resolution plans, including loss-absorbing debt). As to retail banking operations in the UK, in the *Interim Report* the Commission proposed that all large UK ring-fenced banks be required to have a minimum equity-to-RWAs ratio of at least 10% (plus loss-absorbing debt).[11]

8 As discussed in Paragraph 4.9.
9 See Paragraph 4.29 of the *Interim Report*.
10 See Paragraph 4.34 of the *Interim Report*.
11 See Paragraphs 4.35 and 4.39 of the *Interim Report*.

Box 4.4: A worked example of higher equity requirements

Assume that debt costs 5% (net of tax) and that equity costs 15%. Increasing the proportion of RWAs funded by equity from 7% (the Basel III minimum) to 20% (the top of the range of estimates presented in the *Interim Report*) would increase the average cost of funding by 65 basis points (bps) (assuming an average risk weight of 50%).[1] But nearly trebling the amount of equity funding a bank has would make it much less risky, and so reduce the cost of its funding. So a more credible increase would be closer to 30 bps.

If passed on to borrowers in full, this would have a modest impact on the economy, certainly compared to the cost of financial crises, but borrowers would not in any case bear all the cost – it would be shared with shareholders and employees. Moreover, banks have operated in the past with much higher levels of equity without constraining economic growth.[2] The increase in the average cost of funding from raising the equity requirement from 7% to as much as 20% of RWAs could be less than 30 bps, and removing the differential tax treatment of debt and equity would make the effect smaller still.

[1] A bank with an average risk weight of 50% and an equity-to-RWAs ratio of 7% gets 3.5% of its total funding from equity. Assume it now replaces enough of its debt funding with equity to give it an equity-to-RWAs ratio of 20% – i.e. 10% of its total funding comes from equity. The cost of 6.5% of its funding has gone up by 10 percentage points, from 5% to 15%. So its average cost of funding has increased by 6.5% x 10% = 65 bps.

[2] Page 24 of Alessandri, P. and Haldane, A., 2009, *Banking on the State*, shows historical ratios of capital to *unweighted* assets. Available at: www.bankofengland.co.uk/publications/speeches/2009/speech409.pdf.

4.32 Respondents to the *Interim Report* offered a wide range of views on the question of the correct level of a minimum equity ratio. Some thought that Basel III was enough (even without the additional surcharge for G-SIBs).[12] These respondents cited worries about increasing the cost of credit (as discussed above), and also raised concerns that increasing the minimum requirement would incentivise banks to de-leverage, with an adverse impact on the economy. It was also suggested that foreign banks (with lower capital requirements) would be able to branch into the UK, and operate at a competitive advantage to UK banks.[13] Others thought a ratio of equity-to-RWAs of 10% was about right. Another group of respondents – giving some or all of the arguments presented above – thought that equity requirements should be higher in order to enhance financial stability and protect against the high costs of financial crises.[14]

12 For example, see J.P. Morgan, 2011, *J.P. Morgan Response*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/JP-Morgan1.pdf.
13 For example, see HSBC, 2011, *Independent Commission Banking Interim Report – Submission from HSBC*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/HSBC-Response-to-ICB-Interim-Report_Redacted-Version1.pdf.
14 For example, see Admati, A. and Hellwig, M., 2011, *Comments to the UK Independent Commission on Banking*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Admati-Anat-R-Hellwig-Martin-F.pdf.

4.33 The Commission has considerable sympathy for arguments in favour of setting much higher minimum equity requirements, but acknowledges that there are a number of specific counter-arguments that do have some force.

4.34 First, the Commission recognises the (arguably perverse) effect of the differential tax treatment of debt and equity, which creates private incentives for higher leverage.[15] This issue does not on its own make a compelling case against higher equity requirements. The cost of requiring more equity is principally private rather than social – it is not a cost to the wider economy (as discussed in Paragraph 4.12). But the consequences of that private cost are that banks' average costs of funding will increase. At least some of this increase is likely to be passed on to borrowers in the form of a higher cost of credit. Accordingly, imposing very high minimum equity requirements may have a negative impact on economic growth. Were this tax distortion to be removed, there would be a stronger case for higher minimum equity requirements.

4.35 Second, any bank established in the European Economic Area (EEA) can in principle branch into the UK and remain primarily regulated in its home country.[16] Setting capital requirements very much higher than in other EEA countries would create a competitive advantage for EEA banks that branch into the UK. (This problem is mitigated by the Basel Committee on Banking Supervision's (BCBS) proposals for a G-SIB surcharge, but this only applies to around 30 global banks, and none will have a surcharge of more than 2.5%. The vast majority of EEA banks will be unaffected.) While branches of EEA banks would provide welcome competition in the domestic market, there are a number of reasons why having foreign banks constituting a large part of the domestic banking sector may be undesirable. In times of stress lenders tend to re-balance their loan portfolios in favour of borrowers in their home jurisdiction – the 'flight home' effect.[17] Local banks also tend to be better conduits for information between participants in the banking and credit markets and the official sector. More generally, having a large part of a country's banking sector primarily regulated from abroad would give rise to concerns that in a crisis the relevant authorities would be less able (and possibly less willing) to respond rapidly and effectively. This imposes a practical constraint on the extent to which minimum equity requirements imposed on UK banks can exceed those imposed elsewhere.

4.36 Third, the effect of imposing very high capital requirements on UK banks would incentivise the migration of some activities out of the banking sector altogether, and into the (less regulated) non-bank financial institutions that constitute the 'shadow banking' sector. This is not necessarily a bad thing. Indeed, to the extent that as a

15 This differential tax treatment is discussed in the Mirrlees Review of the UK tax system, which makes recommendations to address the issue. See Mirrlees, J. et al., 2011, *Tax by Design: The Mirrlees Review*. The final version of the Mirrlees Review is expected to be available from 13 September 2011 at: http://www.ifs.org.uk/mirrleesReview.

16 This constraint arises out of the UK's international treaty obligations.

17 As discussed in Gianetti, M. and Laeven, L., 2011, The flight home effect: evidence from the syndicated loan market during financial crises, *ECGI–Finance Working Paper No. 304/2011*. Available at: http://ssrn.com/abstract=1726050.

consequence risk is moved away from banks, there could be a financial stability benefit. However, putting in place very strong incentives for activities to move outside the banking sector risks driving activities out of banks that can be more safely conducted and regulated inside them. This imposes a further constraint on setting very high minimum equity requirements for banks.

4.37 Fourth, there is the important issue of transition. Much higher equity requirements imply balance sheets that are much less highly leveraged than they are today. This can be achieved in two ways – fewer (risk-weighted) assets, or more equity. If banks were to seek to reach higher equity requirements through de-leveraging, there would be a risk of a rapid reduction in banks' balance sheets, and a contraction in the supply of lending. However, much higher levels of equity may not be readily achievable through raising new equity in the market. Regulators could deal with this by imposing restrictions on earnings distributions to build up equity, but the impact this would have on dividends could lead to low bank share prices. Low valuations may further constrain banks' ability to raise equity, and in addition may be taken as a signal of distress by other market participants. In such circumstances, there is a risk that banks may seek to meet higher capital requirements as quickly as possible, in order to demonstrate to the market that they are running viable, profitable businesses. So again banks may reduce assets in the short term – even if they are afforded a long transition period – with adverse consequences for (short-term) economic growth.

4.38 Finally, the question of equity requirements must be seen in conjunction with that of loss-absorbing debt – i.e. within the context of loss-absorbing capacity as a whole. Provided that it is truly loss-absorbing, there are advantages in combining debt with equity as far as risk-taking incentives are concerned.[18] Equity holders get high rewards when upside risks materialise. Holders of debt get back their principal unless large downside risks occur, so they have a particular interest, in a way that equity holders do not, in guarding against such downside risk. Sensitivity of creditors to downside risk is reinforced by the fact that they bear the costs of bankruptcy (by that stage shareholders will have been wiped out). Hence the potential value, from the point of view of incentives, in having loss-absorbing debt alongside equity in the liability structure of bank balance sheets. A further benefit of such debt is that its price would be an indicator of perceived riskiness of any bank, which should be of benefit to shareholders, regulators and the wider public.

Recommendation on minimum equity requirements

4.39 Balancing these arguments, the Commission's recommendation is that large ring-fenced banks should be required to have an equity 'ring-fence buffer' of at least 3% of RWAs *above* the Basel III baseline of 7% of RWAs. (A ring-fenced bank is defined to be 'large' if its RWAs-to-UK GDP ratio is 3% or above.) Smaller ring-fenced banks should have correspondingly smaller ring-fenced buffers (as set out in Table 4.2 below).

18 A theoretical analysis of the complementary roles of debt and equity is Dewatripont, M. and Tirole, J., 1994, A theory of debt and equity: diversity of securities and manager-shareholder congruence, *Quarterly Journal of Economics*, 109(4), pp. 1027-1054.

In order to improve resolvability and to benefit from the difference in risk-taking incentives between shareholders and creditors discussed in the preceding paragraph, ring-fenced banks also need to have loss-absorbing debt. (Measures to ensure the loss-absorbency of debt are discussed following Paragraph 4.60 below.)

4.40 The Commission's view remains that in order to allow the wholesale/investment banking operations of UK banks to compete in global financial markets, they should not be required by regulation to have more equity than that agreed at international level, subject to those operations having credible resolution plans, including loss-absorbing debt.

4.41 While the Commission would have been inclined to recommend higher equity requirements for ring-fenced banks were it not for the constraints identified above, there is a further advantage in mandating substantially, but not sharply, higher equity requirements for ring-fenced banks (together with loss-absorbing debt). Under retail ring-fencing there is a range of activities that a UK banking group would be allowed to conduct *either* from the ring-fenced bank *or* from elsewhere in the group. If minimum equity requirements for the ring-fenced bank were very much higher than those required of non-ring-fenced banks, this would invite arbitrage, i.e. the shifting of activities from the ring-fenced bank to the non-ring-fenced bank in order to exploit the difference. The Commission's recommendations on minimum equity requirements avoid creating strong incentives for such arbitrage.

4.42 The equity requirements recommended here are *minimum* levels. The authorities would have discretion to increase these levels, in particular through the use of the Basel III counter-cyclical capital buffer (of up to 2.5%[19] of RWAs). In addition, the Commission recommends that regulators be given the discretion to impose a 'resolution buffer', which may require banks to have up to 3% of RWAs of additional equity (or other loss-absorbing capacity) if they are not readily resolvable. If the counter-cyclical capital buffer is set at 2.5% of RWAs, a bank with a ring-fence buffer of 3% of RWAs and an equity resolution buffer of a further 3% of RWAs would accordingly be required to have a minimum equity-to-RWAs ratio of 15.5%. (Recommendations on the resolution buffer are discussed following Paragraph 4.125 below.)

4.43 Applying a ring-fence buffer of 3% of RWAs to large ring-fenced banks would also help to mitigate the problem – discussed in more detail in Chapter 8 – that small banks are disproportionately affected by prudential regulation, giving larger banks a competitive advantage.[20] However, a situation in which a bank operating just below a size threshold has no ring-fence buffer and a bank operating just above it has the full equity ring-fence buffer of 3% of RWAs would in itself create an anti-competitive

19 The counter-cyclical capital buffer can be set above 2.5% within national jurisdictions.
20 This seems to be at least in part because small banks typically use a simple 'standardised approach' to calculating risk weights for assets, which can produce higher risk weights than advanced 'internal ratings-based' approaches used by many large banks.

discontinuity (although this will be less of a problem to the extent that smaller banks are in any case required to operate with higher capital ratios).

4.44 In order to address this, the Commission recommends that a sliding scale be used to build up the size of the ring-fence buffer from zero to 3% of RWAs (for large ring-fenced banks). A simple method for calibrating the size of this buffer for smaller banks would be to set it to zero for banks with a RWAs-to-UK GDP ratio of 1% or less, and increase the size of the buffer linearly with banks' RWAs-to-UK GDP ratio so that it reaches 3% for banks with a RWAs-to-UK GDP ratio of 3%. This is demonstrated in Table 4.2, which includes an illustration of how different ring-fenced banks might be affected. Using RWAs to UK GDP to calibrate the ring-fence buffer has the (significant) advantages of simplicity and transparency, and it also ensures that a bank's ring-fence buffer does not increase simply because it grows its balance sheet as the economy expands. There is a drawback, however, in that for the same increase in RWAs, a smaller bank would have to increase its absolute level of equity by *more* than a larger bank.[21] Depending on the equity-to-RWAs ratios that smaller banks are in practice required to maintain, it might be appropriate for the scale proposed in Table 4.2 to be modified to minimise any anti-competitive effect.

Table 4.2: Illustrative calibration of the ring-fence buffer

Size of ring-fenced bank (RWAs/GDP)	Illustrative classification of banks by size[22]	Ring-fence buffer (equity-to-RWAs)	Minimum equity-to-RWAs ratio[23]
< 1%	All others	0%	7%
1% – 3%	Co-op, Verde,[24] Clydesdale Bank	(3/2 x (RWAs/GDP–1%))	7% + ring-fence buffer
> 3%	Barclays, HSBC, Lloyds Banking Group (LBG), Nationwide, Royal Bank of Scotland (RBS), Santander UK	3%	10%

4.45 If a ring-fenced bank forms part of a wider group then its equity requirement should be calculated and applied to that ring-fenced bank alone – i.e. on a 'solo' basis. If a group contains more than one ring-fenced bank, the RWAs of all such banks should be combined in order to calculate the appropriate minimum equity ratio, which could

21 Take GDP at £1.5tn. For medium-sized Bank A to increase its RWAs by £15bn from £30bn (2% of GDP) to £45bn (3% of GDP), it will have to increase its absolute level of equity from 8.5% x £30bn = £2.55bn to 10% x £45bn = £4.5bn. So an increase of £1.95bn. For large Bank B to increase its RWAs by £15bn from £45bn (3% of GDP) to £60bn (4% of GDP) it will have to increase its absolute level of equity by 10% x £15bn – an increase of only £1.5bn.
22 This classification has been determined using data from banks' 2010 company accounts and from the Office for National Statistics, and making certain assumptions about the volume of assets that would be held within the ring-fenced bank of universal banking groups.
23 Excluding any G-SIB surcharge or counter-cyclical capital buffer.
24 Verde is the name given to the planned divestiture of a LBG retail banking business as under an agreement between the UK Government, LBG and the EC as one of the remedies to the distortion of competition caused by UK Government support provided to LBG during the financial crisis.

then be applied to those banks in aggregate.[25] (It is not the Commission's intention to incentivise banking groups which contain more than one ring-fenced bank to merge all such banks into a single legal entity. Applying these requirements to ring-fenced banks on a strictly solo basis might have this effect.)

4.46 Equity absorbs losses smoothly both pre- and post-resolution, but as discussed in Box 4.3, it is only equity *above* the hard minimum requirement that can act as pre-resolution loss-absorbing capacity. For this reason, the CCB does not increase the hard minimum equity-to-RWAs ratio of 4.5%. Instead, it functions as a buffer above that level. A bank whose equity ratio falls into this buffer has certain restrictions imposed on it – the more so the further into the buffer it falls – but continues as a going concern. The minimum size of the CCB is 2.5% of equity to RWAs. This is extended if a bank is required to have a G-SIB surcharge[26] and/or a counter-cyclical capital buffer.

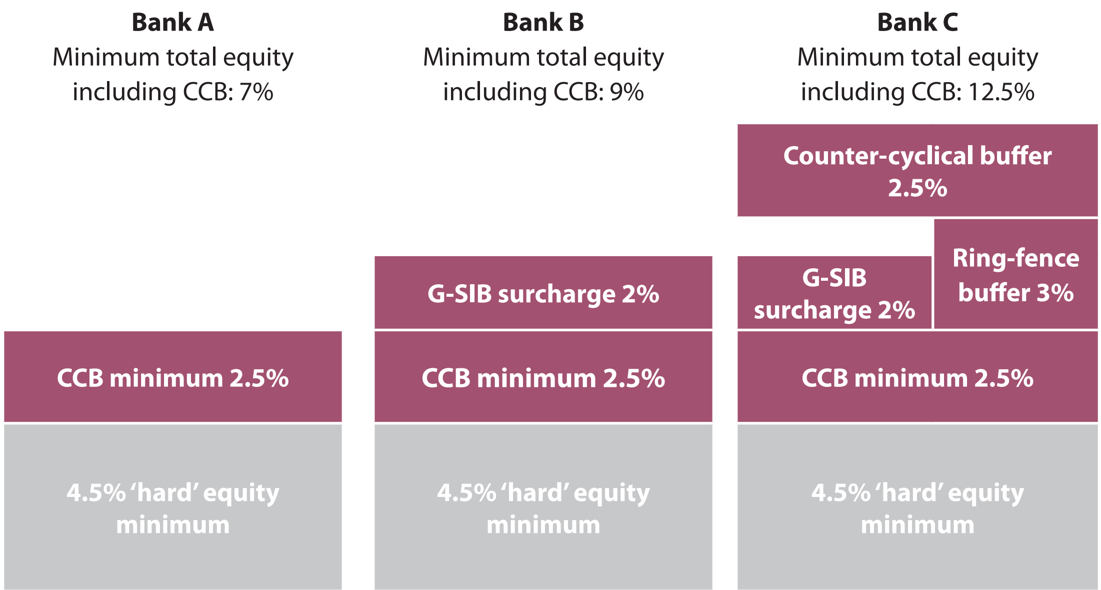
4.47 The Commission recommends that the ring-fence buffer should also extend the CCB. The rationale for the ring-fence buffer overlaps to some extent with the rationale for the G-SIB surcharge, i.e. requiring larger banks to have more equity to reflect the greater social costs of their failure. So the two should *not* be additive. Instead, if a bank is subject to both a ring-fence buffer and a G-SIB surcharge,[27] it is only the higher of the two that should be applied. The counter-cyclical buffer has a different objective – i.e. requiring banks to build up an equity buffer in the good times that can be used to absorb losses in a downturn. So the ring-fence buffer *should* be additive to the counter-cyclical buffer. Examples of how the CCB might be constituted for different types of bank are illustrated in Box 4.5.

25 In technical terms, on a 'sub-consolidated' basis.
26 As discussed earlier, the G-SIB surcharge is technically still at consultation stage.
27 This will occur if the G-SIB surcharge is applied to the ring-fenced bank on a solo basis.

Box 4.5: Determining the size of the capital conservation buffer

The minimum size of the CCB is 2.5%. It is extended by the counter-cyclical capital buffer (if in operation) and the *higher* of any G-SIB surcharge and any ring-fence buffer. The interaction between the various extensions to the CCB is illustrated below using three examples of banks with different buffer requirements. (All the buffer and surcharge ratios in this box are equity to RWAs.)

Bank A	Bank A is a small ring-fenced bank. It has no G-SIB surcharge and no ring-fence buffer. Assume no counter-cyclical buffer. Its CCB is therefore set at the minimum, 2.5% of RWAs.
Bank B	Bank B is a non-ring-fenced bank that is part of a banking group with a G-SIB surcharge of 2%. Assume its supervisor applies the G-SIB surcharge on a solo basis.[1] Assume no counter-cyclical buffer. Bank B's CCB is therefore the minimum (2.5%) plus the G-SIB surcharge (2%) – i.e. 4.5%.
Bank C	Bank C is a ring-fenced bank with a RWAs-to-GDP ratio of 4%, so its ring-fence buffer is 3%. It is part of a banking group with a G-SIB surcharge of 2%. Assume its supervisor applies the G-SIB surcharge on a solo basis. Assume a counter-cyclical buffer of 2.5%. Bank C's CCB is therefore the minimum (2.5%) plus the higher of any G-SIB surcharge (2%) and any ring-fence buffer (3%) plus the counter-cyclical capital buffer (2.5%) – i.e. 8%.



[1] If a capital requirement is applied on a 'solo' basis each banking entity within a group is required to meet it individually.

4.48 For banks' CCBs to provide effective pre-resolution loss-absorbing capacity which can be used without immediately raising concerns about a bank's viability, it is important that the market does not regard them as simply extending the hard minimum equity requirement. The authorities should make it clear that they do not consider the CCB as doing so, and give due regard to this when conducting stress-testing. If market perception will drive a bank to do all it can to avoid dipping into the buffer, it is likely to reduce lending to do so, if necessary. If a significant part of the banking system is similarly affected and responds in the same way at the same time, a system-wide contraction in the supply of credit could result – even with the banking system well-capitalised. Hence the importance of communication from the authorities on this point.

4.49 Market perception plays a similarly important role in the operation of the counter-cyclical capital buffer. For this to work as intended, when the authorities remove a counter-cyclical buffer, banks need to be willing to maintain lending and let their capital ratios fall, if necessary. Responding to a shock by *reducing* capital levels will only be feasible if the market believes that a bank will remain well-capitalised after such a reduction. To achieve this, a bank has to have a sufficiently high level of equity such that after the removal of any counter-cyclical buffer and a reduction in its equity-to-RWAs ratio, its viability will not be called into question.

4.50 In addition to the practical constraints discussed above on the extent to which UK banks can be required to have higher levels of equity, there is also a legal issue. A draft legislative proposal published by the European Commission (EC) in July this year[28] – 'CRD IV' – provides for capital requirements to be 'maximum harmonised' throughout the European Union (EU). Maximum harmonisation seeks to prevent EU countries from setting capital requirements for their banks that are either below *or above* those prescribed in the regulation. (CRD IV is discussed in more detail in Box 5.1 in Chapter 5.)

4.51 The Commission's view is that countries should have the freedom to set higher capital requirements for their banks. If a country chooses to enhance the stability of its banking sector in this way, there will be a benefit, not a detriment, to other countries because of the international nature of financial markets. This is discussed in Box 4.6.

28 EC, 2011, *Proposal for a Regulation of the European Parliament and of the Council on Prudential Requirements for Credit Institutions and Investment Firms*. Available at: http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm.