House of Lords
House of Commons

Parliamentary Commission on Banking Standards

First Report

First Report of Session 2012–13

Volume I: Report, together with formal minutes

Volume II (written evidence) is available on the Commission's website, www.parliament.uk/bankingstandards, along with other oral and written evidence

Ordered by the House of Lords to be printed 19 December 2012
Ordered by the House of Commons to be printed 19 December 2012

HL Paper 98
HC 848
Published on 21 December 2012
by authority of the House of Commons
London: The Stationery Office Limited
£0.00

Parliamentary Commission on Banking Standards

The Parliamentary Commission on Banking Standards is appointed by both Houses of Parliament to consider and report on professional standards and culture of the UK banking sector, taking account of regulatory and competition investigations into the LIBOR rate-setting process, lessons to be learned about corporate governance, transparency and conflicts of interest, and their implications for regulation and for Government policy and to make recommendations for legislative and other action.

Current membership

Mr Andrew Tyrie MP (Conservative, Chichester) (Chairman)
The Lord Bishop of Durham (Non-Affiliated)
Mark Garnier MP (Conservative, Wyre Forest)
Baroness Kramer (Liberal Democrat)
Rt Hon Lord Lawson of Blaby (Conservative)
Mr Andrew Love MP (Labour/Co-operative, Edmonton)
Rt Hon Pat McFadden MP (Labour, Wolverhampton South East)
Rt Hon Lord McFall of Alcluith (Labour/Co-operative)
John Thurso MP (Liberal Democrat, Caithness, Sutherland and Easter Ross)
Lord Turnbull KCB CVO (Crossbench)

Powers

The Commission has the power to require the submission of written evidence and documents, to examine witnesses, to meet at any time (except when Parliament is prorogued or dissolved), to adjourn from place to place, to appoint specialist advisers, and to make Reports to both Houses. The Commission has power in the appointment of a Chairman.

Publications

The Reports and evidence of the Commission are published by The Stationery Office by Order of the House. All publications of the Commission (including press notices) are on the Internet at http://www.parliament.uk/bankingstandards.

Commission staff

The following parliamentary staff are currently working for the Commission:

Colin Lee (Commons Clerk and Chief of Staff), Adam Mellows-Facer (Deputy Chief of Staff), Richard McLean (Lords Clerk), Lydia Menzies (Second Clerk), Robert Law (Commission Specialist), Jay Sheth (Commission Specialist), Gavin Thompson (Commission Specialist), James Abbott (Media Officer), James Bowman (Senior Committee Assistant), Claire Cozens (Senior Committee Assistant), Daniel Moeller (Committee Assistant), Ann Williams (PA to the Chief of Staff) and Danielle Nash (Committee Support Assistant).

The following staff are currently on secondment to the Commission from outside Parliament:

Philip Airey , Paul Brione, Suvro Dutta, Oonagh Harrison, Sadiq Javeri, Zoe Leung-Hubbard, Mayur Patel, Julia Rangasamy, John Sutherland, Greg Thwaites and Elizabeth Wilson.

Contacts

All correspondence should be addressed to the Clerks of the Parliamentary Commission on Banking Standards, 14 Tothill Street, London SW1H 9NB. The telephone number for general enquiries is 020 7219 8773; the Commission's email address is bankingstandards@parliament.uk.

Footnotes

In the footnotes of this Report, references indicated by 'Q' and followed by a question number refer to oral evidence taken by the Commission. Transcripts of this oral evidence and oral evidence taken by the Commission's panels are available at http://www.parliament.uk/business/committees/committees-a-z/joint-select/professional-standards-in-the-banking-industry/publications/.

References indicated by 'Ev w' followed by a page number refer to written evidence published by the Commission in the second volume. This second volume and other written evidence taken by the Commission and its panels is available at the above address.

Contents

Report

Page

Summary 5

1 Introduction 9
- Background 9
- The Government's proposals 10
  - Overall approach 10
  - The five exceptions 11
  - The next steps 12
- Scope of this Report and conduct of our work 12

2 The context 14
- The banking crisis of 2007 and 2008 and its costs 14
- Why bank failure is so difficult 15
- The implicit guarantee and its effects 16
- Reforms already underway 18

3 Possible approaches to structural separation 21
- Introduction 21
- The case for structural separation 21
- The case against structural separation 25
- The overall case for separation 27
- Ring-fence proposals 27
  - Introduction 27
  - The ICB ring-fence 27
  - The Liikanen proposals 28
- Full structural separation 28
  - Introduction 28
  - The Volcker rule 29
  - Other models of full structural separation 29
- Summary of separation options 30

4 How the draft Bill proposes to give effect to structural separation 31
- Introduction 31
- Setting the location of the ring-fence 31
- Setting the height of the ring-fence 33

5 Challenges to the durability of structural separation 35
- Introduction 35
- Complexity and financial innovation 35
- The influence of banks on politicians and regulators 36
- The next banking crisis 39

6 Structural separation in the first instance 41
- The starting point 41

Contagion, diversification and cost 41
Culture and standards 43
Permeability 43
Market-driven separation 44
European law 45
International context 45
Conclusions 46

7 The components of a workable framework 49
Introduction 49
Reducing the risk of failure 49
Making banks more resolvable 49

8 The timetable for ring-fencing 53
Alignment with European initiatives 53
The Government's proposed timetable 54
The legislative context 56
The balance between primary and secondary legislation 57
Conclusions 59

9 Reinforcing the ring-fence 61
Introduction 61
Objectives in primary legislation 61
Regulatory judgement 63
Conditions on the exercise of certain delegated powers 64
Determining the height of the ring-fence 64
Scrutiny 66
Electrifying the ring-fence 69
Evidence received 69
Relevant existing and prospective powers 71
Conclusions 72
Reserve powers in respect of individual banking groups 73
Review mechanism 74

10 Specific issues on ring-fence implementation 77
Introduction 77
Derivatives 77
The issue 77
Risks arising from derivatives 78
The customer benefit 79
Conduct issues 81
Defining "simple" derivatives 81
Conclusions 83
The de minimis exemption 85
The large deposit exemption 87
Geographical restrictions 88
Retail and SME lending 89
Independence and governance of the ring-fenced bank 91
Relationship between the ring-fenced bank and the holding company 95

Liabilities 95

11 Capital and loss absorbency 97

Introduction 97

Bail-in 97

PLAC 101

The main PLAC requirements 101

Proposed exemption from PLAC requirements 102

Exemption from PLAC requirements: burden of proof 103

Conclusions on the PLAC exemption 105

Accountability for use of powers relating to loss absorbency 105

Depositor preference 107

The concept of depositor preference 107

Arguments for insured depositor preference 108

Extending depositor preference beyond insured deposits 108

Potential problems with depositor preference 110

Conclusions 112

Leverage ratios 112

12 Fees to meet Treasury expenditure 118

Conclusions and recommendations 120

Formal Minutes 137

Witnesses 138

List of published written evidence 140

Summary

Separation that can stand the tests of time

Investigations into LIBOR have exposed a culture of culpable greed far removed from the interests of bank customers, corroding trust in the whole financial sector. The separation of deposit-taking from certain investment banking activities can offer benefits not just for financial stability, but also in helping to address the damage done to standards and culture in banking. The Government has proposed a ring-fence to achieve separation, but any ring-fence risks being tested and eroded over time. Pressure will come from many quarters. Any new framework will need to be sufficiently robust and durable to withstand the pressures of a future banking cycle. The precautionary approach of regulators will come under pressure from bank lobbying, possibly supported by politicians. Additional steps are essential to provide adequate incentives for the banks to comply not just with the rules of the ring-fence, but also with their spirit. In the absence of the Commission's legislative proposals to 'electrify' the ring-fence, the risk that the ring-fence will eventually fail will be much higher.

Electrifying the ring-fence

The Commission recommends that the ring-fence should be electrified – that banks be given a disincentive to test the limits of the ring-fence. This should take the form of two measures, set out in statute from the start, which could lead to full separation. First, if the regulator has concluded that the conduct of a banking group is such as to create a significant risk that the objectives of the ring-fence would not be met in respect of a particular bank, it should have the power (subject to a Treasury override) to require a banking group to implement full separation. Second, there should be a periodic, independent review of the effectiveness of the ring-fence across all banks, with the first such review to take place four years after implementation. Each review should be required to determine whether ring-fencing is achieving the objectives set out in legislation, and to advise whether a move to full separation across the banking sector as a whole is necessary to meet those objectives.

The approach to legislating

The draft Bill relies too heavily on secondary legislation, the absence of drafts of which has seriously impeded the Commission in assessing the Government's reforms. The jury is still out on the question of how faithfully the Bill will implement the ICB recommendations. Furthermore, reliance on secondary legislation reinforces the risks to the durability of the ring-fence. It creates uncertainty for the regulators who will be charged with making the new framework operational and for the banks required to operate within it. The draft Bill proposes to leave the Government with too much scope to redefine the location of the ring-fence arbitrarily. Not only is the scrutiny provided for this inadequate, it will also provide an incentive for bank lobbying. The powers to re-define the ring-fence through secondary legislation need to be subject to more rigorous scrutiny, with changes to the location of the ring-fence to be considered by a small ad hoc joint committee of both Houses of Parliament before formal measures are brought forward.

The independence of ring-fenced banks

The draft Bill does not make adequate provision to ensure the independence of ring-fenced banks from other parts of the same banking group. Several steps must be taken to reinforce that independence. The discretion granted to the regulator to set the rules on this is too great, as the regulators themselves have noted. Their mandate should be defined more clearly. The regulator should have a duty of ensuring independence for the ring-fenced bank in respect of governance, risk management, treasury management, human resourcing, capital and liquidity. An element of conflict between the duties of the directors of the ring-fenced bank to that entity and their duties to the wider group may be unavoidable, and this will constitute a permanent challenge for any structural solution which falls short of full structural separation. There should be a legal duty on directors to preserve the integrity of the ring-fence. The regulator should have the power, which the Commission expects to be exercised, to require a sibling structure between a ring-fenced and non-ring-fenced bank, with a holding company, so as to prevent a non-ring-fenced bank owning a ring-fenced bank.

Limits on derivatives and the ring-fence

The sale of derivatives within the ring-fence poses a risk to the success of the ring-fence. The possible cost to customers from excluding derivatives, combined with proposed measures to mitigate this risk mean that there is a case in principle for permitting the sale of simple derivatives within the ring-fence. However, this should be subject to adequate safeguards against mis-selling. "Simple" derivatives should be defined in a way which is limited and durable. In addition to the elements of a "simple" derivative already identified by the Treasury, it is essential that the size, maturity and basis of simple products should be limited to hedging the underlying client risk. A large derivatives portfolio would still pose an unacceptable risk to the stability and resolvability of ring-fenced banks, even if it is supposedly hedged and collateralised. The Government should also impose an additional cap on the gross volume of derivative sales for ring-fenced banks in legislation.

Bail-in that works

A ring-fence alone does not make banks resolvable. Without wider reforms, it is possible that a ring-fence would simply result in one too-big-to-fail bank becoming two such banks, the failure of either of which would require taxpayer support to avoid major disruption. The challenge of resolving non-ring-fenced banks also needs careful attention. Bail-in will be a crucial tool for the resolution of banks. Concerns remain about the design of a bail-in regime and whether it will provide confidence that the authorities would use their powers in the event of a crisis. Parliament will need assurance that bail-in is not a paper tiger, as will the markets. This assurance should be based on a regular report to Parliament on the development and subsequent operation of bail-in by the Bank of England.

Capital and leverage

It is essential that the ring-fence should be supported by tougher capital requirements, including a leverage ratio. Determining the leverage ratio is a complex and technical decision, and one which is best made by the regulator. The Financial Policy Committee (FPC) cannot be expected to work with one hand tied behind its back. The FPC should be given the duty of setting the leverage ratio from Spring 2013. The Commission would expect the leverage ratio to be set substantially higher than the 3 per cent minimum required under Basel III.

Our next steps

This Report is only the first step in the Commission's work to identify steps to tackle the crisis in banking standards and culture. In the New Year, the Commission will return to a number of issues arising from this Report, including:

- The case for prohibiting groups containing a ring-fenced bank from engaging in proprietary trading, and in particular the contribution that this could make to the changes needed to banking culture and standards;
- How the structural changes will affect standards and culture in the long run;
- How to assess bank suggestions that setting the necessary standards for banking in UK might lead to a flight abroad;
- Whether the sale of derivatives inside the ring-fence has a bearing on measures to prevent future mis-selling of such products; and
- The wider issues of competition and transparency raised by the ICB.

The Commission will also consider further the themes of:

- How banks compete;
- How banks run themselves;
- How banks are supervised and regulated;
- How the law, including criminal and civil sanctions, applies to banks and bankers.

1 Introduction

Background

1. Public confidence in bankers and banking has been shaken to its roots. Certain conduct in wholesale markets, for example in relation to the London Interbank Offered Rate (LIBOR), has exposed a culture of culpable greed far removed from the interests of bank customers, at least among some market participants. The systematic mis-selling of a range of retail products, over a number of years, on a scale which is only now becoming apparent, has reinforced the impression of a culture across the banking sector which viewed the customer as a short-term source of revenue rather than a long-term client. The bank failures and weaknesses in 2007 and 2008 required a massive injection of taxpayers' money, yet the bankers and bank creditors who had benefited the most in the years leading up to that crisis were seen to have suffered little, if at all, from the consequences.

2. When the Financial Services Authority (FSA) set out the full-scale of wrong-doing within Barclays in respect of LIBOR, there was a widespread public sense that the cumulative banking scandals had reached a point at which a specific inquiry was warranted. The two Houses of Parliament then established this Commission to consider and report on professional standards and culture in the UK banking industry.

3. We have considered, and will continue to consider, many aspects of the crisis in banking standards and culture and the steps to tackle the crisis which are either underway or still required. Our aim is to help answer the question of how the banking system can properly serve the wider economy. We have identified five main themes for possible reform:

- **How banks are structured:** the possible options to change the structure of banks to strengthen banking standards and change culture, as well as to meet the objectives of structural reform;
- **How banks compete:** the steps that might be taken to create a more competitive banking market and have one that responds better to its customers and to the well-being of society, which will be featured more fully in our final Report;
- **How banks run themselves**: the steps that banks themselves might take to change the ways bankers are trained, incentivised, led and managed in ways that change the culture for the better and raise standards;
- **How banks are supervised and regulated:** the steps to be taken by the supervisors and regulators (and by those to whom they are accountable) to ensure that the actions they take promote and incentivise the right approach and culture in banks;
- **How the law, including criminal and civil sanctions, applies to banks and bankers**: the ways in which changes in the law or its enforcement could re-balance the incentives on bankers and change the culture and standards of banking for the better.

4. Structural changes to UK banks may serve as part of the way forward in relation to banking standards and culture. With that in mind, the Government asked this Commission to conduct pre-legislative scrutiny of the draft Financial Services (Banking

Reform) Bill. When the motion establishing the Commission was moved in the House of Commons on 16 July 2012 by the then Leader of the House of Commons, the Rt. Hon. Sir George Young MP, he clarified that pre-legislative scrutiny of the draft Bill would be included within our work.[1] Our pre-legislative scrutiny work has led to an initial focus on banking structure and related issues. It is these issues which are dealt with in this first report from the Commission. The broader questions of standards, culture and corporate governance will be dealt with in greater detail in our final Report to be published in the New Year.

The Government's proposals

Overall approach

5. The Government's proposals, which are the focus of this Report, are contained in a draft Bill and an accompanying policy paper published in early October 2012.[2] The draft Bill and policy paper principally give effect to most of the recommendations of the Independent Commission on Banking (the ICB). The ICB was established by the Government in June 2010 to consider reforms to the UK banking sector. The ICB published a Final Report in September 2011.[3] The main recommendations of the ICB are summarised below:

- **Structure:** Banking activities, where continuous provision of service is vital to the economy and to a bank's customers, should be ring-fenced from other activities, making it easier to resolve banks that get into difficulty, without the provision of taxpayer-funded support.[4]

- **Capital and loss absorbency:**

    - Ring-fenced banks should maintain higher ratios of capital to assets than required by existing international standards;

    - The UK authorities should be able to impose losses on unsecured debt (bail-in bonds) when a bank gets into difficulty and on all other unsecured liabilities if a bank in difficulty needs to enter a resolution procedure;

    - Further loss absorbing capacity, in the form of capital and bail-in bonds, should be required of UK-based banks deemed to be global, systemically important banks;

    - In insolvency, all insured depositors should rank ahead of unsecured creditors and creditors secured only with a floating charge.[5]

- **Competition and transparency:**

    - The Prudential Regulatory Authority (PRA) and the Office of Fair Trading (OFT) should review the levels of capital and liquidity required from applicants for a

1 HC Deb, 16 July 2012, col 797 [Commons Chamber]

2 HM Treasury, *Sound banking: delivering reform*, Cm 8453, October 2012

3 Independent Commission on Banking, Final Report, September 2011

4 *Ibid.*, para 9.2

5 *Ibid.*, para 9.3

deposit taking licence to ensure they do not unnecessarily limit new entrants to the banking market;

- A current account redirection service should be established by September 2013 to smooth the process of switching current accounts for individuals and small businesses;

- The draft operational objective of the Financial Conduct Authority (FCA) covering efficiency and choice should be replaced with an objective to "promote effective competition" in markets for financial services;

- The OFT and the FCA, should work with the banks to improve transparency across all retail banking products.[6]

6. The Government published a white paper in June 2012, setting out how it intended to implement the ICB recommendations.[7] Following consultation, the Government published an overview in October 2012 of responses, as well as the draft Bill.[8] Other measures recommended by the ICB on capital, competition and transparency are being taken forward largely by other means. Several elements of the ICB's recommendations designed to strengthen the ability of banks to absorb losses are being dealt with at a European level.[9]

The five exceptions

7. The draft Bill and the associated policy measures are intended broadly to give effect to ICB recommendations on structure, capital and loss absorbency, with five exceptions, identified by Sir John Vickers and confirmed by the Chancellor of the Exchequer,[10] and considered in the course of this Report, as follows:

- Smaller banks are proposed to be exempt from the ring-fencing requirement;

- The leverage ratio for ring-fenced banks is not proposed to be increased in line with additional capital requirements;

- Ring-fenced banks are proposed to be allowed to sell derivatives as principal, subject to certain conditions;

- The overseas operations of large banks might be able to be exempted from requirements to hold additional capital; and

- Ring-fenced banks are proposed to be allowed to own non-EEA assets in certain circumstances.

6 Independent Commission on Banking, Final Report, September 2011, para 9.4

7 HM Treasury, *Banking reform: delivering stability and supporting a sustainable economy*, Cm 8356, June 2012

8 HM Treasury, *Sound banking: delivering reform*, Cm 8453, October 2012, para 1.4

9 *Ibid.*, para 2.3

10 Qq 786-8 [Sir John Vickers]; Qq 1061, 1074, 1075, 1094, 1100

The next steps

8. The draft Bill constitutes only part of the Bill due to be introduced to Parliament early in 2013.[11] The provisions on payments systems and the reform of the Payments Council in response to recommendations of the Treasury Committee have not been published for pre-legislative scrutiny.[12] Similarly, changes to the governance structure of the Financial Services Compensation Scheme will be made by the Bill, but have not been published in draft.[13]

9. The new Bill will be the most appropriate vehicle for giving effect to the wider recommendations of this Commission in our final Report in the New Year. The Financial Secretary to the Treasury has given an assurance that the Government will consider broadening the scope of the banking Bill in the New Year to give effect to the recommendations of the Commission in our final Report.[14] Other reforms to the regulation of financial services and the identification of systemic risks have been brought forward in the Financial Services Bill, which has just completed its Parliamentary stages.[15] We consider how these various legislative initiatives interact later in this Report.[16]

Scope of this Report and conduct of our work

10. In this Report we consider the proposals flowing from the ICB's recommendations relating to structure, capital and loss absorbency, including those which do not give rise to measures in the draft Bill. We also make one recommendation in relation to a separate provision of the draft Bill on fees. We will return to those aspects of the ICB Report which relate to competition and transparency in our final Report in the New Year.

11. It is customary for ad hoc joint committees appointed to consider draft Bills to be given at least twelve sitting weeks to complete their work. The Commission was required to report on this complex legislation in less than ten sitting weeks after the publication of the draft Bill. The Commission was also being asked to undertake this task in addition to our principal responsibility of reporting on banking standards and culture, and we have had to combine our work on the draft Bill with taking evidence in pursuit of our principal responsibility.

12. **The timetable for scrutinising the draft Bill which was arbitrarily dictated by the Government has meant that we have been unable to do justice to all of the issues which arise out of the draft Bill and related policy measures. We are concerned that the Government has constrained the ability of Parliament to conduct full scrutiny of a Bill of such vital importance.**

13. The Commission held twelve evidence sessions focused in whole or in part on structural issues, taking evidence from a range of witnesses, including Paul Volcker, former

11 HM Treasury, *Sound banking: delivering reform*, Cm 8453, October 2012, para 1.5

12 Treasury Committee, *The future of cheques,* Eighteenth Report of Session 2010–12, HC 1147, paras 46-47

13 HM Treasury, *Sound banking: delivering reform*, Cm 8453, October 2012, paras 2.63-2.67

14 HC Deb 10 Dec 2012 : Column 74 [Commons Chamber]

15 HM Treasury, *Sound banking: delivering reform*, Cm 8453, October 2012, para 1.2

16 Chapter 8

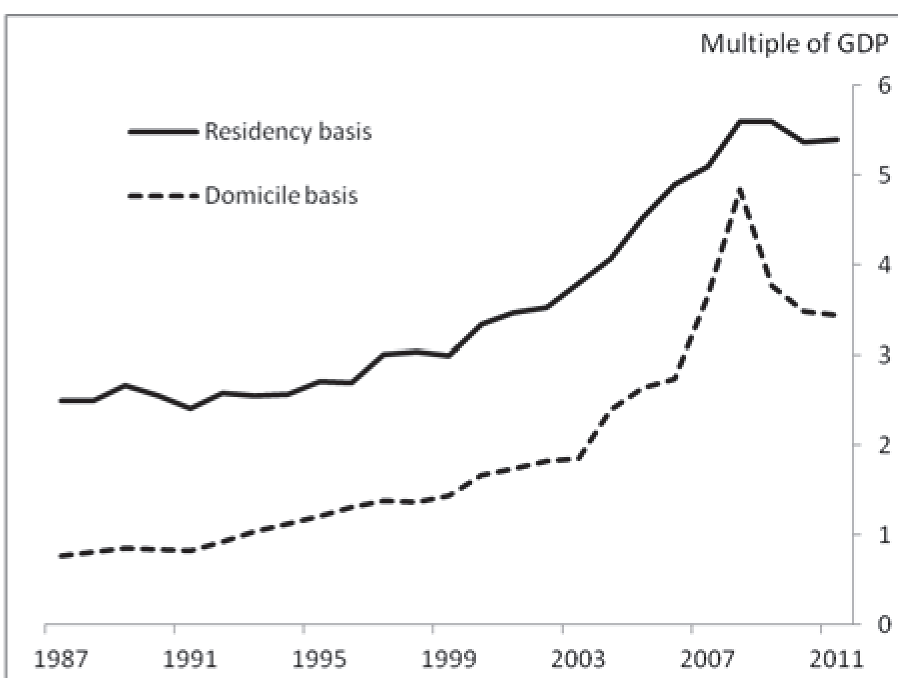
Chairman of the US Federal Reserve, Erkki Liikanen, Chair of the High-level Expert Group on structural bank reforms established by the European Commission, Sir John Vickers and Martin Taylor (both former members of the ICB), Lord Turner of Ecchinswell, Chairman of the FSA, Sir Mervyn King, Governor of the Bank of England, and the Rt. Hon. George Osborne MP, Chancellor of the Exchequer. The Commission also received written evidence of considerable value. The Commission is most grateful to all those who submitted evidence, as well as to the Specialist Advisers for this work, Bill Allen, John Willman and Professor Geoffrey Wood.[17]

17 Bill Allen and Professor Geoffrey Wood declared interests, relevant to the Commission's work, on 29 August 2012. John Willman declared his interests, relevant to the Commission's work, on 12 September. All three declarations of interest are available at http://www.parliament.uk/business/committees/committees-a-z/joint-select/professional-standards-in-the-banking-industry/formal-minutes/ The Commission has also appointed other Specialist Advisers in relation to other aspects of its work.

2 The context

The banking crisis of 2007 and 2008 and its costs

14. The starting point for an understanding of the issues considered in this Report is the crisis that engulfed the UK banking sector from mid-2007 onwards. In the decade leading up to that crisis, UK-based banks expanded their balance sheets rapidly (see figure 1), for many of them leading to a reduction in credit standards. To grow their balance sheets, the banks had become reliant on funding from short-term wholesale markets. In the Summer of 2007, financial markets across the world entered a period of turbulence sparked off by a downturn in the US housing market. As a result, lending between banks and within the wider wholesale market fell sharply and eventually stopped. In September 2007, Northern Rock ran into problems, in part because it was heavily dependent on wholesale markets to fund its activities; this led to the bank being nationalised in February 2008. During the summer of 2008, financial markets remained dysfunctional and the global economy began to slow down. The collapse of Lehman Brothers in September 2008 caused widespread panic across the global financial sector, with dramatic consequences for several UK-based banks made vulnerable by a varying degree of recklessness and imprudence during the preceding years. The crisis revealed poor lending decisions, excessive leverage, weak risk management and vulnerable business models in banks involved in both retail and investment banking activities.



Source: 'residency basis' is UK resident banks' assets less derivatives, i.e. ONS series (NNST-NNUE)/YBHA. 'Domicile basis' is the sum of total liabilities and equity for major UK banks in table 3.01 of BBA Annual Abstract of Statistics, divided by ONS series YBHA

15. During the crisis, the UK authorities carried out a range of interventions to:

- increase liquidity in the banking system;
- facilitate resolutions of smaller financial institutions that got into difficulties; and

- improve solvency and liquidity, including capital injections into RBS and Lloyds Banking Group and Government guarantees of bank assets and liabilities.

As at March 2012, the total outstanding support stood at £228 billion, down from the total a year before of £456 billion and a peak of £1.2 trillion. Of the £228 billion, £109 billion constituted outstanding guarantee commitments and £119 billion was provided as cash.[18]

16. The major social costs of the crisis did not result directly from the costs of bailouts of the banks, but rather from the recession and the ensuing rise in unemployment that the banking crisis caused. More than four years after the collapse of Lehman, the level of real GDP is still 3 per cent below its pre-crisis peak and more than 13% below its trend of the decade before the crisis.[19] Unemployment has risen by nearly one million. The public finances have deteriorated accordingly. As Lord Turner noted in evidence to the Joint Committee on the draft Financial Services Bill in November 2011:

> It is very important for us to understand that the big harm which was done by the banking crisis of 2008 to UK citizens was not the explicit cost of new equity investment. The big harm was the macro-economic instability. Although it is important to have a mechanism which avoids the possibility of future public support for banks which would otherwise fail, it is even more important that we have created mechanisms whereby these banks are stable institutions able to keep a stable supply of credit through to the real economy.[20]

Why bank failure is so difficult

17. When large banks across the world ran into trouble during the crisis, in nearly every country its government stepped in to prevent them from failure and insolvency. As discussed above, in the UK this led to unprecedented cost and contingent liability for the Government. In some countries, in particular Ireland, the costs from preventing bank failures contributed to a sovereign debt crisis. In 2010 alone, the Irish deficit reached 32 per cent of GDP, of which 20 per cent of GDP was due to State support to the banking sector.[21] In June 2012, in response to mounting losses on real-estate lending in Spanish banks, the Eurogroup agreed to provide up to €100bn to support bank restructuring, on top of existing support from the Spanish government.[22] The reason that governments felt the need to step in was that, however undesirable it was to put public funds into bailing out the banks, letting them go into insolvency was felt to have carried an even greater cost. There are three main reasons why insolvencies in the banking sector are so problematic, in comparison to most non-financial firms:

- **Banks provide essential services** such as current accounts, overdrafts and the payment system in general on which the rest of the economy relies. Any interruption in these services, no matter how brief, would risk causing widespread damage. Unlike other

18 HM Treasury, *Annual Report and Accounts 2011–12*, HC (2010–12) 46, p 91

19 Bank of England, Speech by David Miles to Society of Business Economists Annual Conference, 24 May 2012

20 Oral evidence taken before the Joint Committee on the Draft Financial Services Bill on 10 November 2011, HC (2010–12)1447, Q 941

21 Treatment of Special Bank Interventions in Irish Government Statistics, Central Bank of Ireland Quarterly Bulletin October 2011

22 Eurogroup statement on Spain, 9 June 2012

firms providing essential services, such as utility companies, these services cannot be carried on whilst the business's balance sheet is being restructured. For banks, the balance sheet *is* the operating business: its creditors are its customers. Bank deposits are valuable because they are available on demand to make payments.

- **Insolvency destroys value.** The losses involved in banking sector insolvencies are much greater than for non-financial companies. The greater leverage in banks implies bigger balance sheets and larger creditor exposures. Furthermore, unlike other corporate insolvencies, when the operating business can often be maintained or sold to maximise value, in the case of a bank, all that can often be done is to liquidate the assets. Combined with bank leverage this can magnify creditor losses, as the realisable value of assets in a forced sale, or crisis situation, is often very different from their carrying value.

- **Disorderly failure can cause contagion** because banks in general are reliant on the confidence of depositors and other creditors to keep operating. Allowing one bank to fail in a disorderly way could spread panic among creditors of other similar institutions and cause a wider financial crisis. For systemically important firms, the fact that many other financial firms will suffer losses or disruption as creditors and counterparties of the failed bank can be a direct contagion channel, as was experienced in the case of Lehman Brothers.

The implicit guarantee and its effects

18. Before the crisis, it appears to have been assumed among bankers and bank investors that large banks were too important to be allowed to be put into insolvency and that without insolvency there was no workable mechanism for imposing losses on creditors. As a result, if large banks got into trouble, governments would have to step in and would shoulder many of the costs. As the President of the Federal Reserve Bank of Minneapolis wrote in 2004, "too big to fail is a problem of credibility: creditors of large banks do not believe that the government will make them bear all their losses from bank failure".[23]

19. When the crisis hit, this perception of an "implicit guarantee" was confirmed by the bail-outs that were given to most failing banks in the forms of generous loans, government guarantees or capital injections, all of which resulted in a cost or risk to public funds, and spared creditors of the banks from bearing the full cost of their mistakes. The result of this was not only to place a huge burden on the taxpayer—something particularly important to a country such as the UK with a banking sector equivalent to more than four times annual GDP—but also to force the realisation that an implicit guarantee would remain unless action was taken. As Sir Mervyn King warned in a 2009 speech, "The massive support extended to the banking sector around the world, while necessary to avert economic disaster, has created possibly the biggest moral hazard in history".[24]

20. The moral hazard caused by an implicit guarantee was highlighted by the ICB in their interim report:

23 Gary Stern and Ron Feldman, *Too Big to Fail*, (Washington, DC, 2004)

24 Bank of England, Speech by Sir Mervyn King to Scottish business organisations, 20 October 2009

> As a result of the government guarantee, creditors will be prepared to provide cheap funding to a systemically important bank that conducts risky activities, rather than constraining such risk-taking by demanding a higher return to compensate for the risks. This is not only inequitable, but also further incentivises excessive risk-taking by banks.[25]

The size of the implicit guarantee in the UK and the extent of its effect on bank risk-taking provide the background against which the proposed reforms in this area should be judged. Andy Haldane estimated in 2010 that the size of the average annual subsidy for the top five UK banks between 2007 and 2009 was over £50 billion—roughly equal to UK banks' annual profits prior to the crisis.[26] There is a lack of consensus about how best to measure the implicit guarantee, although there is a consensus that such a guarantee exists, and that it should be eliminated over time. After taking evidence on the ICB's interim report, the Treasury Committee concluded:

> The ICB, using the research of others, places the figure at considerably in excess of £10bn [per annum], but has not published detailed analysis as to how it arrived at this figure. The banks meanwhile have been reluctant or unable to come up with any credible figures. We have concluded there is an implicit subsidy. There is a need for at least some measure of agreement between the banks and the ICB about the minimum size of the implicit subsidy, now and in the past, as well as an agreed analytical framework for measuring the subsidy. The need for consensus in this area is critical because of the ICB's goal, shared by the large banks, to eliminate this subsidy. Without an agreed framework for measuring the size of the subsidy it will be difficult to assess when success in this area has been achieved.[27]

21. Sir Mervyn King pointed out in 2009 that there are only two logical ways to tackle the problem of banks that are "too important to fail":

> One is to accept that some institutions are "too important to fail" and try to ensure that the probability of those institutions failing, and hence of the need for taxpayer support, is extremely low. The other is to find a way that institutions can fail without imposing unacceptable costs on the rest of society.

He went on to say that the first solution, while worth trying, should not be relied on, warning "The belief that appropriate regulation can ensure that speculative activities do not result in failures is a delusion".[28] Implementing the second solution, in other words reaching a position where banks can fail and be resolved, in practice means a combination of two things:

- Developing resolution tools to apply to a failing bank, which allow its essential services to be continued without having to rescue the whole bank; and

25 Independent Commission on Banking, Interim Report, April 2011, p 20

26 Andy Haldane speech, "The $100 billion question", 30 March 2010

27 Treasury Committee, Nineteenth Report of Session 2010–12, Independent Commission on Banking, HC 1069, para 22

28 Bank of England, Speech by Sir Mervyn King to Scottish business organisations, 20 October 2009

- Making structural or operational changes to banks, to facilitate the application of such tools or to reduce the societal costs from a failure, managed with the use of such tools, to an acceptable level.

Reforms already underway

22. On the first solution, of reducing the probability of large banks failing, there has been significant strengthening of international capital requirements. Changes have been made both to the ratio of capital held by banks and that ratio's calculation. When fully brought into force, these changes will bring about around a five-fold increase in bank capital compared to levels before the crisis.[29] New liquidity requirements are also being introduced under the Basel III regime to make banks more resistant to the kind of liquidity shocks which occurred during the crisis. These measures are already beginning to have an effect. Finally, the Financial Services Act 2012 introduces a new framework for financial regulation and supervision in the UK, including the creation of the Prudential Regulatory Authority and the Financial Policy Committee.

23. One of the first reforms relating to resolution during the crisis was the extension of deposit insurance. This was first extended to cover 100 per cent of deposits below £35,000, in response to the run on Northern Rock. The pre-existing partial guarantee[30] had not prevented a run. Later it was extended to 100 per cent of deposits up to £85,000.[31] The Financial Services Compensation Scheme (FSCS) was also given a target: it should be able to pay out to most depositors within seven days. The FSCS has worked with banks to develop the data and systems needed to support this.[32] A new "Bank Insolvency Procedure" was introduced in the Banking Act 2009 to support rapid payout in the case of banks placed into insolvency. These measures, taken together, ensure that for smaller banks, where the main essential service provided is deposit-taking, insolvency can be a more orderly process. It should have less impact on ordinary customers, most of whom will get all of their money bank very rapidly. The Chancellor referred to a failure in 2011 that was the first to be managed under this process:

> It was unremarked on that I allowed an institution to fail. I think it was at the end of last year. Ironically, it was the Southsea Mortgage and Investment Company, which was based in Hampshire, and some depositors lost their money above £85,000. We have demonstrated, and we wanted to demonstrate, that we are in the business of protecting £85,000 of deposits, and not beyond that.[33]

However, this bank had only about 250 customers, of whom only 14 had deposits above the £85,000 level.[34] This solution cannot necessarily be applied to larger bank failures. As Sir Mervyn King pointed out:

29 Bank of England, Speech by Sir Mervyn King to Scottish business organisations, 20 October 2009

30 Prior to 1 October 2007, the FSCS covered 100 percent of the first £2,000 of deposits but only 90% of the next £33,000.

31 Financial Services Compensation Scheme, Deposit Limits, www.fscs.org.uk

32 Financial Services Compensation Scheme, Single Customer View,www.fscs.org.uk

33 Q 1102

34 "Southsea bank declared insolvent", *The Guardian*, 16 June 2011

> If you have a very small bank that fails and only 12 people hold deposits above £85,000, in three different constituencies, I am convinced that the Chancellor will decide not to intervene. If you have thousands of people involved, I think the pressure on the Chancellor will be enormous.[35]

24. The "Special Resolution Regime" created by the Banking Act 2009 therefore also created "pre-insolvency stabilisation tools" for dealing with a failing bank. The Bank of England, as the body charged with reorganising banks that get into difficulties—the "resolution authority"—now has powers to break up failing banks up and transfer the pieces which provide essential services to private sector purchasers or a bridge bank (a temporary bank set up as a subsidiary of the Bank of England), keeping these parts running but leaving the rest of the bank and any remaining creditors to enter a modified form of insolvency. These powers were used in the case of the Dunfermline Building Society to move the deposits and some matching assets to the Nationwide Building Society.[36]

25. However, the transfer powers can still result in a cost or risk to the taxpayer. Additionally, it is widely recognised that these powers would be difficult to deploy in the case of a large, complex bank. Andrew Gracie, the head of the Special Resolution Unit at the Bank of England, has acknowledged this:

> these transfer powers do not necessarily offer a fully effective solution in the face of the failure of a large, complex and international financial firm. The critical economic functions of a G-SIFI [Global Systemically Important Financial Institution] are intertwined legally, operationally and financially across jurisdictions and the firm's legal entities. As a result, it can be almost impossible to separate and transfer parts of a financial group to purchasers or a bridge in a short timeframe.[37]

26. The third stabilisation tool in the Banking Act 2009 is the last resort of Temporary Public Ownership. This allows the Treasury to seize the shares of a failing bank, which does not in itself stabilise the bank but does give the Treasury control and ownership to go alongside any other support that might be provided, such as a capital injection or a guarantee of the bank's debts. Use of this tool is a last resort which does not meet the objective of avoiding putting public funds at risk.

27. The Financial Services Act 2010 introduced a requirement for banks to prepare Recovery and Resolution Plans—sometimes referred to as "living wills"—in coordination with the FSA, in order to make them both less likely to fail and easier to resolve if they do. The "recovery" element of the plan requires a bank to identify in advance a menu of credible options for generating capital or liquidity in the event that it encounters stress. The "resolution" element requires a bank to provide the authorities with a range of legal, financial and operational information which would be useful in planning a resolution. The authorities can then consider likely resolution strategies, identify any potential barriers to successful resolution and, if necessary, require the bank to remove those barriers.[38]

---

35 Q 1176

36 Dunfermline Building Society, Financial Stability, www.hm-treasury.gov.uk

37 Bank of England, Speech by Andrew Gracie to International Association of Deposit Insurers' conference, 5 June 2012

38 Financial Services Authority, *Recovery and Resolution Plans*, Consultation Paper CP11/16

28. Recovery and Resolution Plans are still not a formal requirement for UK banks, because the FSA has yet to publish its final rules for their implementation.[39] Additionally, the resolution strategies that are being developed are currently limited by the tools described above. The Bank of England published a paper on 10 December 2012 which pointed out that developing strategies that could handle the orderly resolution of a systemic bank seemed likely to depend on reforms and tools which are still under development, including through the draft Bill:

> the authorities in the United States and the United Kingdom have been working together to develop resolution strategies that could be applied to their largest financial institutions. These strategies have been designed to enable large and complex cross-border firms to be resolved without threatening financial stability and without putting public funds at risk. [...]
>
> In the UK, the strategy has been developed on the basis of the powers provided by the [...] Banking Act 2009 and in anticipation of the further powers that will be provided by the European Union Recovery and Resolution Directive and the domestic reforms that implement the recommendations of the [...] Independent Commission on Banking.[40]

29. The Bank of England stressed to us that a number of further legal changes are required in order for their resolution strategies to become operational:

> The necessary wider reforms [for the delivery of the preferred resolution plans] are: full implementation of the Key Attributes across the G20 jurisdictions; within the EU, implementation of the RRD; and, within the UK, a widening of the scope of the Special Resolution Regime as set out in the Financial Services Bill currently before Parliament and the implementation of the ICB proposals in the Banking Reform Bill.[41]

39 "FSA publishes Recovery and Resolution Plan (RRP) update", FSA press notice 052/2012, 10 May 2012

40 Bank of England, *Resolving Globally Active, Systemically Important, Financial Institutions,* A joint paper by the Federal Deposit Insurance Corporation and the Bank of England, 10 December 2012

41 Ev w182

3 Possible approaches to structural separation

Introduction

30. Structural separation is designed to help create a workable framework for the operation of the reforms described in the previous chapter, as well as to bring wider financial stability benefits. This chapter rehearses the main arguments for and against structural separation and examines different approaches to separation. The approaches vary in where the line is drawn between retail and investment banking and what degree of separation is required between the retail and investment entities. In this chapter, "structural separation" is used as a generic term to describe the range of proposals that require separation in some form between different functions of banks, whether remaining within a bank group or being required to be conducted outside of it.

The case for structural separation

31. Without any form of structural separation, the banking market will include so-called 'universal banks', which combine retail, wholesale and investment banking. The starting point of the case for structural separation is often the view that if universal banks fail—for whatever reason—they are very difficult to resolve without posing a risk to the taxpayer or to financial stability. As the ICB put it:

> Universal banks are important providers of a number of critical economic services and so their disorderly failure has very high costs for society. Yet the size and complexity of universal banks made it impossible, in the recent crisis, for governments to maintain these services without providing taxpayer support to the whole financial institution. [...] UK banks are big enough for this to represent a real threat to the public finances.[42]

Andrew Bailey, Managing Director, Prudential Business Unit, FSA, suggested that the imperative to protect certain systemically important functions of banks, such as deposit-taking, forced the authorities to intervene to resolve the whole organisation, including those parts which were not systemically important:

> one of the biggest problems we have today with contemplating resolution of major banks is that we have a whole range of activities on the balance sheet of the same legal entity [...] Today, we would have to pursue a resolution approach that was driven by the highest priority within that set of activities, but it would effectively be a common resolution approach, because we would have no effective means of splitting things up.[43]

32. The ICB's final report argued that structural separation would make resolution of banks that get into trouble easier and less costly:

42 Independent Commission on Banking, Interim Report, April 2011, p 76

43 Q 983

> 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.[44]

This view was echoed by António Horta-Osório, Group Chief Executive of Lloyds Banking Group, who thought that "ring-fencing enhances the credibility of recovery and resolution mechanisms because it provides, *ex ante*, a separation between retail and investment banking".[45]

33. A second, consequential, benefit associated with structural separation between retail and wholesale banking is that separation reduces the benefits of the implicit guarantee for creditors of wholesale banks. Douglas Flint, Chairman of HSBC, told us of the problem in the recent crisis:

> the implicit guarantee certainly encouraged those who funded banks on the wholesale side to believe that they were taking less risk than the unsecured nature of their lending represented, and because they were prepared to lend to a greater extent and on finer terms than they might otherwise [have] done, that fund of cheaper money gave a pool of resource to bankers to make money from.[46]

Martin Taylor suggested that structural separation could help to reduce this problem:

> the ring-fence is intended to undermine the extension of the implicit Government guarantee to the whole banking organisation—that is, to allow the investment bank, as has been the case in the past, to raise money on the faith and credit, effectively, of the retail organisation. It is our belief that installing the ring-fence will prevent this from happening. If that is successful—and I believe it would be—you will prevent the investment bank from doing certain kinds of business that it was able to do in the pre-crisis years.[47]

Structural separation is thus intended to counteract any perception among creditors of the investment bank that they would be bailed out in a failure, and thus incentivise those creditors to be more prudent in extending credit. This in turn would make it more costly for investment banks to increase leverage and take excessive risks.

34. Third, structural separation may also have the benefit of preventing the possibility of contagion from investment banking operations to systemically important retail functions. For example, the ICB observed that "with integrated universal banking it may be harder to stop problems spreading from one part of the system to another — for example, from wholesale/investment banking to UK retail banking."[48] Although not all crises will originate on the investment bank side, wholesale market operations do have the potential to create problems which may then spill over. For example, RBS was dependent on

44 Independent Commission on Banking, Final Report, September 2011, p 9

45 Q 860

46 Q 453

47 Q 355

48 Independent Commission on Banking, Interim Report, April 2011, p 76

wholesale funding to finance its capital markets business, especially after its acquisition of ABN AMRO, an acquisition which, as the Treasury Committee has concluded recently, was a significant factor in the difficulties that RBS encountered.[49]

35. Fourth, some form of structural separation between retail and wholesale banks might be expected to make banks easier to manage. Andy Haldane, Executive Director for Financial Stability, Bank of England, made the point that "The evidence base is not encouraging about whether the biggest banks in the world can indeed manage themselves across the board".[50] He argued that:

> Ultimately, one of the by-product benefits of things such as structural measures would be to make the balance sheet somewhat simpler and more homogenous, and therefore somewhat easier for investors to value.[51]

Douglas Flint told us that, in his view:

> the real benefit of the ring-fence is that it will aid clarity within institutions and between the industry and the public in terms of better defining the roles of all the individual parts that are today in universal banks, so the separation will actually give greater clarity as to what individual parts of the bank are doing.[52]

36. Fifth, separation could result in higher levels of bank capital across the system. The ICB noted: "Universal banks generally hold less capital relative to assets than if they were separated. While this can provide an economic benefit in good times, it can heighten risk at times of general economic stress, when banking system resilience is most needed."[53] Sir John Vickers also pointed out that structural separation helpfully allowed higher capital requirements to be imposed on UK retail banks, without necessarily imposing the same requirement on investment banking operations, which would be more prone to regulatory arbitrage.[54]

37. Structural separation is also seen as bringing cultural benefits. Paul Volcker told us that his biggest concern about current arrangements was not the risks caused by having different types of banking side by side as such, but "the damage that it does to the culture of the whole institution".[55] He added that "trading operations and impersonal proprietary trading operations are simply different from a continual banking relationship."[56] Michael Cohrs expressed similar views in evidence more recently:

> if a bank is allowed to do proprietary trading, or proprietary investments, you will not have a culture that you like, because de facto, you are then competing with the client, and it is a heck of a lot easier to do proprietary work than it is to do client service. The best and the brightest within the institution will gravitate to the

49 Treasury Committee, Fifth Report of Session 2012–13, *The FSA's Report into the failure of RBS*, HC 640

50 Q 647

51 Q 636

52 Q 452

53 Independent Commission on Banking, Interim Report, April 2011, p 76

54 Qq 784, 795

55 Q 62

56 Q 64

> proprietary activity and we will end up where we have ended up, which is with bankers who sometimes do not understand right from wrong, or at least a pool of them.

Sir Alan Budd recalled the significantly different retail and investment banking cultures at Barclays in the late 1980s and the challenges he saw in integrating the two.[57] Andy Haldane said that "there was a gradual, but very clear, cross-contamination of cultures from the 1980s onwards".[58] Lloyds Banking Group noted that "investment banking has a different business model and culture as it is done deal by deal; retail and commercial banking is about relationship banking through the cycle".[59]Ana Botín, Chief Executive of Santander UK, told us that she believed that "having different subsidiaries helps to have a different culture".[60]

38. Some witnesses also suggested that the particular development of the universal banking model in the UK had changed the culture in a manner that influenced the way banks were led. Martin Taylor said:

> One of the big changes that have taken place in the past 10 years is that these organisations are now—or were until very recently, in the case of Barclays—all run by investment bankers. That is a big change; it was not the case in the 1980s or 1990s. I suppose that was done because boards had so much risk on the table in the investment bank, which they imperfectly understood, that they put someone in place who they knew could manage it, or at least understand what was going on.[61]

This view was echoed by Professor Kay:

> In the 1980s, what we saw in Britain was the retail banks taking over most of the other activities in the City, as jobbers, brokers and the like were acquired by retail banks. [...] Then there was the second round, which we have seen in the past 10 to 15 years, which worked the opposite way round, in that it was the investment bankers who took over the entire conglomerates and the retail banking activities were subordinated, essentially, to them. Until Diamond was removed at Barclays, we had essentially reached a position in which the top positions at British banks had been taken by people who had spent large amounts of time on the investment banking side of the business.[62]

39. One feature of the two different types of banking is in their compensation practices. Paul Volcker argued that:

> the compensation practices that crept in, and the very large compensation in the trading parts of banks, infected the culture of the institutions generally, so the

57 Memorandum from Sir Alan Budd, 8 October 2012

58 Q 588

59 Ev w86

60 Q 455

61 Q 358

62 Q 295

> lending offices dreamt things up—how to make a lot of money in the short run and get a big bonus.[63]

This mindset may have particularly affected the treasury functions in retail banks, whose role had historically been to fund safely profit-generating activity elsewhere in the business, but in the run-up to the crisis the treasury function increasingly became a profit-centre in its own right. Professor Kay said of his experience at Halifax in the 1990s: "I thought that the road to nemesis essentially began at the point at which it was decided that the treasury operations of the bank should be a profit centre rather than a service activity for the business of deposit taking and mortgage lending".[64]

The case against structural separation

40. Structural separation is viewed as imposing additional operational costs on banks, in addition to the higher funding costs that will result from the curtailment of the implicit guarantee. According to the Treasury, in the case of the proposed ring-fence, "there will be upfront transitional costs (such as establishing new subsidiaries) and ongoing costs of operating two entities rather than one (such as operating separate IT platforms)."[65] These costs are estimated to be in the range of £1.7 bn to £4.4 bn a year, with one-off transitional costs in the range £1.5 bn to £2.5 bn.[66] Some witnesses criticised the way the Treasury's impact assessment calculated these costs, suggesting the real figure could be higher. RBS said "Like the ICB's cost/benefit analysis before it, the impact assessment tends to apply a narrower and more selective filter for the estimated costs than for the putative benefits".[67]

41. In the view of some, the costs of structural separation outweighed the modest gains in terms of stability and resolution over and above what could be achieved by improvements in banks' capacity to absorb losses and associated measures to discourage risk-taking. RBS argued that ring-fencing would bring "at best modest incremental gains in resolvability over and above the more targeted measures already in train through the recovery and resolution planning process".[68] Stephen Hester, Chief Executive of RBS, said he did "not think [ring-fencing] will produce any safety benefits to the financial system or the UK",[69] while Peter Sands, Chief Executive of Standard Chartered, also argued that "it will not deliver a stability benefit, and it will be more expensive".[70] This was also the view of Barclays in written evidence to the Treasury Committee in October 2011 when they suggested that ring-fencing:

> has, at best, marginal benefits as a resolution tool over and above reforms already in place, underway, or in development, including the improvement and alignment of

63 Q 61

64 Q 294

65 HM Treasury, Sound banking: delivering reform, Cm 8453, October 2012, Annex B: Impact Assessment, para 20

66 *Ibid.*, para 27

67 Ev w110

68 Ev w101

69 Q 855

70 Q 859

resolution plans and powers and improvements to loss absorbency requirements for banks at the global level.[71]

42. Barclays had also disagreed in 2011 with the suggestion that structural separation insulated retail banks from external shocks.[72] This view was echoed in evidence to us by Peter Sands:

> The stability benefits are illusory, because what you are actually creating is more homogenous, less diversified entities that will have less resilience in times of stress.[73]

43. Some of those sceptical about the benefits of structural separation also point to the fact that destabilising losses can just as easily be concentrated on the supposedly "safe" side of a structural separation.[74] Thus, for example, the operations of several banks which failed or needed support during the crisis, including Northern Rock, HBoS, and Bradford & Bingley fell almost entirely within the traditionally understood functions of a retail bank. The Association of British Insurers summarised the view that the risky lending behaviour of banks in markets that are traditionally more associated with retail banking—such as in the real estate sector—was a more important cause of the recent crisis than the risk-taking by investment banks:

> the universal banking model was not the root cause of the financial crisis [...] Within the UK, banking cycles have been closely correlated to real estate valuations and 'bubbles' rather than to investment banking cycles or structural limitations or weaknesses within universal banks.[75]

44. Some witnesses rejected the concept of cultural contamination, or said that the blame for many of the recent problems lay more with cultural influences arising within the retail side of banks.[76] Lord Turner told us that in his view "the culture of classic commercial banking was probably contaminated by three different things", only one of which was investment banking culture. Equally important in his view were two other factors:

> it was polluted to a degree by the invasion of consumer goods companies' and retailers' approaches to banking in a way that is perfectly okay in retailing and consumer goods, but dangerous when you get to retail financial services products [...]
>
> The third thing that was a pollutant was that, over the last 30 years, there has been a very strong tendency across business to have an overt focus on shareholder value and return on equity. [...]. But applied to banking that is potentially dangerous, because in banking the easiest way to boost return on equity is simply to boost your leverage either in direct open ways or in a set of hidden ways.[77]

71 Treasury Committee, Independent Commission on Banking Final Report October 2011, Oral and Written Evidence, HC (2010–2012) 1534, Ev 130

72 *Ibid.*

73 Q 860

74 Ev w110, para 7.1

75 Ev w25

76 Qq 449 [Douglas Flint], 451 [Anthony Jenkins], 753 [Sir John Vickers], 861 [Stephen Hester], 1164 [Paul Tucker]

77 Q 967

The overall case for separation

45. **The Commission finds the evidence that it has received on the benefits for financial stability of some form of separation convincing. The evidence that there has been damage to standards and culture by having these activities side by side, an area not examined by the ICB, is comprehensive and a crucial consideration. There is evidence to suggest that, as well as supporting financial stability and reducing the risk to the taxpayer, separation has the potential to change the culture of banks for the better and to make banks simpler and easier to monitor. These are propositions to which the Commission expects to return in the New Year.**

Ring-fence proposals

Introduction

46. A ring-fence attempts to secure some of the benefits of structural separation while maintaining some of the benefits of synergy and diversification held to exist in organisations undertaking both retail and investment banking operations.

The ICB ring-fence

47. The ICB proposed one particular form of a ring-fence. It recommended that activities "whose continuous provision is imperative and for which customers have no ready alternative" should be required to take place within a ring-fenced bank. Ring-fenced banks would not be permitted to engage in activities which either (a) are not integral to the provision of payments services or to intermediation between savers and borrowers, (b) directly increase the exposure of the ring-fenced bank to global financial markets, or (c) significantly complicate its resolution or otherwise threaten the objective of the ring-fence.[78] Any activities that were neither mandated nor prohibited could take place on either side of the ring-fence. In summary, the practical effect would be that:

- activities required to be within the ring-fence should include taking deposits and providing overdrafts to individuals and SMEs;
- prohibited activities should include what are broadly thought of as investment banking activities, including proprietary trading, market making, dealing in derivatives and underwriting securities; and
- permitted activities could include wider customer banking activities such as retail and SME lending, taking deposits from customers other than individuals and SMEs and lending to large companies outside the financial sector.

48. The ICB's proposals would allow the ring-fenced bank to be owned by a wider banking group that conducts prohibited activities. In order to get the benefits of structural separation, the ICB set out a series of characteristics, required of the ring-fenced bank to ensure its independence from the wider group, including that:

- it should meet capital and liquidity requirements on a standalone basis;

78 Independent Commission on Banking, Final Report, September 2011, p 11

- its relationships with the rest of the group should be conducted on a third-party basis;
- it should have independent governance and make disclosures as if it were independently listed.[79]

The Liikanen proposals

49. Another approach to a ring-fence was more recently set out by the High-level Expert Group on reforming the structure of the EU banking sector, chaired by Erkki Liikanen (the Liikanen Group), which produced its report on 2 October 2012. This Group recommended a form of structural separation similar to that proposed by the ICB. The way the Group's report describes the proposal focuses on the risky activities which are being separated off, rather than the core activities which are being protected. As Martin Taylor, a member of the ICB, expressed it:

> In a sense, we are trying to put a fence round the deer park and Liikanen is trying to cage the wild animals. It comes to the same thing in the end. I thought the Liikanen report very interesting and highly compatible in many ways with Vickers.[80]

The Liikanen Group proposal allows a broader range of activities to take place alongside deposit-taking than the ICB ring-fence. In particular it allows underwriting of securities, which in the UK would be viewed as an investment banking activity. Sir John Vickers voiced his surprise that the Liikanen Group had chosen to permit underwriting within the deposit-taking bank,[81] but Erkki Liikanen argued that "universal banks as a whole have served the European economy well when they have acted with prudence". He said that his proposals aimed to preserve the benefits of the universal bank while protecting such banks from high-risk activities:

> If you study the history of banking you will see that universal banks are quite recent in the United States, but they are historical in Europe—they have existed since the 19th century. By universal banks, we mean banks that are able to offer all types of services to their corporate clients and to households. What has happened since 1990 is that some of the universal banks have changed, in the sense that, while their deposit base remained more or less the same and their lending to households was not very different, they rapidly extended their investment banking activities, especially in proprietary trading and market making.[82]

Full structural separation

Introduction

50. Full structural separation, in contrast to a ring-fence, requires certain activities to take place in completely separate organisations, not just different subsidiaries of the same group. The bank which provides retail deposit-taking services cannot be in the same

79 Independent Commission on Banking, Final Report, September 2011, p 12

80 Q 391

81 Q 854

82 Q 100

corporate group as an entity which undertakes certain risky activities. As with the ring-fence, there are various models, both current and historic, which determine how full separation should or can be defined.

The Volcker rule

51. The proposed Volcker rule, which is being implemented through the Dodd Frank Act, excludes some activities from the banking group altogether, but sets out a much narrower range of prohibited activities than the ICB or Liikanen proposals, focusing just on proprietary trading and investment in hedge funds or private equity funds. Proprietary trading is held to be bank speculation on the market with its own funds. Paul Volcker explained to us that he viewed all customer-related activities as belonging together—even those, such as underwriting or market making, which might be regarded as investment banking—because of the enduring relationship and fiduciary duty to the client that these involve. In contrast, proprietary trading involves an impersonal relationship with counterparties, and should not take place within the same entity.[83] Martin Taylor contrasted the effect of the Volcker rule on banks with the effect of the proposal ultimately put forward by the ICB:

> We obviously looked at the Volcker rule, because it was pre-existent. [...] We did not see that it would solve the problem we were trying to solve. [...] A Volcker rule is of course a lot less radical from the banks' point of view than a ring-fence.[84]

52. One possibility which was raised by some witnesses was that of combining the ICB ring-fence with a Volcker rule, in order to exclude from even non-ring-fenced banks the kind of speculative trading activity which causes the greatest concern.[85] Lord Turner said that he believed it should be possible to discourage undesirable trading book risks by increasing the capital requirements against it, but added "I am not completely against a three-step solution. [...] I think that if we observe that Volcker-rule proprietary trading does work in the US, I would not necessarily exclude it".[86]

Other models of full structural separation

53. The forerunner to modern proposals for full structural separation was the Glass-Steagall Act passed in the US in 1933, which included provisions prohibiting banks which accepted deposits from engaging in securities-related activities.[87] As Paul Volcker summarised it:

> Glass-Steagall was originally a very simple law. I am simplifying a bit, but it only had a paragraph or two that said a bank can't trade. With the exception of Government securities and a few other things, you cannot hold a trading security in your account. You can act as a broker for a customer but you can't deal with it.[88]

83 Qq 58, 64, 68 [Paul Volcker]; Memorandum from Paul Volcker, October 17 2012, para 2.

84 Q 390

85 Qq 390 and 753.

86 Q 963

87 Banking Act of 1933 (Pub. L No. 75-66, 48 Sta. 162); Section 21 of the Banking Act 1933 (12 U.S.C. 24 (Seventh))

88 Q 74

The range of activities which retail banks were prevented from conducting was closer to the ICB proposal than either the Liikanen Group proposal or the Volcker rule, in that Glass-Steagall as originally enacted excluded retail banks from both underwriting and market-making.[89] The US approach under the Glass-Steagall Act was to separate activities so that deposit taking and prohibited activities took place in fully separate organisations, with tighter restrictions on how each is owned, although these restrictions were loosened over time, with the relevant sections of the Glass-Steagall Act that required full separation being repealed in 1999.

Summary of separation options

54. The table below provides a necessarily simplified comparison of the broad principles of four versions of structural separation.[90] Grey and dark blue activities must be conducted in separate entities. White activities can be conducted in either:

	ICB	Liikanen	Volcker	Glass-Steagall
Retail and SME deposit-taking				
Retail and SME overdrafts				
Retail and SME lending				
Corporate deposits and lending				
Hedging services				
Underwriting and structuring securities				
Market making				
Proprietary trading				
Type of separation	Ring-fence	Ring-fence	Full separation	Full separation

Before assessing the merits of the options, the next two chapters describe the Government's proposed approach to giving effect to its preferred approach and consider the challenges to which any form of structural separation will be subject in the long-term.

89 Banking Act of 1933 (Pub. L No. 75-66, 48 Sta. 162); Section 21 of the Banking Act 1933 (12 U.S.C. 24 (Seventh))

90 The Volcker rule (section 619 of the Dodd-Frank Act) only looks at proprietary trading and investments in hedge funds or private equity funds and effectively prohibits US Banks, Bank Holding companies and their non-banking subsidiaries engaging in these activities. This relates to Glass-Steagall (the US Banking Act of 1933) as originally enacted. For reference to subsequent changes, see next chapter, paragraph 73.

4 How the draft Bill proposes to give effect to structural separation

Introduction

55. The draft Bill and accompanying policy document reflect the Government's intention to implement the form of structural separation and associated measures proposed by the ICB, with five exceptions which were set out in paragraph 7 of this Report. This would place a ring-fence around the core functions of banks. This chapter sets out the mechanism through which the draft Bill gives effect to the ring-fence, focusing in particular on which features are established in primary legislation and which it is proposed be implemented through secondary legislation and regulatory rules.

Setting the location of the ring-fence

56. The ICB recommended that all household and SME deposit-taking and current account provision must take place within a ring-fenced bank, and that ring-fenced banks should be prohibited from carrying out a range of wholesale and investment banking activities. A large proportion of the provisions in the draft Bill relate to the "location" of the ring-fence, together defining, or allowing the Government to define, which activities must or must not be carried out within ring-fenced banks. In summary, the draft Bill gives effect to the ICB recommendations by inserting provisions in the Financial Services and Markets Act 2000 ("FSMA") as follows:

i) Defining a "ring-fenced body" as one which conducts "core activities" (new section 142A);

ii) Defining the regulated activity of accepting household and SME deposits as a "core activity" (new section 142B);

iii) Defining the regulated activity of "dealing in investments as principal" as an "excluded activity" (new section 142D);

iv) Establishing that any "ring-fenced body" which carries on an "excluded activity" is in breach of its regulatory requirements (new section 142G).

The activity of dealing in investments as principal, which is defined in existing legislation, captures "most of the derivatives and trading activities currently undertaken by wholesale and investment banks".[91] The four proposed new sections therefore together have the broad effect of preventing deposit-taking and investment banking from taking place within the same entity.

57. The draft Bill also provides the Treasury with a range of delegated powers which in summary allow them to do the following, subject to certain conditions:

91 HM Treasury, *Sound banking: delivering reform*, Cm 8453, October 2012, para 2.24

i) Define a class of institutions which should not be regarded as "ring-fenced bodies" even if they otherwise meet the definition (new section 142A(2)(b));

ii) Define circumstances in which accepting deposits is not to be regarded as a "core activity" (new section 142B(2));

iii) Define circumstances in which a regulated activity other than accepting deposits is to be regarded as a "core activity" (new section 142B(5));

iv) Define circumstances in which dealing in investments as principal is not to be regarded as an "excluded activity" (new section 142D(2));

v) Add any other activity to the definition of "excluded activity" (new section 142D(4));

vi) Impose prohibitions on what a "ring-fenced body" can do in relation to specific categories of transaction, establishing branches in specific countries, or holding shares in companies of a specified type (new section 142E).

58. The provisions described in paragraph 57 allow the Government scope to refine the broad definitions set out in the provisions described in paragraph 56. The delegated powers, taken together, could allow the Government to re-define almost any aspect of the ring-fence location. To illustrate this using extreme hypothetical examples:

- The delegated power under section 142D(4) could be used to define virtually all bank activities apart from investing in Government bonds as "excluded activities", which would resemble a form of John Kay's "narrow banking" proposal under which banks holding insured deposits would not be permitted to engage in any risky lending;[92]

- The delegated powers under sections 142A(2)(b) or 142B(2) could be used to exempt most banks or most deposit-taking activity from the requirements of the ring-fence; and

- The delegated powers under section 142D(2) could be used to permit ring-fenced banks to conduct a wide range of otherwise prohibited trading activities, such as those permitted under the Volcker rule or the Liikanen Group's proposals.

59. The Government's stated intentions for using these powers include the following, some of which will also be considered later in more detail:

i) Setting a "de minimis" threshold so that banks holding deposits below a certain value are not brought within the ring-fence;[93]

ii) Providing that deposits from high-net-worth individuals and larger firms do not have to be held within the ring-fenced bank;[94]

iii) Allowing ring-fenced banks to conduct some trading activities in order to manage their own liquidity and risks;[95]

92 John Kay, *Narrow Banking*, 15 September 2009

93 HM Treasury, *Sound banking: delivering reform*, Cm 8453, October 2012, para 2.16.

94 *Ibid.*, paras 2.18 and 2.19.

iv) Prohibiting / allowing the ring-fenced bank to provide certain types of derivative to customers;[96]

v) Restricting what exposures ring-fenced banks can have to other financial institutions;[97]

vi) Prohibiting ring-fenced banks from operating branches or subsidiaries outside the EEA.[98]

60. One important way in which the draft Bill constrains the use of delegated powers is by setting tests in relation to their impact on the continuity of provision of "core services". Such services are defined in proposed new section 142C. These comprise the main facilities for operating bank accounts: making deposits, withdrawing funds and managing overdrafts. The Treasury can add to the definition of core services through a further delegated power. Two examples of how delegated powers are constrained by reference to "core services" are:

- In order to make an order allowing a ring-fenced bank to do things that would otherwise qualify as "dealing in investments as principal", the Treasury must be of the opinion that this "would not be likely to result in any significant adverse effect on the continuity of the provision in the United Kingdom of core services".
- To define an additional excluded activity which ring-fenced banks cannot undertake, the Treasury must be of the opinion that it is "necessary or expedient for the purpose of protecting the continuity of the provision in the United Kingdom of core services".

Setting the height of the ring-fence

61. The ICB set out a series of principles to ensure the independence of the ring-fenced bank from the rest of the group. The relevant section of the draft Bill which makes provisions for this question of the "height" of the ring-fence is proposed in a new section of FSMA, 142H. This requires the regulator to make rules for ring-fenced banks with the aim of ensuring that it can act independently of the group, and that ring-fenced banks' core activities (deposit-taking, in the first instance) are not jeopardised by the acts or omissions of other persons. The rules must cover intra-group exposures, independent corporate governance and payment of dividends. The policy document accompanying the draft Bill stated:

> The draft Bill requires the regulator to make rules to ensure that the ring-fenced bank is able to act independently of the rest of its group while carrying on its business. In relation to ring-fenced banks that are members of a group, it specifies the areas in which rules should be made, including holding shares in other corporate entities, entering into contracts with other members of the group, governance of the ring-fenced bank, restricting payments that a ring-fenced bank may make to other

95 HM Treasury, *Sound banking: delivering reform*, Cm 8453, October 2012, para 2.26.

96 *Ibid.*, para 2.27.

97 *Ibid.*, paras 2.31 and 2.32.

98 *Ibid.*, paras 2.33 and 2.34.

> members of the group and disclosure. These provisions do not limit regulators' power to make general rules. These requirements are designed to ensure that a ring-fenced bank interacts with the rest of its group on a third party basis, and that it remains legally, economically and operationally independent.[99]

62. Proposed section 142H is the only section of the draft Bill which deals with the "height" of the ring-fence. It contains only limited detail about what the rules on the height of the ring-fence must contain; this does not contain some of the elements needed to ensure effective independence for the ring-fenced bank which are considered later in this Report. In contrast to the location of the ring-fence, which will largely be established by the Government in secondary legislation, the height of the ring-fence beyond what is to be set out in primary legislation is proposed to be a matter for the regulator.

99 HM Treasury, *Sound banking: delivering reform*, Cm 8453, October 2012,paras 2.35 and 2.36

5 Challenges to the durability of structural separation

Introduction

63. Many of the key features of any new framework to give effect to structural separation may not be tested for many years to come. In the interim, a new framework will face number of challenges. This chapter identifies some.

Complexity and financial innovation

64. The first challenge to structural separation lies in the complexity of financial products. This can be illustrated by the example of the development of the rules relating to the implementation of the Volcker rule following the passage of the Dodd-Frank Act. The Volcker rule is based on an ostensibly simple principle, and yet defining what is proprietary trading (which is forbidden for banks) as opposed to other types of (permitted) trading has proved complex. When asked why enactment had required a vast, complex amount of regulation, Paul Volcker replied:

> I don't think it does. I think it requires some regulation and that can be complex. Part of this is parody by opponents. How many times have you heard that the proposed rule a year ago was 300 pages long? It was not 300 pages long. It was 35 pages long and 160 pages of questions that lobbyists had raised about how the rule would work. And they said it wouldn't work because it was a 300-page rule. I am cheating a little bit. The rule was 35 pages and had an appendix of 30 or 35 pages laying out the so-called metrics that I was talking about which are probably too complex. I hope that they are getting this better. It comes back to the vexing question of principles against rules. There is no doubt that the American legal system and American habits say, "We want a rule, clear and simple, black and white, so we know when we are obeying the rule". They don't say that they want to know how to get around it, too, but that is part of the deal. With that attitude, 400 bank lobbyists lobbied the agencies on the regulation: "Spell this out exactly or we won't like it" or "How do you tell the precise difference in a proprietary deal?"[100]

65. Paul Volcker went on to suggest that it should be straightforward to require bank directors to distinguish between trading for market-making purposes and proprietary trading.[101] Sir Mervyn King doubted this, suggesting that while "a good banker can tell the difference [...] that is not the issue. The question is whether the regulator or a court can tell the difference between the two and whether it is possible to pull the wool over the eyes of the regulator or to confuse the issue legally."[102]

66. A second challenge derives from the fact that financial products change, sometimes radically, over time. Innovation is characteristic of the financial services industry, and

100 Q 86

101 Q 68

102 Q 1149

banks have often been at the forefront of that innovation. Households have access to an ever-broader range of savings and borrowing products. The advent of securities markets has broadened the forms of external finance available to firms. A range of insurance products and financial derivatives are now available to enable both financial and non-financial firms to hedge risks that arise in the course of their business so they can provide services to their customers more cheaply. In the years preceding the crisis, asset-backed securities, credit default swaps, interest rate swaps and other derivatives in particular experienced explosive growth. However, this increased the interconnectedness of the financial system, with mixed consequences for its stability.[103]

67. Some new products may not fall neatly on one or other side of the line drawn as part of structural separation. Paul Tucker argued that "we must not jeopardise this regime by trying to define things that it is not actually possible to define, because then the regime will end up in disrepute".[104] The ring-fence may also incentivise the creation of such products. Andrew Bailey warned, "This is an industry that is habitually innovative and habitually wanting to go around regulations or to tunnel under the ring-fence".[105] The Chancellor of the Exchequer drew a lesson from experience and from the prospect of financial innovation:

> I would warn against creating a kind of Maginot line in primary legislation that is absolutely right for 2012—absolutely impenetrable to all the weapons that the banks have and that the industry has in 2012—and then find out in 2022, let us say, that the banks and the industry have completely bypassed it.[106]

The influence of banks on politicians and regulators

68. The desire for regulatory clarity might derive in part from experience of the interaction between banks, regulators and politicians over the regulatory framework. Banks have a legitimate interest in the environment in which they operate and seek to change it. The way in which they seek to do so is likely to have more regard to their commercial interests than to the wider public interests in the safety and soundness of the financial system and in the continuity of core services with which regulators are concerned.

69. Speaking of a specific argument which is explored later in this Report, Andrew Bailey drew attention to the danger of a power being "neutralised by the force of lobbying and other pressures that might be set off".[107] He then expanded on this point, saying that he was talking about

> the lobbying of politicians and the lobbying of us. There is a very strong lobbying force; it is one of the things that I observe. [...] In the field we operate in—this is, in simple terms, a reflection, if you like, of the concentration of the banking industry in

103 Bank of England, *Financial innovation: what have we learnt?*, Bank of England Quarterly Bulletin 2008 Q3, p 330; Beck, Tao Chen, Chen Lin, and Frank M Song, "Financial Innovation: The Bright and the Dark Sides", HKIMR Working Paper 05/2012, January 2012

104 Q 1201

105 Q 948

106 Q 1053

107 Q 949

> this country—there is a very powerful lobby out there; I read it in the newspapers most days.[108]

70. A similar concern was expressed by Professor Kay. When he gave evidence to the Treasury Select Committee in 2011, shortly after publication of the ICB's report, he said "I would have preferred full separation, but I think 98 per cent of a loaf is pretty good and I am fairly happy with that".[109] He elaborated on this statement when he gave evidence to us:

> I was probably in a fairly optimistic mood at the time. But certainly I have taken the view that at least half, or more than half, a loaf is better than no bread. A problem that has always concerned me is that even that half loaf would have crumbs knocked off it as a result of lobbying and the passage of time before it actually came into effect. There is certainly nothing that has happened since then that would have alleviated that particular worry.[110]

71. The challenges that result from the banks' approach to the development of public policy are also illuminated by the evolution of the view of banks on the ring-fence. Martin Taylor told us that "when the banks realised that we were going in the ring-fence direction, they all came to see us and said 'why don't you do the Volcker rule instead', because it is much less inconvenient for them".[111] The banks maintained their opposition to ring-fencing when the ICB's proposals were published in interim and final form during 2011. When responding to the ICB's interim report, RBS wrote:

> We think that [existing] far-reaching changes, when digested, will eliminate the implicit state support perceived in the past to be extended to banks. Consequently, these reforms should be allowed to bed down before deciding whether to add to them the additional burden of ring-fencing, which in most variants bears a high risk of failing the tests set by the ICB's terms of reference.[112]

Following publication of the ICB's final report, Barclays expressed a similar view in written evidence to the Treasury Select Committee:

> We remain un-persuaded that a retail ring-fence offers enhancements to financial stability and believe it has, at best, marginal benefits as a resolution tool over and above reforms already in place, underway, or in development, including the improvement and alignment of resolution plans and powers and improvements to loss absorbency requirements for banks at the global level.[113]

72. When concerns over lobbying were raised with Sir John Vickers, he replied:

> I believe that the regulatory institutions and the legislature would be alert and robust enough to resist that [lobbying]. It is a very welcome thing that our proposals, at least

108 Q 951

109 Evidence taken before the Treasury Committee, 18 October 2011, HC 1534-ii, Q190

110 Q 292

111 Q 390

112 RBS Group response to ICB Interim Report of 11 April 2011, www.rbs.com

113 Treasury Committee, *Independent Commission on Banking Final Report October 2011*, Oral and Written Evidence, HC (2010–2012) 1534, Ev 130

> in broad terms, have not only the support of the Government but cross-party support. That, too, is helpful in resistance to creep.[114]

73. The Glass-Steagall Act in the USA provides a case study for the erosion of what was initially a clear and concise piece of legislation. Paul Volcker described to us how loopholes in the Glass-Steagall Act relating to the activities of subsidiaries were widened in the six decades between its passage and repeal:

> Then you have a subsidiary and you say, "Why can't the subsidiary do it?" Somehow the language is put in there, "Well, if it's not principally engaged, maybe you can do some underwriting." What does principally engaged mean? For 30 years people assumed that meant, "No, you can't do it." Then the banks began getting more serious. "What do you mean? The law says 'principally engaged'. We made up this subsidiary to sell apples and it is principally engaged in the apple market, but we wanted to do some underwriting. That is what the law says." "Oh," we said, in our great wisdom, "with 5 per cent of the activity elsewhere you can do it. That is not principally engaged." But another chairman of the Federal Reserve Board and a few Federal Reserves later, that got to be 25 per cent, 30 per cent or whatever. Through the years a whole lot of additional securities were added to what was possible for a bank and for the subsidiary to own. You could find language in the law that said the regulators had some discretion. There is some justice in those that say by the time Glass-Steagall was abolished it had already been abolished in practice.[115]

He added that the failure of Glass-Steagall was not because full separation was ineffective, but because the separation became less full, saying "the restrictions between the 'commercial bank' and the 'investment bank' in Glass-Steagall broke down over time. I have a little fear that that might happen in Vickers too."[116]

74. Sir Mervyn King also highlighted the difficulties faced by regulators in terms of their relationship with the banks they regulated:

> I have been struck in the last five years, learning more about how the regulatory process worked, by how much of it has turned out to be a negotiation between the regulators on the one hand and banks on the other [...] The big principle is that, to be effective, the regulator has to be able to use judgment. That is what we want to get to. But if judgment ends up simply as a negotiation between the regulator and the regulated bank, there is only one winner in that, and that will be a very bad outcome. Clarity is crucial to enable the regulator to exercise judgment within a very well-defined framework, and the regulator needs to be able to tell banks, "This is the capital requirement you will have", as opposed to merely entering into a negotiation.[117]

114 Q 778

115 Q 74

116 Q 92

117 Qq 1144-5

The next banking crisis

75. To many market participants and others, financial crises can seem to come out of a clear blue sky. The July 2006 Bank of England Financial Stability Review, for example, said the following:

> All of the stress scenarios considered are low probability tail events. Far and away the most likely outcome in the near term is that none of the vulnerabilities crystallise. Moreover, even if these vulnerabilities were to crystallise individually, they would be unlikely to erode to any significant extent the capital base of the UK banking system. This provides strong support for the continuing high resilience of the UK financial system. Market estimates of default probabilities for the major UK banks — as proxied by CDS premia — remain very low and are consistent with that encouraging picture.[118]

The IMF expressed a similar view in its 2006 Global Financial Stability Review:

> There is growing recognition that the dispersion of credit risk by banks [...] has helped to make the banking and overall financial system more resilient [...] The improved resilience may be seen in fewer bank failures and more consistent credit provision. Consequently, the commercial banks, a core segment of the financial system, may be less vulnerable today to credit or economic shocks.[119]

Referring to similar developments in risk transfer mechanisms, Tim Geithner said in February 2006:

> These developments provide substantial benefits to the financial system. Financial institutions are able to measure and manage risk much more effectively. Risks are spread more widely, across a more diverse group of financial intermediaries, within and across countries. These changes have contributed to a substantial improvement in the financial strength of the core financial intermediaries and in the overall flexibility and resilience of the financial system in the United States. And these improvements in the stability of the system and efficiency of the process of financial intermediation have probably contributed to the acceleration in productivity growth in the United States and in the increased stability in growth outcomes experienced over the past two decades.[120]

118 Bank of England, Financial Stability Report, Issue No.2, July 206, p 10-11

119 IMF April 2006 GSFR, Chapter 2. It should be noted that the IMF did go on to say: 'At the same time, the transition from bank-dominated to more market-based financial systems presents new challenges and vulnerabilities. These new vulnerabilities need to be understood and considered in order to form a balanced assessment of the influence of credit derivative markets.'

120 Tim Geithner speech to the Global Association of Risk Professionals, 28 February 2006. It should be noted that Tim Geithner did go on to say: 'These generally favorable judgments require some qualification, however. These changes appear to have made the financial system able to absorb more easily a broader array of shocks, but they have not eliminated risk. They have not ended the tendency of markets to occasional periods of mania and panic. They have not eliminated the possibility of failure of a major financial intermediary. And they cannot fully insulate the broader financial system from the effects of such a failure.'

76. Major financial crises are infrequent, but recurring events. Their infrequency creates an added challenge in designing frameworks for such events due to loss of collective memory. As Lord Turner said:

> How do we guard against it in future? Well, in part, the generation of us who lived through October 2008, we may be reasonably safe against the re-emergence of this delusion. The classic problem for human institutions and for the design of our regulatory structures and our policy is how do we design against it in 25 years' time, when the generation of those who were there in October 2008 are in retirement and we have another: "This time it's different. This time we're cleverer than the previous generation." That is the institutional challenge, and we have got to try and embed the intellectual challenge, the counter point of view—but also try and embed through what we do on structure things which are resilient to changes in intellectual fashion.[121]

77. Major financial crises are also not identical to one another. The ICB Interim Report noted, "Reforms to financial regulation must not aim solely at addressing past crises," adding "The goal must be to improve the resilience of the banking system to shocks regardless of the form they take".[122]

78. **The characteristics of financial crises and the nexus between banks, politicians and regulators together pose fundamental challenges for the design and implementation of structural separation. Any framework will need to be sufficiently robust and durable to withstand the pro-cyclical pressures in a future banking cycle. Those pressures will include the siren voices of those who contend that structural separation as implemented represents a barrier to financial innovation and growth. Politicians need to face up to the possibility that they may prefer those siren voices to the precautionary approach of regulators, particularly if, once again, it appears that banks are performing alchemy. In the chapters that follow, we consider the approach needed best to ensure that structural separation is able to withstand these challenges.**

121 Q 1011

122 Independent Commission on Banking, Interim Report, April 21011, p 20

6 Structural separation in the first instance

The starting point

79. The Chancellor of the Exchequer contended that not only is there a consensus on the need for structural separation, a matter considered in chapter 3, but that there is also a UK consensus that this Commission should not seek to re-open on what form such separation should take:

> I do agree we have a consensus that some form of separation is required. That consensus has been created through the Vickers process, but Vickers specifically looked at what form of separation and specifically addressed the question of complete separation. Indeed, it was part of his remit to look at that issue. He looked at it and rejected it. When asked by this Commission, he rejected it again and, indeed, other people who have come before your Commission have rejected it. So I would say to you that there is a consensus about structural reform and that you need to pull apart investment and retail banking in some way, but we also have in this country a consensus of how that is done.[123]

80. **There is widespread, but not universal, support for structural separation in some form. However, views in evidence to the Commission about how separation should operate, where a ring-fence should be placed and indeed whether ring-fencing can achieve the desired policy aims, fell well short of consensus.**

Contagion, diversification and cost

81. One argument for full separation, i.e. moving some activities completely outside the banking group containing the core activities, is that anything short of this will not be able adequately to insulate the retail bank from the risk of contagion, in the sense that a loss of trust in an investment bank, should it fail, could lead to a run on the retail bank. Paul Volcker highlighted the importance of a shared brand to a bank's reputation:

> If the name is on the institution, or parts of the institution, it will be protected; to the extent possible, each part will be protected. If your name is on the door, you are going to protect it. As I understand it, under the philosophy of Vickers and Liikanen that would not happen. I think Britain is going a little bit uphill.[124]

The ICB, in its final report, argued that reputational links between different parts of the banking group could be a feature of ring-fencing that enhances rather than threatens financial stability.[125] An investment bank, in order to secure its own reputation, may be encouraged to provide assistance to a retail bank that bears its name. Martin Taylor explained that:

123 Q 1066

124 Q 53

125 Independent Commission on Banking, Final Report, September 2011, p 63

> One sees banks going to enormous lengths to protect subsidiaries or commitments they have made with their brand on. If you look at this with the object that the investment bank is the only dangerous thing, you can make a bad mistake. I don't terribly like the idea. If we enforced a split in the UK, you would have a rather strange ecosystem with very large, very highly correlated retail banks with no earnings diversification from elsewhere, and I don't think that is a particularly good idea.[126]

A number of banks also emphasised the benefits of having a number of diverse functions or operating in a number of territories, broadly suggesting that this would help to insure them against one narrow area of the business falling into difficulties.[127] Sir John Vickers told us:

> I do not believe that we are in a simple world of utility and casino, where the utility is totally safe. There are risks in any form of credit extension and they can be correlated risks, when an economy hits trouble. One, in my view, cannot dismiss the possibility that a stand-alone, undiversified sector would get into trouble. If it got into trouble when the rest of the world or the rest of banking was doing okay, one would have lost a great deal by a full split, because there would not be the group resources to mitigate the losses in UK retail.[128]

82. The Chancellor of the Exchequer argued that the additional costs from full structural separation as opposed to a ring-fence would need to be justified by additional benefits:

> there is a very considerable cost to the industry in what we are doing. [...] I have taken a judgment [...] that this is a price worth paying and that it is outweighed by the broader economic benefits that greater stability will bring. However, there is a cost to the industry, and exactly the same Members of Parliament who get up and say, "You must screw the banks down" are the same people getting up and saying, "We've got to get the banks to lend and when are we going to do it?" [...] I think that full separation would be an even greater cost and I'd have to justify it. I would be prepared to do so if I thought it was bringing benefits that outweighed that cost.[129]

Sir John Vickers explained that the ICB's rejection of full separation was founded on the belief that ring-fencing could deliver similar benefits at a lower cost.[130] The contention that the costs of ring-fencing would be lower was set out in the ICB's final report:

> 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 [...] average analyst estimates suggest [diversification benefits] could be as much as £4bn annually but the empirical evidence is mixed.

126 Q 369

127 Q 860 [Peter Sands]; Ev w30 [Barclays]

128 Q 760

129 Q 1066

130 Q 762

> 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 it may be possible to preserve a greater degree of operational synergies than under full separation.[131]

Martin Taylor referred to how the ICB made a deliberate attempt to preserve these operational synergies where they did not pose a threat:

> Where we had a choice, we tended to take the line that would not put extra cost or inconvenience on the banks. For example, we allowed the ring-fenced bank and the non-ring-fenced bank to share treasury functions and IT functions. This saves these banks a lot of money.[132]

Culture and standards

83. Paul Volcker considered that the cultural advantages of structural separation would best be secured through full separation.[133] The ICB did not consider standards and culture as part of their remit, and it should not be expected that their solution would necessarily be that which best addresses the wider problems in banking standards. Nevertheless, Sir John Vickers argued that they did examine cultural issues:

> We certainly gave thought to questions about culture. "Culture" was the word we used more than "standards", and it was before some of the events of this year. Our view was that, given the questions that we had been set, it was not for us directly to seek to regulate cultural standards, which is a difficult thing in any case, but that the issues that we were looking at, both on structure and on loss absorbency and on the competition and consumer side, all had a very clear bearing on questions of culture and, as we might now say, of standards.
>
> I do not believe that the recommendations that we made on the questions that were put to us would have been materially different if standards had been explicitly among, let us say, the issues that we were to have regard to.[134]

Permeability

84. One of the arguments for full structural separation compared with a ring-fence is that full separation would entail fewer rules and therefore less monitoring and enforcement, because the two entities would be separately owned and would have no more incentive to create interdependencies than any other two banks. Paul Volcker's main doubt about the effectiveness of a ring-fence was that they "tend to be permeable over time".[135] He added:

131 Independent Commission on Banking, Final Report, September 2011, p 64

132 Q 395

133 Qq 55 and 62

134 Q 746

135 Q 53

> If you really want to separate some operations very clearly and decisively, you put them in different organisations. In my experience, you do not put two functions in the same organisation and say that they cannot talk to each other or interact.[136]

85. Sir John Vickers and Martin Taylor both argued that full separation would not be much simpler than a ring-fence, concentrating on the fact that determining the location of the split would be just as complex for full separation as for a ring-fence.[137] In the words of the latter:

> [An] error that people are prone to make is that somehow splitting is simple, and a ring-fence is complicated. In fact, if you are going to split, you have to go through all the complexity that we have gone through with ring-fencing and decide exactly where the split should come. You would have just as much regulatory complexity, and of course you would also risk putting it in the wrong place.[138]

86. Lord Turner pointed out that Glass Steagall, which is thought of as a full-separation approach, nevertheless eroded away over time.[139] However, Paul Volcker argued that the failure of Glass-Steagall was not because full separation was ineffective, but because the separation became less full, saying "the restrictions between the 'commercial bank' and the 'investment bank' in Glass-Steagall broke down over time. I have a little fear that that might happen in Vickers too."[140]

Market-driven separation

87. It is possible that even if not mandated, some banks may decide to pursue full separation of their retail and wholesale activities voluntarily. A robust ring-fence would retain some synergies between the two banks, but would remove many of the benefits that banks obtain from conducting retail and wholesale activity side-by-side. In such circumstances, shareholders might consider themselves better served by spinning off one of the banks and allowing it to compete without the costs and constraints of the ring-fence. António Horta-Osório said:

> if the synergies that customers perceive in having an integrated approach are more than offset by the internal costs that you impose on the organisation, I think that shareholders in the future will say that the synergies do not compensate for the costs, and that banks should spin off their investment banks or their retail banks. They will separate, but it will be a market force separation.[141]

Professor Kay went further, arguing that if a ring-fence really did result in effective separation, then banks should want to split themselves up:

> I have thought, and in some ways I continue to think, that the effectiveness of ring-fencing would be demonstrated by whether Barclays wanted to split itself up. If the

136 Q 53

137 Qq 369 and 761

138 Q 369

139 Q 761

140 Q 92

141 Q 899

ring-fence were really effective, they would have little reason to want to maintain that structure. In that world, the interest that certainly the previous management of Barclays would have in the retail side of the activities would probably be rather small.[142]

European law

88. One difficulty that the imposition of full structural separation might pose is that it may conflict with European law. The final ICB report noted that:

> 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. [...] 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."[143]

89. Martin Taylor referred to "the deep difficulties under European law of mandating full separation" as a factor in the ICB's deliberations when he gave oral evidence.[144] The limitations on change of ownership are set out in Article 19(1) of the Banking Consolidation Directive (2006/48/EC), which was incorporated into that Directive by the Acquisitions Directive (2007/44/EC), and which was transposed into national law by sections 185 and 186 Financial Services and Markets Act 2000 (FSMA). The provisions were intended to ensure that acquisitions were blocked only on strictly prudential grounds, rather than discriminatory grounds. A ban on the acquisition of a retail bank by an investment bank, *because it is an investment bank*, could be held to breach the obligation on the FSA under section 185 of FSMA to object to an acquisition only on the limited set of prudential criteria set out in section 186 FSMA, which do not include the criterion that an acquirer of a retail bank is not an investment bank.[145] In considering the impact of these current restrictions, it needs to be borne in mind that, if the European Commission puts forward a legislative proposal based on the work of the Liikanen Group, as expected, then this might provide an appropriate vehicle within which to negotiate the necessary changes to EU law if full separation were to be pursued.

International context

90. The ICB remit included a requirement to have regard to the impact of their recommendations on "the competitiveness of the UK financial and professional services sectors".[146] Bill Winters told the Treasury Select Committee in May 2011 that "we spent some time thinking about whether either large universal banks or parts of universal banks

142 Q 312

143 Independent Commission on Banking, Final Report, September 2011, p 65

144 Q 369

145 There is also a public policy exception, but this has generally been interpreted narrowly.

146 Independent Commission on Banking, Terms of Reference. www. hm-treasury.gov.uk

were likely to re-domicile”.[147] He noted that the ICB made recommendations based on “what we thought the right structure was for the banking industry in the UK, considering financial stability, competition costs, and service to society, not focused primarily on whether banks would re-domicile”.[148] In evidence to us, Martin Taylor voiced scepticism over the suggestion that banks would be driven to relocate by the current set of proposals:

> I do not believe that we will have wholesale moving of banks’ head offices, which is what we were worried about two or three years ago, simply because pretty much the entire world is going in the same direction. I work in Switzerland and spend half my time there. I remember in 2009–10, all the people in the City were saying they wanted to move to Switzerland, and all the Swiss banks wanted to move to London. Each of them was ignorant about the changes taking place on the other side.[149]

Michael Cohrs noted that the UK has a number of distinct advantages as a location for banks which would remain regardless of the UK’s approach to financial regulation:

> generally speaking, it is really hard—just as it is really hard to separate a bank—for a bank to move its jurisdiction. That is before you get into the cultural issues, which, for a bank, should be very important. So I am dismissive of bankers when they tell me—I used to be one of them—“If you don’t give us a good regime, we will go elsewhere.” It is rubbish... You know the most important reason? Greenwich Mean Time.... Two, language is critically important. The world has adopted our language; that is very important. Three, our legal system is very clear. It works. People want to litigate in this country. That is a big asset that we have. We should make this into an industry, as a country. We are probably not charging enough for people to come here and use our courts [...] Finally, London is a pretty neat place to live. These people make a lot of money. They want to spend their money in a pleasant place, and London is a very pleasant place.[150]

Conclusions

91. Sir Mervyn King drew the Commission’s attention to the fact that he had long supported structural separation:

> I have made no secret of the fact, and I have spoken about it for five years, that I have always felt that total separation was the right way ultimately to go. I have been joined in arguing this by some distinguished company, but it has been a lonely and difficult furrow to plough. I am glad that many more people are now coming on board the idea that a move to some kind of serious separation is the right thing to do. Even the *Financial Times* has now advocated a move in this direction.[151]

However, he went on to say why he strongly supported introducing a ring-fence “now”:

147 Oral evidence taken before the Treasury Committee on 24 May 2011, HC (2010–12) 1069- i, Q35

148 Oral evidence taken before the Treasury Committee on 24 May 2011, HC (2010–12) 1069- i, Q35

149 Q 393

150 Uncorrected transcript of oral evidence before Parliamentary Commission on Banking Standards Panel on Regulatory Approach on 11 December 2012, HC 821-i, Q 34

151 Q 1160

> I really do not want the last five years of effort to go to waste through the whole issue being kicked into the long grass by not implementing Vickers. We appointed the Vickers Commission in the UK, and I think this is the best-qualified group of people to serve on such a Commission in my lifetime in the UK. These are very impressive individuals, and they have thought about it.[152]

This viewed was echoed more recently by a fellow member of the Financial Policy Committee, Michael Cohrs:

> I am not completely pessimistic. I think that Vickers is a step in the right direction. To me, however, it is only a step in the journey because I think a modern Glass-Steagall will ultimately see total separation. [...] I think that we are on a journey, and Vickers is a good path for us to follow.

92. The Chancellor of the Exchequer emphasised in his evidence how a change of approach at this stage would cause significant delay and be hard to justify:

> [W]e have reached this point, we have got agreement, we are fundamentally going to change the structure of British banking. We have got that consensus. Let's get on and implement it and legislate for it, instead of getting to the top of the snakes and ladders board and then going all the way down the big snake that takes you to the bottom again.[153]

93. **Whatever their views on arguments for and against full separation, which are finely balanced, the majority of witnesses told the Commission that the partial structural separation of the ring-fence would probably bring significant benefits for public policy and for banking. The Commission therefore welcomes the Government's action to bring forward legislation to implement a ring-fence.**

94. **The ICB's proposals should be the starting point for proposals for legislation for implementation of structural separation. However, that does not mean that they should be the final destination. The current proposals may not be sufficient. In addition to concerns about proprietary trading, the case that a ring-fence will in practice be able to achieve the necessary level of separation remains unproven. The ring-fence may also be tested and eroded over time. The Commission considers it essential that steps are taken to reinforce the ring-fence, and makes specific recommendations to this effect in chapter 9.**

95. **There is evidence to suggest that proprietary trading, which under the current proposals could still take place within the non-ring-fenced part of banking groups, is an activity which is incompatible with maintaining the required integrity of customer-facing banking and which could have harmful cultural effects if permitted to continue. This was the primary concern of Paul Volcker in suggesting the prohibition of such activity in US banks.**

96. **The Commission has not considered fully the ramifications and practical issues of supplementing the proposed UK ring-fence with something akin to the Volcker rule.**

152 Q 1160

153 Q 1027

The Commission intends to take further evidence on this in the New Year. The Bill which the Government will shortly introduce provides the appropriate vehicle for establishing the future structural form of the UK banking industry.

97. **The Commission will consider further the implications of introducing a prohibition on groups containing a ring-fenced bank from engaging in proprietary trading and, in particular, the contribution such a prohibition could make to the changes needed to banking culture and standards. The Commission expects to report in good time in order that legislative effect to any recommendations can be given as the Bill progresses.**

98. **Measures to tighten the regulation of UK banks beyond international norms should be assessed for their potential to cause an unwelcome shift of activity abroad. However, concerns about relocation of banks may be over-stated. They should not be allowed to dominate the decision on the measures necessary to remove the implicit guarantee and ensure the banking system serves the UK economy. We will address this in our final Report.**

7 The components of a workable framework

Introduction

99. This chapter considers the ring-fence in the context of wider reforms in order to assess its relative importance in solving the problems identified in chapter 2. A ring-fence can contribute significantly to the two broad objectives of making banks less likely to fail and reducing the risk to financial stability and public funds if they do fail. However, although a ring-fence may be a necessary component of reform, it is not sufficient. The ring-fence proposal gets considerable public attention because of its novelty and the simplicity of its underlying concept, but other proposed measures—particularly those on loss-absorbency and bail-in—are also important. These proposals, and the way they are treated in the draft Bill and associated measures, are explained further and considered in detail in chapter 11.

Reducing the risk of failure

100. An effective ring-fence can contribute to reducing the riskiness of the banking system through several of the channels discussed in chapter 3. In particular, it would stop banks from being able to fund wholesale activities on the back of their retail activities, encouraging creditors to demand the appropriate risk premium and making it more costly for investment banks to pursue excessive levels of leverage. The scope for improvements to culture, manageability and ease of oversight from having smaller and more focused banks could also be important.

101. Financial stability should also benefit from the tougher capital and liquidity requirements being introduced under Basel III. The other two components with the potential to bring benefits for financial stability are the proposals for even tougher capital requirements including a higher leverage ratio and the introduction of a "bail-in" tool in order to make sure that creditors bear losses when banks fail, so that they are incentivised to impose tighter monitoring and discipline on the risks which banks are running.

Making banks more resolvable

102. There is a danger that putting a ring-fence around certain systemically-important parts of a bank could be interpreted as an even stronger signal that such banks benefit from a government guarantee. Stephen Hester warned of this, saying that "the language of ring-fencing has a huge risk of moral hazard". He acknowledged that this was not the intention of the ICB, but identified a risk of customers "thinking that if they are inside the ring-fence, they have a Government stake, an imprimatur, on top of them".[154] Sir Mervyn King also warned against assuming that this was the case:

> The purpose of the ring-fenced regime is not to stop a bank from failing, and I hope that all of you on this Commission will do a great deal to make all your colleagues in both the Lords and the Commons aware that the purpose of this legislation and the

154 Q 909

> ideal policy is not to get to a world where ring-fenced banks are guaranteed by the Government. That is not the case, and it will be very important for all of you not to stand up in the House and complain bitterly about losses to your constituents, whether debt holders, shareholders, or deposit holders, above the insurance limit if a bank fails. That is absolutely vital. You can undermine the whole regime by behaving in that way.[155]

103. Just as it would be a mistake to think that ring-fenced banks are guaranteed, it would also be a mistake to assume that, as a result of the ring-fence, the investment banks on the other side of it can be ignored. Although some vital economic functions would no longer reside in these investment banks, they would remain sufficiently large, complex and interconnected with the rest of the financial system that a disorderly failure could cause enormous, systemic damage. Lehman Brothers would have sat outside the ring-fence, but as the Chancellor of the Exchequer pointed out, when it was allowed to fail and simply placed in insolvency, "Armageddon unfolded".[156] The Bank of England suggested that the key operations of a non-ring-fenced bank which might need to be protected through a failure "would be likely to include any international payments functions, clearing and settlement functions, and possibly wholesale market and capital markets activities where the firm had a dominant position in key markets".[157]

104. **A guarantee, whether implicit or explicit, distorts incentives of managers and creditors, encouraging them to pursue excessive risk and leverage. It also distorts competition, and the allocation of resources, away from smaller banks to those large enough to be regarded as systemic. These problems are not removed simply by limiting guarantees to ring-fenced banks. While ring-fenced banks will carry out the majority of essential economic functions which need protecting, it is important to be clear that it is these functions that enjoy protection and not the bank itself or its shareholders or creditors. There should be no government guarantee of ring-fenced banks, nor perception of one. Neither does ring-fencing mean that risks from non-ring-fenced banks can be ignored, as such institutions will remain systemic and difficult to resolve. The stated aim of public policy, endorsed by the Commission, should be to reach a position in which a failing bank, whatever side of the ring-fence it may be, can be resolved without risk to financial stability or to public funds. The measures that we have considered in this Report fall well short of fulfilling this aim. The issues of banks which are 'too-big-to fail' and of investment banks in whatever country whose failure would pose systemic risks to the UK banking system are ones which will require further measures and to which the Commission will return in the New Year.**

105. As noted in chapter 3, it is widely argued that an effective ring-fence could be a major contribution to making banks resolvable. As noted in chapter 3, structural separation should better facilitate the application of resolution strategies to retail and investment banks. It may also make it easier for the resolution authority to extract the key functions that need protecting from the failing bank, because these would no longer sit alongside and have links with such a wide range of other activities. For these reasons, the Chancellor of

155 Q 1160

156 Q 1069

157 Ev w181

the Exchequer considered that the ring-fence proposal addressed the problem of banks that were "too big to fail".[158]

106. The Bank of England noted that the reforms proposed in the draft Bill, including the ring-fence, "need to be seen in the wider context of other prospective developments in the resolution regime." They added:

> Those changes stem from the Financial Stability Board's *Key Attributes of Effective Resolution Regimes for Financial Institutions* [...] In Europe, the Key Attributes are currently scheduled to be incorporated into law via the proposed Recovery and Resolution Directive (RRD). Two elements of this wider regime are worth highlighting. First, resolution powers are to be extended to bank holding companies; that is already being effected in the UK via the Financial Services Bill. Second, the RRD powers include a 'bail-in' resolution tool, under which, once the equity of a distressed bank was exhausted, the Resolution Authority could write down debt claims in order to cover expected losses and could convert part of the residual debt into equity to recapitalise the distressed firm (or a successor entity).[159]

The Bank's subsequent explanation of how they would expect to resolve large banks after the introduction of the ring-fence illustrated the importance of being able to impose losses on creditors via bail-in. For example, in setting out how a failing ring-fenced bank might be resolved, they pointed out that "In order to avoid any taxpayer solvency support in resolving the failed RFB, the unexpected losses need to be imposed on external creditors of the RFB. One way of doing this would be via a bail-in".[160] Similarly, for resolving a large non-ring-fenced bank, they said "bail-in could again be appropriate." While other resolution strategies were outlined, these involved transfers or break-up of the failing bank's operations, but as the Bank of England noted, "the size and complexity of the books of most global wholesale banks greatly increases the challenge in rapidly separating the critical economic functions in this manner without causing severe systemic disruption."[161] HSBC also echoed the conclusion that a ring-fence alone did not deliver resolvability:

> while ring-fencing adds clarity to different parts of the banking model and makes explicit the risks being borne by creditors to each portion it has less practical impact on the 'sorting out' of failed banks: it is financial bail-in which provides the solvency support to allow for a more considered restructuring of the firms at the necessary granular level using the information from the resolution planning process rather than the structural separation of activities.[162]

The Bank of England pointed out that ring-fencing plays an important part in facilitating the use of bail-in or permitting alternative resolution strategies if bail-in is not possible.

> In those cases where a group was toxic through and through, [bail-in] would not be possible. Instead, the distressed business would need to be broken up into critical and less critical parts. In those circumstances, ICB-style ring-fencing of the domestic

158 Q 1059

159 Ev w180

160 *Ibid.*

161 Ev w181

162 Ev w130

> retail deposit-taking business comes into its own [...] The utility to the resolution strategy of the ring-fence of core services will be especially evident in such cases, where a [...] resolution from the top of the group was not feasible.[163]

107. **A ring-fence alone does not make banks resolvable. Without wider reforms, it is possible that a ring-fence would simply result in one too-big-to-fail bank becoming two such banks, the failure of either of which would require taxpayer support to avoid major disruption. The resolution challenges of non-ring-fenced banks in particular should not be ignored. Of the measures still needed in order to make banks resolvable, ring-fencing and bail-in are the two most important. The draft Bill seeks to deliver a ring-fence and introduces some elements which will support bail-in, although this tool is mostly being delivered through the EU Recovery and Resolution Directive.**

163 Ev w181

8 The timetable for ring-fencing

Alignment with European initiatives

108. In determining the right timetable for the implementation of ring-fencing within the UK, it is appropriate to bear in mind the possibility of an EU-wide ring-fence emerging as a result of the work of the Liikanen Group. The proposals for reform made by the Liikanen Group are under consultation and will take time to be implemented. It is impossible to be certain what form they will take. The Law Society considered that the proposals were unlikely to follow the form of the draft Bill, given the popularity of the universal banking model in EU countries.[164] Standard Chartered also told us that there was considerable uncertainty about how the Liikanen recommendations would be implemented, adding:

> The scope of the ring-fence and the extra-territorial application are key issues on which there is currently a lack of clarity. Until these issues are clear it will be difficult to understand the interplay with the ICB regime, therefore, although we appreciate the need to make steady progress on the ICB legislation, the interaction with Liikanen will be key.[165]

109. Several witnesses highlighted the risk that UK banks might end up having to operate with two ring-fences in different parts of their businesses. Barclays set out the risk in some detail:

> depending on how [various product, service and customer groups] are treated, the result could be the requirement for UK banks to create three tier banking groups separated by two differently constructed ring-fences. Barclays initial analysis suggests that the most important activities that sit within this indeterminate group include larger clients, interbank lending, loan syndication, wealth management and some hedging services to non-bank customers. It is vital that the treatment of these activities is defined consistently between the UK and EU.[166]

The Law Society thought that "front-running changes which may then not fit with what the UK becomes bound to do under EU law would add both to uncertainty and cost for UK regulated banks and in turn detract from their ability to support economic growth".[167] If the Government did decide to run ahead of the EU proposals, the Law Society thought that there ought to be a lengthy transition period and that the flexibility over implementation allowed for in the draft Bill should be limited by a commitment not to place UK banks at a competitive disadvantage to banks elsewhere in the EU.[168]

110. On the other hand, António Horta-Osório thought that UK legislation should not be delayed:

164 Q 688

165 Ev w149

166 Ev w27

167 Ev w75

168 Ev w74

> it is very important, especially for us in the UK and Europe, that the two proposals are compatible, but given the timeline of Liikanen, which is much delayed related to Vickers, I would think very carefully about delaying the Vickers timetable in order to accommodate Liikanen. I think it is very important to implement the proposal with a clear timeline in terms of the ring-fencing in the UK.[169]

111. **Compared with other EU Member States, the banking sector represents a very large part of the UK economy. It is important that measures to strengthen the stability and resolvability of UK-based banks are put in place on a timetable that best meets the need of UK public policy. The UK cannot wait for or rely on appropriate implementation of the Liikanen proposals. It is desirable to maximise compatibility between the banking reforms to be enacted in the UK and the EU. The task of obtaining agreement across twenty-seven countries might also lead to a long delay in implementation. This could create uncertainty for public policy and for banks. The Commission has therefore concluded that the prospect of EU legislation arising from the Liikanen proposals should not be a determining factor in deciding upon the appropriate timetable for or substance of UK legislation, which should be proceeded with on a timetable that meets the needs of the UK economy.**

The Government's proposed timetable

112. The Government has pledged to complete all legislation for ring-fencing before the end of this Parliament in 2015 and to implement the ring-fence before the ICB's recommended deadline of 2019.[170] The policy documents published by the Treasury in June and October 2012 shed no further light on the timetable for implementation. The Chancellor of the Exchequer confirmed the timetable and provided further information on the timing of secondary legislation in response to a request from the Commission:

> The Government intends to introduce this legislation early in the New Year. [...] The Government is committed to completing all primary and secondary legislation before the end of this Parliament in May 2015. The PRA will be empowered to make relevant rules once section 142H of FSMA as amended is brought into force. It will ensure that its rules are completed (including impact assessments and consultation) within sufficient time to ensure that affected banks are able to meet the requirement to have their ring-fence in place no later than the start of 2019.

113. Allen & Overy LLP expressed concern at the "lack of progress" on a range of implementation issues, and queried whether the timetable remained realistic.[171] A number of witnesses commented that there was a need for greater clarity on the timeline and process between now and 2019, given the amount of work and preparation which remained to be done.[172] HSBC said that they did "not understand the process by which [secondary legislation]will be determined and implemented",[173] while Santander noted:

169 Q 895

170 "Government publishes draft Banking Reform Bill", HM Treasury press notice, 12 October 2012

171 Ev w10

172 Ev w36 [British Bankers Association]; Ev w85 [Lloyds Banking Group]; Ev w11[Allen & Overy LLP]; Ev w145 [Legal and General]; Ev w162, [Which?].

173 Ev w134

> as yet there is not sufficient clarity in the rules for banks to begin preparing for the proposed changes. While the purpose and principles of the Bill have been made clear, the mechanics of a separation are extremely complex and will require further detail from the Government.[174]

Bob Penn of Allen & Overy suggested that the lack of clarity over key decisions is "weighing still on banks' share prices and on their ability to raise debt within the markets", adding that

> if we do not start to move from opacity to transparency pretty quickly, you will see an almighty scramble to get there and, on the way, things will be dropped. It will be disruptive. Effecting a split of a major bank takes a lot of time. It takes a lot of senior management time, and it is a distraction from running a bank.[175]

114. Other witnesses were more sanguine about the feasibility of the 2019 timetable, subject to legislative milestones being hit and there being enough clarity on requirements in good time for banks to undertake the necessary work.[176] Several witnesses highlighted the importance of thorough consultation on the detail of implementing measures.[177]

115. As chapter 4 set out, the Government is proposing a framework where the majority of the features of the ring-fence will be set out in secondary legislation and regulatory rules rather in primary legislation. To assist in understanding of the final form of the ring-fence and the challenge that will be faced by those responsible for its implementation, the Commission wrote to the Chancellor of the Exchequer requesting more detailed information on how certain of the delegated powers would be used. In his response, the Chancellor of the Exchequer committed to "produce principal draft secondary legislation before House of Commons Committee stage and publish draft secondary legislation for consultation later in the year".[178] The Treasury also provided the Commission with further written evidence on the intended use of the proposed powers.[179] When he gave oral evidence to us, the Chancellor of the Exchequer acknowledged that "the secondary legislation is incredibly important" and should be "properly scrutinised by Parliament". He felt that the Government had been sufficiently clear about its intentions for implementation:

> people should be in absolutely no doubt that the secondary legislation will faithfully reflect our conclusions, our White Papers, our response to the Vickers Committee and it will faithfully implement the Vickers report, except, as I say, in those five areas at the margin where we have come to a slightly different conclusion from Vickers.[180]

On the timetable more generally, the Chancellor of the Exchequer said:

174 Ev w123

175 Q 679

176 Ev w26 [Barclays Bank]; Ev w85 [Lloyds Banking Group]; Ev w100 [RBS]

177 Ev w128 [HSBC Holdings]; Ev w75 [Law Society of England and Wales]

178 Ev w194

179 Ev w194

180 Q 1031

> what we have tried to do is to sequence this. We are moving at quite a pace to try to get this done. Quite frankly, almost all the pressure I am under at the moment is to get on with it rather than delay it. The Second Reading debate is an opportunity to discuss the principles of the legislation, whether it is appropriate and whether it is the right answer to the right problem. Then I think you can have a very good Second Reading debate, on the basis of all this information and, indeed, on the basis of the legislation. The detail of how high the ring-fence is, how impermeable it is, and all the other issues, which will be dealt with in secondary legislation, I think are appropriately ones for the Committee. If this Commission recommends further ways of scrutinising that secondary legislation, of course I will be very willing to listen to it. I do not think you have to wait for every single piece of paper before you can have a discussion. As I say, our ambition and our intention is to implement the Vickers recommendations into law, except in the very clearly defined areas where we depart a little from them.[181]

The legislative context

116. The proposed new primary legislation, planned for introduction early in the New Year, follows hard upon the heels of other legislation in response to the banking crisis. The Banking Act 2009 established the new bank resolution regime. The Financial Services Act 2010 amended FSMA to create a new financial stability objective for the FSA and to establish requirements for bank resolution and recovery plans. The ink is not yet dry on the Financial Services Act 2012, which further amends FSMA to create two new financial regulators, the PRA and the FCA, and to give them new objectives and new powers. Like the last two Acts, the draft Financial Services (Banking Reform) Bill proceeds largely by further amending FSMA, in some cases amending provisions which are themselves to be inserted by the Financial Services Act 2012. The Treasury Committee suggested as long ago as February 2011 that a new Bill would be better than the substantial amendment of FSMA.[182] This was also the view of Sir Mervyn King when he gave evidence to the Treasury Committee in June 2011. He said that by having an amending Bill rather than a fresh replacement Bill:

> We are losing the simplicity and the ability to have a cleaner debate about the new framework. Certainly the Government rejected our request to have a new Bill and the argument that they gave, understandably, was that at the cost of some complexity we could ensure that all the provisions that were appropriate could be put into an amended FSMA and it would be a faster way of doing it. I think we have seen the complexity. I am not quite sure whether we have avoided delay.[183]

Sir Mervyn was again critical of the process of making legislation in evidence to us, in the context of the objectives of the new measure:

181 Q 1037

182 Treasury Committee, Seventh Report of Session 2010–12, *Financial Regulation: a preliminary consideration of the Government's proposals*, HC 430-I, para 25

183 Oral evidence taken before Treasury Committee on 28 June 2011, HC 874-v, Qq 372–3

> I have never understood the drafting of legislation. This is your responsibility, you pass this stuff. Mostly it is incomprehensible, and it does not include basic statements like the objective of the legislation or in clear words what it is all about.[184]

The balance between primary and secondary legislation

117. As the Treasury pointed out when publishing the draft Bill:

> It is primarily an enabling Bill. That is, it provides the Treasury with the requisite powers to implement the policy underlying the Bill through secondary legislation. With a few very important exceptions, the majority of the detail of the policy will be set out in secondary legislation and regulatory rules.[185]

As has been illustrated above, many of the policy questions about ring-fencing are therefore not addressed in the draft Bill itself. However, the Treasury does indicate its intentions on some of these issues in the accompanying policy document.

118. The Chancellor of the Exchequer explained that finding the "balance between primary and secondary legislation [...] is genuinely a difficult challenge for Parliament and for the Government". He explained that the motivation for leaving so much to secondary legislation was to ensure that it could respond to financial innovation over time and was not "set in stone that is then unalterable". He added that implementing the legislation would require a great deal of technical detail which was not suitable for inclusion in the Bill itself:

> If we tried to put that all into a piece of primary legislation we would have hundreds and hundreds of clauses and either this Government or some future Government would be faced with a very difficult problem. As financial innovation went on and the industry adapted to the regulation, and perhaps things started to happen that we did not want to happen or had not anticipated, then some future Government would have to bring back primary legislation with all the length of time that takes and the competition for space in the parliamentary timetable. It is much better to have an enabling Bill and to be very clear about what we are seeking to achieve, and for you to test whether this enabling Bill is fit for purpose.[186]

119. RBS said "We recognise the need for the Government to retain a certain amount of flexibility".[187] A number of other witnesses agreed with this view.[188] Davis Polk & Wardell LLP argued that:

> as much flexibility as possible be given to the Treasury, the Prudential Regulation Authority, and the Financial Conduct Authority […] Flexibility is an indispensable

184 Q 1184

185 HM Treasury, *Sound banking: delivering reform*, Cm 8453, October 2012, p 6

186 Q 1031

187 Ev w13

188 Ev w77 para 55 [Law Society of England and Wales]; Ev w123, para 5.2 [Santander UK]; Ev w152, para 35 [Virgin Money].

> tool for dealing with the "unknown unknowns" of the ring-fence model or any other significant change in the structure of financial institutions and their regulation.[189]

120. However, several witnesses questioned whether the balance between primary and secondary legislation currently proposed was right. Andrew Bailey identified the need for clear Parliamentary authority behind the implementation of the ring-fence:

> What we have to get right is the balance between giving us the job of implementing a rule book essentially—the short version of it—and Parliament having sufficient hands on in terms of the objectives so that the legitimacy and authority of Parliament is very clearly behind it. That is a balance. At the moment, this is a very short piece of legislation in a sense. It says, "We'll define some objectives and then send you off to police them." I think we have to get the balance right in terms of being a very clear statement of Parliament's intent here.[190]

Jessica Ground, Fund Manager and Analyst, Schroders, expressed a concern about "the level of secondary legislation and the level of scrutiny that goes with it," adding "These are very complicated things, with huge unintended consequences, so if you leave a lot to secondary legislation, you are not going to be able to have the type of scrutiny to make sure that we are not making a mistake".[191] Barclays suggested that more of the important policy issues should be dealt with more directly in the Bill itself:

> we believe that issues such as the thresholds for customer inclusion and the structural requirements for ring-fenced banks are directional policy matters which should be dealt with by the primary legislative process and are disappointed that the draft Bill provides no certainty on these matters.[192]

The Law Society made the point that "the reliance in the draft Bill on substantial amounts of secondary legislation increases legal uncertainty",[193] and speculated that "the wide ranging use of delegated powers appears to be a function of the fact the Government is pushing this Bill through quickly, leaving little room for the detailed scrutiny that is required for such a complicated new set of laws".[194]

121. Many witnesses said that it was not possible to tell how faithfully and effectively the Government would implement the ICB recommendations relating to the ring-fence due to the lack of detail in the draft Bill. Sir John Vickers himself said "I think that it is impossible to answer whether it goes far enough without seeing the secondary legislation". He added "I see no reason to doubt that the secondary legislation will flesh out [the ICB recommendations], but I am reserving judgment on that until I have seen it".[195] RBS also drew attention to the limits of scrutiny that can be applied to an enabling Bill in the absence of secondary legislation:

189 Ev w50

190 Q 977

191 Q 719

192 Ev w27

193 Ev w71

194 Ev w77

195 Q 782

> Since the draft legislation is framed as an enabling Bill, it is not possible (beyond the high level of generality […]) to talk of any deviation from the Government's stated objectives. The extent to which these objectives are met will depend on how secondary legislation and regulatory rule-making is, in practice, defined and implemented.[196]

Which? went further, concluding that "the draft Bill does not sufficiently give effect to the objectives" set out in the policy document, adding that "the lack of detail [...] together with the substantial delegation of authority [...] means that the Bill alone will not ensure that the objectives will be achieved".[197]

Conclusions

122. **There is a good case for placing technical detail in secondary rather than primary legislation, in particular because of the importance of "future proofing" to allow a flexible response to developments in the banking sector. However, given the evidence we received about past regulation being too much of a negotiation between banks and regulators, we do not believe that too much of the burden of defining the ring-fence should be left to regulators. It is important that legislation properly equips the regulator with the clarity and authority necessary to maintain the ring-fence. The Commission is concerned that the heavy reliance on secondary legislation leaves open too many questions of significant policy importance. It would be unacceptable if the Commission's work in considering the framework were not matched by adequate scrutiny of the policy detail which follows in secondary legislation. This is not simply a parliamentary issue; it matters most because it creates uncertainty for the regulators who will be charged with making the new framework operational and for the banks required to operate within it. The Commission considers steps that could be taken to address these concerns through changes to the primary legislation in the next chapter. In the meantime, the Commission welcomes the firm commitment of the Chancellor of the Exchequer given in evidence to the Commission to "faithfully implement" the relevant measures of the ICB Report, subject only to previously identified exceptions. However, Parliament should not be expected to rely on his assurances alone. It is for this reason that the Commission makes specific recommendations about the timetable for parliamentary consideration and scrutiny of the forthcoming primary legislation and the accompanying draft secondary legislation.**

123. **The absence of secondary legislation has seriously impeded the Commission in discharging the task which we have been set by the two Houses of Parliament. In view of the fact that the Treasury has been committed to publishing the primary legislation to enable effect to be given to the ring-fence since at least May 2012, the Commission finds it regrettable that further thought was not given at an earlier stage to the effects of the timing of draft secondary legislation on the process of pre-legislative scrutiny and the wider process of preparing for implementation. Without further information about the secondary legislation, it is not possible for this Commission to assess with any certainty how faithfully the Bill will give effect to the ICB recommendations. The jury is still out**

196 Ev w101

197 Ev w163

on the question of whether the Bill will implement those recommendations in letter and spirit.

124. **The Commission notes the commitment to publish the principal secondary legislation in draft in time for the Commons Committee stage, but considers it inadequate. The Commission strongly recommends that the Government publish the principal secondary legislation giving effect to the ring-fence at the time the Bill itself is published. This is essential to provide a reasonable opportunity for its consideration by regulators and by others directly affected, as well as Parliament. In the absence of their views, parliamentary consideration by relevant Committees and in the two Chambers will inevitably be of very limited value. This would be unacceptable in the case of legislation of such importance.**

125. **The Commission has not received evidence to call into question the appropriateness of a 2019 deadline for full implementation of the ring-fence. The extended timetable for implementation creates a risk of erosion even before the ring-fence is first put in place. This reinforces the need for a high level of transparency during the implementation phase. In addition, the primary concern of Government, Parliament, regulators and the affected institutions should be on getting the new legislation right. The Commission is not persuaded that immediate introduction of the primary legislation and its passage through the two Houses on a normal timetable would best serve this greater interest, given that much of the substance will reside in secondary legislation which should be available in draft. The Commission strongly recommends accordingly that, if the Government proceeds with publication of the Bill before the February 2013 half-term recess, there be a period of three sitting months between the second reading of the Bill in the House of Commons and the commencement of the Committee stage. The Commission would expect a pause prior to Committee stage of at least two sitting months even if the Bill is published later than mid-February.**

9 Reinforcing the ring-fence

Introduction

126. In previous chapters we have indicated how the approach taken by the Government to give effect to a ring-fence leaves that ring-fence especially vulnerable to erosion over time. The Commission has also identified the propensity of regulated firms to seek to press at the limits of permitted activities for short-term economic gain, and the risks that such efforts might be supported by pressure on politicians to agree to convenient changes which reduce the long-term effectiveness of the ring-fence. The Commission has also concluded that the ring-fence requires reinforcement if it is withstand pressures in the long-term. This chapter makes specific recommendations for reinforcement.

Objectives in primary legislation

127. The legislation begins by setting a continuity objective for the regulator described as "protecting the continuity of the provision in the United Kingdom of core services".[198] Barclays pointed out that the continuity of core services objective is "subjective and hard to measure".[199] Chapter 3 illustrated the wide range of options for structural separation in addition to the ICB's proposals, intended in part to provide for continuity of core services. Therefore it could leave the regulator able to use these powers to pursue a wide range of approaches. This could be all the more concerning, given the vulnerability of the regulators and the banking community to fashionable mantras. The legislation's lack of clear objectives leaves its future operation vulnerable to changing attitudes over time.

128. Andrew Bailey identified how specifying objectives more clearly could also help provide greater legitimacy:

> in the context of the legislation that you are scrutinising, we need to have the objectives and the powers set out very clearly. I think it needs to go a step further than it has gone in the draft that we have today, which is a bit too enabling without specifying how the objectives work. Fitted together, that would be a big step forward because it creates a much greater sense of legitimacy.[200]

Andrew Bailey has also requested "better narrative regarding how the PRA's safety and soundness and continuity objectives interact." The FSA believe that, as currently drafted, the draft Bill "implies that if there is a clash, the [PRA's] continuity objective would prevail over the safety and soundness objective".[201]

129. The Chancellor of the Exchequer, when challenged on the lack of objectives in the draft Bill, argued that the continuity objective was all that is needed:

> there is a very clear objective in the Bill, which is that the regulators and the Government of the day can continue the provision of core services in the banking

198 Draft Financial Services (Banking Reform) Bill, Clause 1

199 Ev w29

200 Q 1015

201 Ev w188

> industry in the situation in which a bank is failing. [...] If we crack that, I would say that we will have cracked one of the significant problems—not the only problem—that arose during the banking crisis.[202]

He also expressed concern that adding other objectives would reduce rather than enhance clarity:

> I do not think that adding a load of further objectives would clarify the situation; I think that it would add to the complexity of what we are asking to be done. [...] I think it is important to have a very clear focus on the objective, rather than a load of objectives, and the objective is to allow core services to continue even when we allow a bank to fail. You would muddy the waters if we created more objectives in this legislation.[203]

In a written response to Andrew Bailey's request for clarity, the Chancellor of the Exchequer confirmed that:

> The draft Bill currently sets out how the PRA's objective for ring-fencing and its general objective interact. When the PRA is acting in relation to matters related to ring-fencing, and only then, the PRA is required to act at all times compatibly with its continuity objective. [204]

130. **The ICB final report sets out three, not one, objectives for the ring-fence. These are:**

- **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.**

The continuity objective does not adequately reflect these. In order to anchor implementation of the ring-fence more securely to the ICB's proposals, the Commission recommends that the Bill as introduced imposes additional requirements under the new section 2BA(4) of FSMA to ensure that in advancing the continuity objective, the PRA must also seek to meet the following requirements as set out in paragraph 1.3 of the policy paper accompanying the draft Bill, namely:

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

202 Q 1044

203 Q 1058

204 Ev w191

The continuity objective must be properly understood as being about protecting the continuity of the provision of core services, not about the continuity of institutions. The regulator seeks clarity about how the continuity objective relates to the other objectives of the regulator when exercising powers in relation to the ring-fence. The Commission will take further evidence and report on this matter in the New Year.

131. **In the light of recent revelations the Commission has taken evidence regarding the ability of the ring-fence to protect and enhance standards and culture in the banks and will consider in our final Report whether an additional objective should be considered to address these concerns.**

Regulatory judgement

132. In written evidence, Andy Haldane identified the main steps the regulator could take if it felt a firm were breaching regulatory rules:

- Impose higher capital requirements, or tighter liquidity requirements;
- Take action under the approved persons regime, potentially including removal of approvals;
- Impose a financial penalty;
- Remove links to owners and group companies;
- Vary a bank's authorisations to limit or prevent activities.[205]

In seeking to exercise these powers and otherwise enforce the ring-fence, the regulator is likely to encounter the difficulties which Sir Mervyn King highlighted:

> I have been struck in the last five years, learning more about how the regulatory process worked, by how much of it has turned out to be a negotiation between the regulators on the one hand and banks on the other [...] The big principle is that, to be effective, the regulator has to be able to use judgment. That is what we want to get to. But if judgment ends up simply as a negotiation between the regulator and the regulated bank, there is only one winner in that, and that will be a very bad outcome. Clarity is crucial to enable the regulator to exercise judgment within a very well-defined framework, and the regulator needs to be able to tell banks, "This is the capital requirement you will have", as opposed to merely entering into a negotiation.[206]

133. **It is essential that the new framework for the ring-fence and the secondary legislation and rules that flow from it are not seen by the banks merely as a basis for negotiation. The legitimate role of the judgement of the regulator in implementing the framework must be beyond doubt. The regulator's decision-making, in line with its judgement in pursuit of its objective in relation to the ring-fence, should not require it to identify a specific breach of rules in order to take action to maintain the integrity of**

205 Ev w198

206 Qq 1144-5

the ring-fence. The Commission considers that it is of paramount importance that the new legislation is drafted in such a way as to make this clear.

Conditions on the exercise of certain delegated powers

134. The extreme examples included in paragraph 58 illustrate that the design of the conditions which govern the delegated powers are of vital importance. Those examples demonstrate that the subsequent secondary legislation will not be merely technical, but central to the way the ring-fence operates. Previous chapters have demonstrated that the Government's reliance on secondary legislation poses significant risks to the durability of the ring-fence. Two examples of areas where this may of particular concern are the powers under proposed sections 142A(2)b and 142D(2). The first power allows the Treasury to exempt a class of institution from the requirements of the ring-fence. This is intended in particular to allow the introduction of a de minimis test to exempt small deposit-takers, which is considered in chapter 10, but the power is not limited to this purpose. The second power allows the Treasury to change the definition of an excluded activity—one which ring-fenced banks cannot conduct—for example, a particular type of derivative trade. The test that must be met for use of either power is very similar—that the Treasury believe it would "not be likely to have a significant adverse effect on the continuity of the provision in the United Kingdom of core services".[207]

135. **In addition to the enhanced scrutiny arrangements recommended later in this chapter, the Commission recommends that the Treasury's delegated powers under proposed sections 142A(2)(b) and 142D(2) be tightened. It is insufficient to require only that exemptions from the ring-fence restrictions do not have a "significant adverse effect on the continuity in the United Kingdom of the provision of core services". The fact that this condition is framed as a negative test could too easily allow a series of exemptions cumulatively to weaken and complicate the ring-fence, even if individually these fall short of risking a "significant adverse effect". The provisions should be tightened by requiring that exemptions should be made only if they:**

a) **do not pose a risk to the continuity objective; and**

b) **provide a significant economic or financial stability benefit.**

Determining the height of the ring-fence

136. The draft Bill requires the regulator to use its existing rule-making powers to make additional ring-fencing rules, the stated purpose of which is "ensuring

> a) that the carrying on of core activities by a ring-fenced body is not adversely affected by the acts or omissions of other persons, and

207 Draft Financial Services (Banking Reform) Bill, Clause 4, proposed new section 142A(3). A similar but not identical wording appears in proposed section 142D(3).

b) that any ring-fenced body which is a member of a group is able to act independently of other members of the group in carrying on the business of the ring-fenced body."[208]

137. Constructing the ring-fence will entail major corporate restructuring of all the large UK banks. A great deal of judgement will be involved in this process. The regulator largely tasked with making these rules has said that its mandate in the draft Bill is not strong enough to protect it from challenge:

> should the PRA choose to make ring-fencing rules that are not mandated in the draft Bill, it could potentially be seen to be acting beyond its remit.
>
> In our view the draft Bill should provide 'parameters' within which the PRA is given a statutory mandate to make rules to enforce the appropriate degree of separation between the RFB and the NRFB in the event that it needs to exercise its rule-making powers in ways not specified in the draft Bill.[209]

Andrew Bailey expanded on this in his oral evidence:

> What we have to get right is the balance between giving us the job of implementing a rule book essentially—the short version of it—and Parliament having sufficient hands on in terms of the objectives so that the legitimacy and authority of Parliament is very clearly behind it. That is a balance. At the moment, this is a very short piece of legislation in a sense. It says, "We'll define some objectives and then send you off to police them." I think we have to get the balance right in terms of being a very clear statement of Parliament's intent here.[210]

Paul Tucker concurred, adding that:

> We are clear, and I think that if Adair and Andrew were here they would say the same, that it is important that the meat of the regime is set out in secondary legislation; that the PRA board does not become a quasi-legislative body. I completely agree with Andy that the things that he has set out, and that type of thing, should be in the secondary legislation.[211]

Paul Tucker also summarised the concerns that arose from this approach:

> I think what the FSA is concerned about, and certainly what we are concerned about, is that as drafted, the primary legislation allows the meat of the regime to be set out in secondary legislation, or in PRA rules, or in a combination of the two. Technically, therefore, it would be possible for the secondary legislation to be almost silent, leaving the whole of the regime to be set out in the PRA rules. We are clear [..] that it is important that the meat of the regime is set out in secondary legislation; that the PRA board does not become a quasi-legislative body.[212]

208 Draft Financial Services (Banking Reform) Bill, Clause 4, proposed new section 142H

209 Ev w61

210 Q 977

211 Q 1187 [Paul Tucker]

212 Q 1187

138. The Chancellor of the Exchequer told us that "the rules will ensure the economic and operational independence of ring-fenced banks from the rest of the group in which they sit. The regulator is best placed to deal with these matters but the outcome and objective will be clearly expressed in legislation."[213]

139. **The Commission is extremely concerned, as are the regulators themselves, that the key issues determining the height of the ring-fence are proposed to be a matter for determination by the regulator alone. A regulator enforcing rules of its own creation will have less authority in doing so than a regulator giving effect to a clear mandate in legislation with parliamentary authorisation. There is a compelling case for strengthening the regulator's hand when it makes ring-fencing rules through such a mandate. The Commission recommends accordingly that proposed section 142H of FSMA be amended either to define the parameters of the rules to be set by the regulator more fully or to require that secondary legislation made by the Treasury and subject to the affirmative resolution procedure defines the parameters. The objective of this legislation should be to empower the regulator to police and enforce the ring-fence. The Commission considers in chapter 10 what the legislative parameters should be.**

Scrutiny

140. The Commission received a very helpful memorandum from the House of Lords Delegated Powers and Regulatory Reform Committee in response to our request that they consider the appropriateness of, and scrutiny arrangements for, the delegated powers in the draft Bill. In its submission, that Committee identified two consistent themes: "a lack of appropriate Parliamentary control; and a lack of explanation for some significant powers contained in the draft Bill".[214]

141. The draft Bill proposes only the weakest form of Parliamentary scrutiny—the negative resolution procedure—for all but one of the delegated powers which it gives the Government. Under this procedure, secondary legislation can be made and comes into effect immediately, and only ceases to have effect in the exceptionally rare cases where one House of Parliament passes a resolution requiring it to be annulled. In the House of Commons, even a debate on the secondary legislation in question can only be secured with the agreement of the Government. This procedure is often held to be appropriate in circumstances where delegated powers provide technical detail which implements policy, but does not have the ability to change its direction.

142. The only power relating to the design of the ring-fence where secondary legislation will be subject to the affirmative resolution procedure is the one under proposed section 142A(2)(b) (the power to exempt classes of institution from the ring-fence). Under the affirmative procedure, secondary legislation can only come into force (or, in certain urgent cases, remain in force) if both Houses of Parliament agree to this after a debate, usually in a Delegated Legislation Committee in the House of Commons and in Grand Committee in the House of Lords.

213 Ev w191

214 Ev w3

143. The other five powers listed in paragraph 57, which together give the Treasury the ability to add or exempt activities which must or cannot be done in a ring-fenced bank, are only subject to negative resolution. The Treasury's delegated powers memorandum attempts to justify the choice of procedure for several of the powers by reference to the fact that the power is likely to be technical or that there are restrictions on the use of the power.[215] As discussed in chapter 4, while these powers may well be technical in content, their scope is not confined just to matters of detail but can have important policy implications, and allow for a wider departure from the ring-fence as currently planned.

144. The assessment of the Delegated Powers and Regulatory Reform Committee was that all six powers listed in paragraph 57, which together define the ring-fence, should be subject to affirmative procedure, not just that under proposed section 142A(2)(b). That Committee questioned in particular one of the justifications given in the delegated powers memorandum for the choice of procedure for the power under proposed section 142B(2), which is the power to define when accepting deposits is not to be regarded as a "core activity". The justification referred to "the fact that the effect of the power will be to narrow the range of cases where a person who accepts deposits must be a ring-fenced bank or an exempt bank".[216] As the Committee noted, this is "based on the assumption that removing control needs a lower level of Parliamentary scrutiny than imposing it and we do not consider that the assumption may be so easily made here where important issues of public policy may be at stake".[217]

145. Another justification for negative resolution which the Committee challenged was that given for the power to create new core activities (under proposed section 142B(5)), where the Treasury referred to the fact that it is possible that it might in some cases be desirable to take urgent action to protect the activity in question.[218] The Committee noted that "the possible need for urgency [...] cannot be accepted as a justification, since FSMA itself deals with urgency in other affirmative cases by means of the 28-day 'made affirmative' procedure (i.e. in force immediately but lapses if not approved within 28 days)."[219]

146. **The scrutiny arrangements for secondary legislation as specified in the draft Bill are unacceptably weak. Many of the delegated powers may involve significant policy choices, not merely implementation decisions of a technical nature. The Commission recommends that use of each of the delegated powers under proposed new sections 142B(5), 142D(2), 142D(4) and 142E should be subject to the affirmative resolution procedure.**

147. The Delegated Powers and Regulatory Reform Committee also noted the significance of the powers under proposed section 142F. According to the Delegated Powers Memorandum, these are supplementary powers which enable the Treasury to "give the regulator power to make technical provisions related to core activities and excluded

215 Ev w1, paras 5, 31, 35, 44, 51

216 Ev w3

217 Ev w54

218 Ev w3

219 Ev w54

activities, in areas which are generally treated as the preserve of the regulator".[220] In other words they permit the Treasury to delegate responsibility for some of the technical detail to the regulator rather than this all needing to be set out in secondary legislation. However, the Committee explained to us that section 142F also "enables an order:

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

The Committee concluded that as a result of this

> for example, an order could authorise the Treasury to make regulations or give directions for the purposes of the order, without a need for Parliamentary procedure, thus relegating parts of the material covered by the order to an instrument free of any Parliamentary control. We were not convinced that this is appropriate.[221]

148. In response to the concerns expressed, the Treasury stressed that the power under section 142F was a subsidiary one, and that it would not enable the Treasury to give itself the power to create new excluded activities or core activities, or to provide for exceptions to the core and excluded activities provided for on the face of the Bill without following the parliamentary procedure laid down under the earlier sections.[222]

149. **The Commission has concluded that the range of powers available to the Treasury under proposed section 142F is unacceptably wide. As a first step, the Commission recommends that the power of the Treasury to give itself further order-making powers be more fully circumscribed. In particular, there should be a requirement that the power further to delegate under secondary legislation a power to make what might be termed tertiary legislation should be subject to the same parliamentary procedure as the instrument by which the power to make it is delegated. The Commission also recommends that, in the delegated powers memorandum accompanying the Bill itself, the Government set out in more detail the proposed use of each of the additional delegated powers it is seeking in section 142F.**

150. The concerns expressed about certain delegated powers are magnified in many ways by the underlying concern that has run through our consideration of the ring-fence proposals, namely that, even if the ring-fence is faithfully implemented at first in accordance with the firm commitment of the current Chancellor of the Exchequer, it risks being eroded over time. We have therefore considered what additional parliamentary bulwark could be established to prevent, or at least highlight, such erosion.

220 Ev w6

221 Ev w54

222 Ev w193

151. **The Commission has concluded that a necessary form of parliamentary bulwark against erosion is the creation of a specific statutory provision for enhanced parliamentary scrutiny of the proposed use of delegated powers which have the potential to change the location of the ring-fence in a significant way. This would apply to all uses of the powers referred to in paragraph 146, subject to exceptions for secondary legislation of an urgent nature, which should be subject to the 'made affirmative' procedure. This scrutiny would be undertaken by a small ad hoc joint committee of both Houses of Parliament, to be established on each occasion subsequent to the first use of each delegated power when the Treasury proposes to exercise one of those delegated powers. Although the membership of the joint committee would be determined by decisions of the two Houses, there should be a statutory requirement for the Chairman of the House of Commons Treasury Committee to be an ex officio member of it.**

152. **The Government would be required to publish its case for the proposed new use of the power, alongside a provisional version of the secondary legislation itself. This provisional version would be subject to public consultation. The ad hoc joint committee would be established at the outset of this consultation phase. It would examine and report on the proposal within a specified period. After that report, the Government could proceed with secondary legislation in the usual way, albeit subject to the affirmative resolution procedure in accordance with the Commission's recommendation in paragraph 146, but would do so in a way that secures far greater transparency about the purpose and likely effect of any changes.**

Electrifying the ring-fence

Evidence received

153. The final element which the Commission has considered to create the best prospects for the long-term effectiveness of the ring-fence is its electrification, by which we mean creating a very significant disincentive for banks to depart from the spirit of the ring-fence by creating full structural separation as a viable alternative.

154. Advocates of a ring-fence did not rule out the possibility of full structural separation in the future. Sir John Vickers told us that, while he was optimistic about the prospects of the ring-fence succeeding, full separation might become necessary:

> If the industry turned out to be unreformable, and I am not so pessimistic as to think that, of course it is possible that total separation would turn out in due course to be the better step to take[223]

Martin Taylor identified circumstances in which his preference for a ring-fence might change over time:

> The main reason why I would support a full split was if I thought a ring-fence was unworkable. I do not think that—I think a ring-fence is a superior solution—but if a

223 Q 762

ring-fence were put in place and proved to be unworkable because of attrition, as you call it, there would be a case for going further, but I do not start from that.[224]

155. Referring explicitly to the exchanges between the Chairman of this Commission and Martin Taylor in which the possibility of a contingent power to impose full separation was raised, Andy Haldane developed the proposition further:

> I was struck by the point made by you, Chairman, in the testimony provided by Martin Taylor, where you floated the idea of having as a back-stop, perhaps as a legislative back-stop, the possibility of separation if the ring-fence proves permeable or impossible to police. That is an idea that is worth thinking about. I can see some attractions to that from an incentives perspective. What it makes clear is that if for whatever reason the ring-fence does not work as planned, the next step is not to remove it entirely but to go the next step.[225]

Andrew Bailey also voiced his support for such a measure to deter banks from attempting to circumvent the ring-fence, but noted the importance of making this a credible tool:

> Get it right, and it is a very sensible deterrent that would make people think twice about tunnelling. My point is that we need to get it right in the sense that we need to construct a deterrent power that the institutions know we could use.[226]

156. Witnesses noted that the way in which a full-separation backstop was designed would be central to its effectiveness, and that there would be important questions about accountability for use of such a tool. Sir John Vickers said:

> there are obvious questions about who would exercise that power, if it were there as a reserve power, and under what conditions that power would be exercised. It is not unprecedented for companies in this country to be required to separate, but I believe it is very rare.[227]

Paul Tucker pointed out that the appropriate accountability for the use of a backstop would depend on whether it was intended to trigger full separation across the whole industry or to target an individual firm that was causing problems:

> It is important to make a distinction between whether this question is about changing the ring-fencing policy to full separation across the board as a general policy, which should lie with Parliament—we do not want to be legislators—or about specific institutions. [...] In terms of dealing with individual banks burrowing under the ring-fence and rendering themselves unresolvable or not super-resolvable in consequence, the regulator should have the power to say something.[228]

157. Andrew Bailey explored further the idea of a regulatory tool that could be used against individual institutions:

224 Q 361

225 Q 596

226 Q 952

227 Q 748

228 Q 1155

> if you found that the institution was misbehaving in the sense that it was tunnelling under the ring-fence, that it was masquerading things one side of the ring-fence that should be the other side of the ring-fence, that would risk invalidating your resolution plans. [...] at which point you would say, "I am sorry but you have effectively voided the right to operate this system because we cannot be sure that we could actually resolve you in that situation because you seem to be so tricky to deal with that we could not be sure that the plans were actually operable."[229]

Sir John Vickers noted that the requirement for full separation in the case of individual banks would not pose the same risk to diversification as requiring this for the sector as a whole:

> One reason why I, and we, were wary of mandating a full split for the sector as a whole was that it could create a sector of stand-alone, rather similar, undiversified, highly correlated institutions, whereas if a power were deployed in relation to one or two banks, but not the others, that loss of diversity point would not have such traction.[230]

158. Andy Haldane pointed out that it would take "further legal work to see whether that ultimate sanction was practical",[231] but pre-empted one argument that he expected might be deployed against it:

> I would be resistant to the notion that merely having this sanction power would cause banks to look inward—to hoard capital and not lend. We have heard that argument far too much over the last few years, and we must not be held hostage, in doing the right thing, by the notion that the banks will stop lending.

He also recommended that the way to "avoid any adverse behavioural consequences" arising from the existence of such a backstop sanction would be to "seek absolute clarity about where the boundaries of the ring-fence were drawn":

> If there is ambiguity, blurriness or greyness in where the boundary lies, that could legitimately cause banks to hold back and to worry about getting on the wrong side of the line and then facing the ultimate sanction. The greater the clarity about where that line is drawn, the less the chances of adverse behavioural consequences from the ring-fence.[232]

Relevant existing and prospective powers

159. In examining the likely form and effectiveness of a back-stop power of the kind that was canvassed in evidence, it is necessary to consider the relevant existing powers of the regulator. We noted earlier the range of powers listed by Andy Haldane.[233] One of these powers was to the power to vary or cancel a firm's permission to carry on regulated business under section 45 of FSMA. This power might notionally be used to prevent a ring-

229 Q 964

230 Q 752

231 Q 1151

232 Q 1151

233 See paragraph 132.

fenced bank from carrying on certain specified regulated activities, which might amount to all activities that fall outside the ring-fence. However, it stops short of being a power to require a restructuring or reorganisation of the business of a bank breaching the ring-fence.

160. There a number of safeguards for the exercise of the power under section 45 of FSMA. First, the regulator may only exercise this power in pursuance of its regulatory objectives, which for these purposes will include the continuity objective that we have discussed in the previous section when the relevant legislation comes into force.[234] Second, any restriction imposed upon a firm must be proportionate to the objectives the FSA is seeking to achieve.[235] Third, a regulator must give the regulated firm written notice of any proposal to exercise the power, provide that firm with a chance to make representations (whether or not the firm has referred the matter to the Tax and Chancery Chamber of the Upper Tribunal (Upper Tribunal)) and inform the firm of the right to refer the matter to the Upper Tribunal. Fourth, if having considered the representations the regulator decides to proceed, it must provide the firm with written notice which confirms the decision and informs the firm of the right to refer the matter to the Upper Tribunal. Where a firm does refer a matter to the Upper Tribunal, the case will be heard by at least one High Court judge sitting with one or two non-legal experts. Fifth, an appeal may be made, with leave, from the Upper Tribunal to the Court of Appeal on a point of law.[236]

161. Paul Tucker also drew attention to the fact that the draft Recovery and Resolution Directive (RRD), if passed in its current draft form, would give the regulator

> the power to say to a bank, including a ring-fenced bank, that it is not resolvable, "You need to do one of a number of things, including shifting around your organisational structure to ensure that you are resolvable."[237]

Andy Haldane expanded on this possibility in written evidence:

> The range of sanctions envisaged in the RRD is extensive, including divestment, limiting or ceasing certain activities and, ultimately, requiring changes to the legal or operational structures of the firm [...] The rationale for a reserve power would be slightly different than in a resolution context (continuity of core service rather than resolvability) but the underlying rationale would be the same (protecting financial stability).[238]

Conclusions

162. **There is a strong case for the proposition that full structural separation would be the wisest course to take. As we noted earlier, Sir Mervyn King told us that he had "always felt that total separation was the right way ultimately to go" and that he was "glad that many more people are now coming on board with the idea that a move to**

234 Section 45(1)(c) FSMA

235 FSA Enforcement Information Guide, www.fsa.gov.uk, Chapter 8

236 Section 53 FSMA

237 Q 1152

238 Ev w198

some kind of serious separation is the right thing to do". At the very least, it is essential that it remains a possibility.

163. **The ring-fence envisaged by the Government may, in the long run, not provide an adequate degree of separation. Nor may it be adequate to buttress banking standards. The role that separation might play in strengthening standards across the banking sector is a matter to which we will return in the New Year. The inadequacies of the framework may become apparent over time, as banks seek to test the strength of the ring-fence. The evidence received by the Commission from the current regulators, and to which we referred in chapter 5, highlighted the pressure which is likely to be exerted on the regulator by banks and by politicians to take steps consistent with short-term profitability and sectoral development, but inconsistent with the long-term objectives of the ring-fence. Additional powers are essential to provide adequate incentives for the banks to comply not just with the rules of the ring-fence, but also with their spirit. In the absence of the Commission's legislative proposals to electrify the ring-fence, the risk that the ring-fence will eventually fail will be much higher.**

Reserve powers in respect of individual banking groups

164. **The regulator already has powers under section 45 of FSMA to require banks to cease certain activities in specified circumstances. The Commission believes that it is necessary to go further. The Commission recommends that the forthcoming legislation add reserve powers to implement full separation.**

165. **The first reserve power would be a power exercisable in respect of individual companies. A second reserve power would relate to the sector as a whole and would be exercisable in consequences of the review to which we refer in paragraph 171. With regard to the first reserve power, the Bill should include powers for the regulator to take steps that could lead to a specific banking group affected by the ring-fence being required to divest itself fully of either its ring-fenced or its non-ring-fenced bank. The powers would be exercisable only if the regulator had concluded that the conduct of that banking group was such as to create a significant risk that the objectives of the ring-fence would not be met in respect of that bank. In these circumstances the regulator should consider the group's adherence to the principles and spirit of the ring-fence as well as its compliance with the letter of the law. The Commission recommends that the objectives for this purpose should be aligned with those for the relevant work of the regulator set out on the face of the Bill, as amended from the draft Bill in accordance with our recommendation in paragraph 130.**

166. **The Commission recommendation is of sufficient significance to require a number of limitations and safeguards. First, in order to allow time for the ring-fence to demonstrate its effectiveness, the Commission recommends that the Bill provides that the powers should not be exercisable by the regulator until after the completion of the first independent review of the effectiveness of the ring-fence that we propose in paragraph 171 and that we envisage should be completed less than four years after the ring-fence comes into force. The opportunity of this delay in commencement should also be taken by the Government to secure amendments to European legislation to ensure that the provisions relating to full structural separation are compatible with European law.**

167. The Commission is convinced that there is a need for clarity and certainty about these powers. They should be separately provided for in the legislation which the Government plans to introduce early next year. The Commission considers that the new provisions should set out a series of steps that would have to be taken by the regulator. First, the regulator might be required to inform the banking group concerned of the regulator's intention to take steps which might lead to a requirement for full structural separation of the group. This would provide the group with an opportunity to make representations for remedy. If the regulator wished to proceed, the regulator might be required to propose the appointment of an external reviewer to consider the standards and conduct of the bank and its relationship with the regulator. The involvement of an external reviewer at this stage would be a crucial safeguard against discriminatory conduct by the regulator. The Commission envisages that there would be a statutory requirement modelled on the provisions of paragraph 1(1)(a) of Schedule 1 to the Budget Responsibility and National Audit Act 2011 (on the appointment of the chair of the Office for Budget Responsibility) requiring the consent of the Treasury Committee for the regulator's proposed appointee as external reviewer.

168. In the light of the report of the external reviewer and any representations of the banking group, if the regulator still wished to proceed, it would have the power to recommend that divestment of activities either inside or outside the ring-fence take place. This power would be subject to the same rights of appeal as the power currently exercisable by the regulator under section 45 of FSMA. The Commission has concluded that it would be inappropriate for the regulator, acting alone, to move directly to enforcement of full separation in respect of a banking group. The regulator should therefore make its recommendation known, in the first instance, to the Treasury, which would have the power, in the last resort, to override its implementation. In order to ensure transparency and parliamentary accountability, the recommendation would need to be made public at an appropriate stage. Should the Treasury decide to exercise its override power, that too, together with the Treasury's reasoning, would need to be made public at the same time. If, for reasons of confidentiality and market confidence (amongst other reasons), there is a delay in the publication of the recommendation, the Chairman of the Treasury Committee should be informed in confidence of the final recommendation.

Review mechanism

169. The draft Bill currently contains only a narrow review mechanism, which requires the regulator to report on the effectiveness of its own ring-fencing rules after five years and every five years thereafter. That review would not necessarily comment on the wider design of the ring-fence as defined in secondary legislation. For example, it is not obvious that the review could comment on the de-minimis threshold or the exemption for large depositors. The current provisions for the review laid down in proposed section 142I of FSMA also do not prescribe the terms of the review or any follow up mechanism, beyond requirements for the report to be given to the Treasury, laid before Parliament and published.

170. Reliance on the regulator to conduct the review has the advantage that it is likely to have the best understanding of the operation of the ring-fence in practice, through its regular engagement with firms. However, this also carries the risk that that the regulator could be too close to the issues, and could find it hard to provide objective criticism of a set

of rules which it had principal responsibility for preparing and implementing. Virgin Money noted that alternative bodies could conduct such a review:

> there is a case for the reviews to be carried out by a body other than a body that was involved in setting the rules. If not by the PRA, the reviews could be carried out either by the Treasury Committee and/or by an independent body with appropriate credentials.[239]

Sir Mervyn King favoured the legislation including:

> a provision to reconstitute this body, or a successor body, three, four, five years down the road to review how far the ring-fencing of Vickers had worked and whether any amendments were needed. In other words, a definite compulsory review should be built which could not just be avoided and put off; it has to take place in order that there would be an open study of whether or not there had been too much borrowing.[240]

171. **The review mechanism currently included in the draft Bill is narrow and unacceptably weak. The Commission recommends an annual report from the PRA on the operation of the ring-fence. This is important to provide transparency on any issues arising between the regulator and banks and will give the regulator a vehicle for exposing attempts to game the system, get round or burrow under the ring-fence. The Commission recommends that the Bill be greatly strengthened. It should require a regular review of the effectiveness of the ring-fence across all banks to which the rules apply. The review body's terms of reference should require it to express a view on whether ring-fencing is achieving the objectives set out in legislation, and to assess the case for a move to full separation across the banking sector as a whole. The terms of reference for the review should be set out in statute, based on the objectives for the ring-fence as laid down in legislation. The review body should have a duty to make recommendations to the regulator and the Treasury about the design and application of secondary legislation and ring-fencing rules. Prior to that review, the Bill should require that the PRA publish a statement which summarises how the ring-fencing rules have been implemented by the industry with specific consideration being given to how the position of the ring-fence has evolved, primarily focusing on what activities and services, in addition to the core activities and core services, sit within the ring-fenced bank and to the type of derivative products are being offered by the ring-fenced banks. The review body should be able to draw upon the work conducted by the regulator as part of its statement on the position as it has evolved by then. If the first review does not lead to full separation, second and subsequent reviews should also draw upon the regulator's accounts of experience in relation to the first reserve power the creation of which the Commission has recommended. Significant use of this reserve power would indicate that full separation across the banking sector would be very likely to be the appropriate step. The independent review should take place within four years of the rules implementing the ring-fence taking effect, and regularly at an interval specified in statute of no more than five years.**

239 Ev w156

240 Q 1152

172. **The review body should be independently-led in order to provide appropriate challenge to the Treasury and PRA, who may otherwise find it difficult to criticise their own involvement in designing the framework. We would expect the body to have a range of backgrounds and views comparable to that of the ICB, although we believe that it should also include a former very senior central banker or regulator.**

10 Specific issues on ring-fence implementation

Introduction

173. We noted earlier that the Treasury has already provided information on six intended uses of its proposed delegated powers under the new primary legislation. In this section we explore four of those proposed uses. We also consider whether retail lending and lending to small and medium sized enterprises (SMEs) should be required to be inside the ring-fence, and the question of assigning legacy liabilities following the creation of ring-fenced and non-ring-fenced entities.

Derivatives

The issue

174. Banks currently provide a range of derivative products to help businesses manage risk, commonly from movements in interest and exchange rates. The ICB final report set out a series of principles about what services ring-fenced banks should be prohibited from providing. It explained that these principles would only allow the provision of risk management products such as derivatives if a number of restrictive conditions were met. A ring-fenced bank could only offer risk management services if:

> 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.[241]

The ICB went on to state that the most straightforward way to fulfil these conditions "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".[242] Sir John Vickers confirmed that the ICB had come down against ring-fenced entities being allowed to sell hedging products as principal, rather than just as an agent for another part of the bank.[243]

175. The Treasury, in its June White Paper, took the contrary view. A ring-fenced bank should be permitted "to provide 'simple' derivatives products to its customers, provided that a number of conditions are met".[244] The white paper went on:

> The Government proposes to take a power to set out in secondary legislation the conditions in which ring-fenced banks may deal in investments as principal [...] These proposals will enable ring-fenced banks to provide a full range of services to

241 Independent Commission on Banking, Final Report, September 2011, para 3.43

242 *Ibid.*

243 Q 786

244 HM Treasury, *Banking reform: delivering stability and supporting a sustainable economy*, June 2012, Cm 8356, p 4

> individuals and SME customers, while ensuring that the vast majority of other investment banking services remain firmly outside the ring-fence.[245]

On publishing the draft Bill, the Chancellor of the Exchequer wrote to the Commission requesting a view on "the question of whether ring-fenced banks should be permitted to sell simple risk-management products, including simple derivatives, to their customers".[246]

Risks arising from derivatives

176. Derivatives can both generate risk and protect banks from risk, depending how they are used. Allowing a ring-fenced bank to sell a derivative directly to a customer can expose the bank to market risk. For example, if a bank sells protection against rising interest rates and rates subsequently rise, the bank will be exposed to a loss. In practice, banks also hedge such market risk using derivatives, by buying onward protection in the wholesale market. They also use derivatives to hedge a range of other risks arising from their normal activities. Selling products such as fixed-rate mortgages or savings accounts exposes banks to the same kind of market risks as selling derivatives to SMEs, and on a significantly larger scale, given that these products comprise a higher portion of a typical retail bank's balance sheet. Even if a position is hedged, this may leave a bank exposed to counterparty risk—the risk that the institution providing the hedge would be unable to meet its obligations.

177. The Government is proposing to allow an exemption to the ban on "trading in investments as principal" to allow banks to hedge risks arising on their own balance sheet. However, in permitting the trading of derivatives, there is a risk that while they are intended as a tool for mitigating risks they could also be misused, and this could be hard for supervisors to detect without detailed monitoring. The proposed exemption would therefore come with a series of conditions on such hedging activity to minimise the scope for it being a back-door to proprietary trading, for example a cap on residual market exposure and a requirement to collateralise counterparty risk.[247]

178. Andrew Bailey identified a possible impact on resolution of banks if they were allowed to sell derivatives as principal:

> In my experience, derivatives are typically not the proximate reason why banks fail. They can be very complicated to deal with when banks fail, even very small banks, but they are not typically the proximate reason. What we don't want is the derivative equivalent of proprietary position-taking going on.[248]

The presence of derivatives on a bank's balance sheet is likely to complicate resolution in the event that it fails, since they can be hard to value and hard to close out or sell off in a hurry without incurring losses. As highlighted by the resolution of Dunfermline Building Society, even the presence of a small derivatives book can significantly complicate

245 HM Treasury, *Banking reform: delivering stability and supporting a sustainable economy*, June 2012, Cm 8356, para 2.39

246 Ev w1

247 HM Treasury, *Banking reform: delivering stability and supporting a sustainable economy*, June 2012, Cm 8356, p 23

248 Q 993

resolution.[249] Large derivative books or the use of complex, non-standardised contracts would worsen this problem.

179. In contrast, Stephen Hester argued that there might be a greater risk in resolution from forcing all derivatives outside the ring-fenced bank:

> Suppose the ring-fencing works as some people desire, and a crisis happens in which one side goes bust and the other does not. A customer might believe they had a fixed-rate loan, which is a combination of a floating-rate loan and a swap that made it fixed rate, but one of those is cancelled as non-operative because of the bust entity, and the other is not. Suddenly, the customer is exposed. They did not want to be exposed, but they were forced to take out those contracts with two different people.[250]

180. In the White Paper, the Government proposed a cap on the net residual market risk of a ring-fenced bank's derivatives. Under these proposals, un-hedged risks would be capped, but banks would be allowed to sell any volume of derivatives, provided that they hedged the market risk and collateralised their credit exposure. RBS suggested that there might also be a case for imposing a gross cap, which would ignore the extent to which market and credit risks were hedged and therefore place a ceiling on the ring-fenced bank's overall derivatives activity:

> These restrictions could be supported by a materiality threshold on how much of the ring-fenced bank's business could be taken up by these client-originated products – for example, a cap on the proportion of the ring-fenced bank's revenues or gross balance sheet devoted to such products. This would address concerns about the impact of providing these products on the resilience and resolvability of a ring-fenced bank in a more general market crisis.[251]

The customer benefit

181. A number of witnesses made the argument that prohibiting ring-fenced banks from acting as principal for derivatives would have a detrimental impact on SME customers, and that some form of derivatives should therefore be allowed within the ring-fence.[252] Vedanta Hedging summarised the rationale for SMEs' use of derivatives:

> For SMEs that import, export or have a material exposure to foreign currency movements, derivatives can help them to budget and plan their business more effectively. Significant currency swings can easily erode tight profit margins in an increasingly global and competitive marketplace.
>
> SMEs that have a substantial amount of borrowing relative to the value of their assets (gearing) may also wish to use some type of derivative to protect themselves from rising interest rates. In the same way that an individual obtaining a mortgage will

249 Bank of England, *Bank resolution and safeguarding the creditors left behind*, Bank of England Quarterly Bulletin 2011 Q3, p 220

250 Q 943

251 Ev w106

252 Ev w42 para 9 [Building Societies Association]; PLS 014: Ev w70 para 23 [ICAEW]; Ev w24 [Lloyds Banking Group]: Ev w10 para 16.1; Ev w124 para 9.1 [Santander UK]; Ev w135 para 1.56; Q 709 [John Grout]

> have an option of repaying their loan on a fixed, floating or tracker basis, SMEs should also be able to make such risk management decisions.[253]

The Chancellor of the Exchequer pointed out that many customers buying derivatives in these circumstances might not even be aware they were doing so:

> If you are a farmer who wants to hedge your income or protect yourself in fluctuations in the euro-sterling exchange rate, you go to your local branch in rural North Yorkshire and buy yourself a derivative. You may not know that you are doing so, but you are.[254]

182. Santander suggested that, if ring-fenced banks could only sell derivatives to SMEs on an agency basis, without it going through their own balance sheet, this would increase the cost and complexity for customers. Santander explained that increased costs would be largely due to the fact that a third-party provider would lack the same relationship with a small customer and would require additional collateral:

> If businesses are unable to access simple risk management products from ring-fenced banks, Santander UK believes that SMEs and mid-caps will not be able to access them at all, or will only be able to access them from institutions outside the ring-fence. These institutions are unlikely to have the same close relationship and long term commitment to the business as the ring-fenced bank. Furthermore, as SMEs will also have to post additional collateral to entities outside the ring-fence for these services, they will also be more expensive, and likely prohibitively so.[255]

This point was echoed by others.[256] John Grout pointed out that non-ring-fenced banks might need to charge a high margin in order to make it worth their while offering such products to SMEs:

> They can always provide those risk-management products on margin. That is to say that they can take cash off the small company to reduce their risk that the small company goes bust when its obligation under the derivative is to the bank [...] Additionally, that begins to tie up the credit of the company because no netting off is possible, which it would be in a broader relationship. That makes it expensive. Small companies, being small, do not provide a lot of business, so the return on understanding—doing the credit work to understand and set up a line of credit to use for dealing purposes—would not be remunerated.[257]

183. The ICB concluded, in the words of Sir John Vickers, not to accept the suggestion that "the agency model [...] would increase costs greatly".[258] It is notable that the Federation of Small Businesses submitted evidence in favour of a prohibition, suggesting that businesses themselves might not be concerned about the possible impacts on cost and convenience.[259]

253 Ev w189

254 Q 1075

255 Ev w124

256 Ev w105, para 16.2 [RBS]; Q 694.

257 Q 708

258 Q 786

259 Ev w188

Conduct issues

184. The extent of the interest-rate swap mis-selling scandal only began to emerge in early 2012. The conduct of derivative sales was therefore not a factor which the ICB considered. It is also unlikely to have influenced the Government's conclusions in their June White Paper. In drawing the Commission's particular attention to this issue in October, the Chancellor of the Exchequer wrote that "recent events have highlighted the conduct risks around the sale of derivatives, including the risk of mis-selling by banks".

185. Some who opposed allowing derivatives within the ring-fence based their case in part on the view that a prohibition would improve conduct and prevent mis-selling. Hermes argued that excluding derivatives would mean that banks would need to convince customers that "the benefits of such tools made it worthwhile to deal with the bank outside the ring-fence".[260] Based on the experience of Payment Protection Insurance, Which? argued that, as key providers of credit, the ring-fenced banks would be in a stronger position to make the provision of a loan depend (or appear to depend) on the purchase of a derivative product. Which? suggested that, in consequence, "if ring-fenced banks are allowed to sell derivatives then they could be used to extract value from the ring-fenced bank to the wider group". In addition, there was a "risk of derivatives being sold inappropriately leading to subsequent payments of redress which might destabilise the ring-fenced bank".[261]

186. The Chancellor of the Exchequer noted that, "regrettably, mis-selling can, of course, occur with any product, and under any business structure".[262] Vedanta Hedging argued that it was possible that allowing the ring-fenced bank to provide some derivatives could even improve conduct if doing so resulted in SMEs being presented with only a limited choice of simple products:

> We believe that if ring-fenced banks are permitted to provide simple derivative risk management options as per above, this will actually improve the conduct of how these products are sold. This is because there will be tighter rules governing how and what may be sold to these SMEs. If the ring- fence bank cannot provide these derivatives, and the SME must seek an alternative (non ring-fenced bank) for them, there is nothing to stop that bank providing any type of derivative, for any amount of notional size and duration.[263]

Defining "simple" derivatives

187. The case that the riskiness, resolvability and conduct of ring-fenced banks will not be damaged by allowing them to sell derivatives rests upon the presumption that ring-fenced banks will be restricted to the sale of "simple" derivatives. The Government has proposed to restrict the sale of derivatives by ring-fenced banks as principal to "simple" derivatives. In June 2012 it stated that "the appropriate definition of a 'simple' derivative could be one, or a combination of the following:

260 Ev w65

261 Ev w167

262 Ev w w1

263 Ev w191

- an instrument whose purpose is to fix or cap client market exposures to interest rate or foreign exchange rate risk related to the business of the ring-fenced bank (for example lending and payments services);
- an instrument defined by the Prudential Regulation Authority (PRA) as standardised and for the purpose of hedging only interest rate and/or foreign exchange risk in deep and liquid markets [...]."[264]

188. Several witnesses argued that the range of permitted derivatives should be restricted just to those for managing interest rate and foreign exchange rate risk, and that the vast majority of SME needs could be served with only a few, well-understood products.[265] Lord Turner said:

> It is clear that if the ring-fenced banks are basically selling products to households and small businesses, it is extremely unlikely that complex, bespoke derivatives will have a useful role. They are likely to be a relatively small suite of relatively well understandable derivatives in the arena of taking a variable rate and turning it into a fixed or the other way round, which is pretty much the limit of the sensible things for them to be selling.[266]

John Grout considered that another feature of "simple" derivatives should be that they do not include any options that can be exercised by the bank against the customer,[267] a point supported by Vedanta Hedging, who said:

> By 'simple' derivatives, we mean derivatives where there are no knock-in / knock-out or digital options (a feature of 'structured collars') and no ability for the bank to unilaterally extend or cancel the derivative. These 'complex' products typically involve the SME selling one or more 'options' to the bank. These types of derivative can be viewed as more akin to 'speculative' products rather than 'hedging' products.[268]

Both John Grout and Vedanta Hedging also recommended that "simple" derivatives should require that the hedge be matched to the underlying risk, so that, for example, the term and notional value of an interest rate swap would not exceed those of the floating rate loan which was being hedged.[269]

The FSA highlighted the importance of clear limits in legislation around what kind of derivatives can be provided:

> Any hedging exemption, for example, will require consideration of limits around product type, client type, and size of activity. It is essential that any exemption is crafted with certainty to enable the PRA to effectively supervise it. Without clarity, there is a significant risk that supervising the exemption could become unachievable

264 HM Treasury, *Banking reform: delivering stability and supporting a sustainable economy*, June 2012, Cm 8356, p 4

265 Ev w97 [Nomura]; Ev w124, para 9.5 [Santander UK].

266 Q 994

267 Q 743

268 Ev w190

269 Ev w190

> or extremely resource intensive. Similarly, if the exemptions become too complex to supervise then the objectives of ring-fencing may be undermined.[270]

189. Some banks argued that narrow restrictions on derivative products would limit their ability to offer more customised and sophisticated products to clients who needed them. RBS said that one of the Government's proposals could "exclude innovative products of material befits to clients",[271] while HSBC said that restricting the range to just interest rates and foreign exchange would be "less efficient than they might be" because "not all risk hedges will be capable of being put in place using standardised derivatives contracts". They argued that "scope, within limits, should be created for non-standardised transactions, under standardised [...] documentation and with collateral posted".[272]

190. Several witnesses were concerned that permitting the sale of even simple derivatives within the ring-fenced bank could be, as Martin Taylor put it, the "thin edge of the wedge". He argued "This seems to be absolutely the sort of area that will go the slippery slope way, as Paul Volcker described on Glass-Steagall".[273] The ICB final report pointed out that

> 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.[274]

Sir Mervyn King said "It is almost impossible to differentiate between a simple and a complex derivative",[275] while Sir John Vickers said:

> It is easier to say "You can't do it" than "You can do it, but only if they're simple". It would be a supreme irony if we ended up with a 100-page rule book defining the meaning of the word "simple".[276]

However, Lord Turner was more sanguine about this challenge, saying "This is not something that terrifies us in terms of this being an open season for escaping and getting round it".[277]

Conclusions

191. **Allowing ring-fenced banks to sell derivatives other than as an agent creates additional prudential and conduct risks. There are genuine concerns that this may lead over time to the sale by ring-fenced banks of more complex and risky products. The larger and more complex the derivative book, the more of a threat it could pose.**

192. **The effects on consumers of allowing or prohibiting certain derivatives from being sold by ring-fenced banks as principal are uncertain. Banks have argued that a**

270 Ev w62

271 Ev w106

272 Ev 135

273 Qq 386-387

274 Independent Commission on Banking, Final Report, September 2011, p 36

275 Q 1191

276 Q 786

277 Q 993

prohibition would result in consumer detriment, but selling derivatives to SMEs has been a highly profitable activity for them and investigations of mis-selling of interest rate swaps demonstrate the risk this poses to trust between banks and their customers; if ring-fenced banks were limited in their ability to provide these products directly it is plausible that the wider market would evolve and that other providers would compete to pick up the business to the benefit of consumers. The control of the sale of derivatives to prevent mis-selling is a matter of fundamental importance, to which the Commission will return in the New Year, but it is far from evident that the use of a structural solution (preventing ring-fenced banks from acting as principal) would be the best tool to deal with this issue.

193. **The sale of derivatives within the ring-fence poses a risk to the success of the ring-fence. The Commission has concluded that there is a case in principle for permitting the sale of simple derivatives within the ring-fence. However, such permission would need to be subject to conditions. The first is that there are adequate safeguards to prevent the mis-selling of derivative products within the ring-fence, a matter to which the Commission will return in the New Year. The second is that "simple" derivatives can be defined in a way which is limited and durable, a matter we consider in the next paragraph. The third is that there are limits on the proportion of a bank's balance sheet which is allowed to be taken up by these products. We remain concerned that allowing these products within the ring-fence may be the thin end of a wedge which could undermine the ring-fence.**

194. **In addition to the elements of a "simple" derivative already identified by the Treasury, it is essential that there is a requirement that the size, maturity and basis of simple products should be limited to hedging the underlying client risk. The definition of 'simple derivatives' must appear in legislation. The Commission recommends that the proposed initial definition should be provided to the Treasury Committee before the Bill has completed its Commons stages. Whatever definition is chosen in the first instance, the banks will argue, as certain banks argued to this Commission, that customers would benefit from broadening the definition. For this reason, the Commission recommends that the regulator be required to report annually to Parliament on the extent and nature of the sale of derivatives within the ring-fence, including the effects of any changes to secondary legislation proposed by a future Government.**

195. **The Government's proposals to limit the prudential risks arising from derivatives activity, such as limiting net market exposure to a small percentage of capital, are important and necessary. However, this would not limit the absolute volume of derivative activity. A large derivatives portfolio would still pose an unacceptable risk to the stability and resolvability of ring-fenced banks, even if it is supposedly hedged and collateralised. It could also affect the culture of the bank in an undesirable way. The Commission recommends accordingly that the Government impose an additional cap on the gross volume of derivative sales for ring-fenced banks, and on the total value of derivatives used for hedging. The Commission would expect consultation to take place before determining how a gross cap should be measured.**

The de minimis exemption

196. In its final report, the ICB considered whether banks below a certain size should be exempted from the ring-fencing rules, but was not persuaded of the need for such a 'de minimis' exemption. It considered that, although the costs of ring-fencing them would be relatively high, complex small banks could pose significant risks and any such exemption might mean that some banks would have a disincentive to grow, creating a competitive distortion. Furthermore, an exemption could confuse consumers.[278] In its response to the ICB's final report, the Government set out its view that some form of exemption would be desirable. The Government considered that imposing the ring-fence rules on small banks would be a disproportionate response to the risk they posed and might create barriers to entry. Nevertheless, the Government acknowledged that an exemption would be difficult to implement and undertook to consider the issue further.[279]

197. The draft Bill gives the Treasury the power to exempt certain deposit takers from the requirement to ring-fence core activities.[280] This is subject to a general condition relating to possible adverse effects on the continuity of the provision of core services that we discussed earlier.[281] Building societies are currently excluded from the definition of ring-fenced bodies, although, in due course, the Government will amend the Building Societies Act 1986 to bring it into line with the ring-fencing provisions of the draft Bill.[282] It is anticipated that institutions with total deposits from individuals and SMEs below £25 billion should be exempt from ring-fencing provisions. The exact form and size of the threshold will be confirmed in secondary legislation. [283]

198. Financial institutions supported an exemption, but there were differences of view on where the threshold should be set. The Building Societies Association considered that £25 billion of deposits might be too high a threshold on the grounds that, in the past, difficulties even at smaller banks have required significant amounts of public support:

> £25 billion may simply be too high a threshold. This would have excluded Bradford & Bingley plc before it failed, even though at the time that bank was undoubtedly of systemic importance.[284]

RBS made a similar point:

> We note that Northern Rock, at the end of 2006, had £22.6bn of retail deposits, yet the Government of the day took the view that it was necessary to take Northern Rock into temporary public ownership.[285]

278 Independent Commission on Banking, Final Report, September 2012

279 HM Treasury, *The Government Response to the Independent Commission on Banking*, Cm 8252, December 2011, para 2.70

280 HM Treasury, Sound banking: delivering reform, Cm 8453, October 2012, Chapter 3, p 3

281 *Ibid.*, para 2.17

282 *Ibid.*, para 2.17

283 *Ibid.*, para 2.16

284 Ev w42

285 Ev w104

Barclays developed the argument further by pointing out that a threshold of £25 billion would mean that only six UK banks would be captured by the ring-fencing provisions and that "an important lesson from this and previous financial crises is that smaller, less resilient institutions, without the stability that comes with scale, can be very easily compromised in large numbers by the impact of a shock".[286] Sir John Vickers said that on balance he had been convinced by the arguments in favour of a de minimis exemption since the ICB Report was published, but he also thought that the suggested £25 billion amount for the threshold should be considered further:

> I think there are pretty good reasons for having a de minimis exemption. The Government are speaking about that threshold being £25 billion of mandated deposits. My instinct is that that is on the high side. In our own discussions, we were talking about £20 billion of total assets, which is probably a lot less than half of the £25 billion, if you think of total assets versus deposits. But I think it is probably right to have a de minimis exemption. I query whether it should be so high.[287]

199. The Chancellor of the Exchequer told us that, while concerns around the risks to financial stability from the exemption of large numbers of smaller deposit-taking institutions were understandable, the de minimis exemption had been introduced primarily for competition reasons. In terms of the level of the threshold, he said:

> I think that it is just a judgment, if you have a de minimis, of where you apply it. We have chosen £25 billion. That means that currently 90 per cent of the banking industry will be in the ring-fence [...] As I say, it is not an exact science, but £25 billion is our estimate of where we think the right place to cut off is [...] One of the things that I think is wrong with the banking industry at the moment is that it is extremely difficult for new entrants [...] I would hate to impose, though this legislation, an overly restrictive, too low de minimis that runs completely counter to that policy.[288]

When asked why the threshold limit for such an important power had not been spelled out in more detail on the face of the draft Bill, the Chancellor of the Exchequer said:

> The only thing is that you would presumably have to be able to uprate for prices. I am not sure you would want to put a number in primary legislation, because then it really would become out of date over time.[289]

When it was noted that one of the suggestions made in the papers supporting the draft Bill was that the threshold could either be a number or a proportion of GDP, the Chancellor of the Exchequer responded:

> I am very happy to think about that. We can certainly discuss and try to get to an agreement on how we do this. One of the areas where I have departed from the

286 Ev w30

287 Q 786

288 Q 1071

289 Q 1072

> Vickers report is in suggesting this de minimis, and if there is agreement on that, we can then discuss what it should be and how it should be applied.[290]

200. **A de minimis exemption from ring-fencing for smaller deposit-taking institutions represents a sensible compromise between maintaining financial stability and encouraging new entrants to the banking industry. Although the level of the threshold is ultimately a matter of judgement, the Commission recommends that the considerations to be taken into account by the Chancellor of the Exchequer and his successors in setting or varying the de minimis exemption should appear on the face of the Bill. In addition to the factors that we have recommended in relation to the general power under proposed section 142A(2)(b) in paragraph 135, there should be a specific requirement for a decision imposing or revising a de minimis requirement to have regard to its effect on competition in retail banking and on new entrants in the market in particular. The Commission also recommends that the regulator be required to report annually to Parliament on developments affecting the appropriateness of the level of the de minimis requirement.**

The large deposit exemption

201. The ICB proposed that the deposits of large corporations and private banking customers be exempted from the definition of core activities.[291] The draft Bill is consistent with this, in that the Treasury may determine the circumstances in which accepting deposits is not a core activity and does not need to be undertaken only by ring-fenced banks. The Treasury expects that this power will be used to allow deposits from larger companies and high net worth individuals to be held outside of ring-fenced banks. The thresholds for these exemptions will be subject to further consultation before secondary legislation is finalised.[292] Larger companies and high net worth individuals will be entitled to place deposits inside the ring-fence, and, in the case of high net worth individuals, there will be a presumption that their deposits will be inside the ring-fence. If individuals wish to deposit money in a non-retail bank, they will be required to self-certify that they understand the risks and benefits of such a decision.[293]

202. The Treasury has indicated that the thresholds for exemption might be up to £750,000 of free and investible assets for individuals and an annual turnover of up to £25.9 million for companies.[294] When eventually defined in secondary legislation, these thresholds will have a bearing on the range of services (such as derivatives) that ring-fenced banks may need to offer in order to service their clients fully.

203. **The exemption for large deposits makes sense. It is right that holders of large deposits should be required to make an informed decision to hold their deposits in a non-retail bank.**

---

290 Q 1073

291 Independent Commission on Banking, Final Report, September 2012, paras 3.17-3.18

292 HM Treasury, *Sound banking: delivering reform*, Cm 8453, October 2012, paras 2.18 to 2.21

293 Ev w174, Para 13

294 Ev w174, paras 14 and 15

Geographical restrictions

204. With the aim of insulating UK retail banking from external shocks elsewhere in the financial system, the ICB recommended that a wide range of services should not be permitted in the ring-fence. One of its recommendations was that ring-fenced banks should be prohibited from serving non-European Economic Area (EEA) customers. The ICB's final report included illustrative examples of such potentially prohibited activities, such as providing mortgages to American homeowners, or a loan to an Australian energy company with no base, or subsidiary, in the EEA.[295]

205. The Government white paper proposed that, rather than imposing a prohibition on non-EEA customers, the Government would act to prevent ring-fenced banks from operating non-EEA subsidiaries or branches. It also proposed to require that all major service and credit contracts for ring-fenced banks be written under the laws of an EEA member state. It argued that this would "ensure that cross-border activities do not present a barrier to the resolution of ring-fenced banks". The Government also noted that, where arrangements were in place that ensured that doing business in a non-EEA jurisdiction did not present risks to resolution (for example having mutual recognition of resolution regimes), such a prohibition might not be necessary. [296]

206. In response to a question about whether the Government's modification of the ICB recommendation on geographical restrictions would represent a serious threat to the ring-fence, Sir John Vickers said "I believe the issue will be taken care of, but I think it is an important one to be alert to. I have no reason at all to think that the Government's intention is to allow that kind of thing to happen—on the contrary. However, it will be important to scrutinise the secondary legislation to make sure that such things cannot happen".[297]

207. Some witnesses expressed concern that overly stringent prohibitions could have an adverse impact on a ring-fenced bank's ability to support trade finance outside the EEA, or inward investment.[298] The Law Society has warned of possible unintended consequences from "the crude measure of blanket bans affecting all ring-fenced banks".[299] Dorothy Livingston expanded on the Law Society's concerns:

> Nobody has modelled how a ring-fenced bank that is unable to deal, other than to a very limited extent, with non-EEA persons is going to be well equipped to have capital for a customer whose principal business is carried out in, say, dollars but whose manufacturing costs are in sterling. [...]If you put in place all the restrictions that Vickers proposes [...] you are squeezing down *w*hat the bank does closer and closer to what a building society does and making it less and less what a business would need.[300]

295 The Independent Commission on Banking Standards, Final Report, September 2012

296 HM Treasury, *Banking reform: delivering stability and supporting a sustainable economy*, June 2012, Cm 8356, para 2.22

297 Q 850

298 HM Treasury, *Sound banking: delivering reform*, Cm 8453, October 2012, para 2.34

299 The Law Society, *Banking Reform: delivering stability and supporting a sustainable economy*, September 2012, para 80

300 Q 692

208. The Treasury sought to address some of these concerns:

> The ICB noted that cross-border activities can pose a significant threat to resolvability. In order to reduce this threat, the Government proposes [...] to ensure that ring-fenced banks should not carry out any banking activities through non-EEA subsidiaries or branches, where this would present risks to the resolution of ring-fenced banks. Where arrangements are in place that reduce such risks, such as mutual recognition of resolution decisions, a blanket prohibition would not be necessary. This is therefore likely to limit the ability of ring-fenced banks to have non-EEA subsidiaries or branches except in approved circumstances, and determine the way in which such subsidiaries or branches may be approved.[301]

209. **The Commission is broadly content with the Government's approach to meeting the ICB's objective of effective geographic limits on the business of ring-fenced banks. In pursuing this primary consideration, however, consideration needs to be given to the effects of the solution devised on UK banks' ability to support trade. It is essential that full consideration is given to the repercussions of the measures proposed. For this reason, the Commission recommends that the Treasury undertakes a full separate consultation exercise on the draft secondary legislation to give effect to geographical restrictions and publish its findings two weeks prior to the House of Commons report stage. The Commission also considers it essential that, when the relevant secondary legislation comes into force, the Treasury monitors and reports to Parliament on its assessment of the trade-off between the direct intended effects of the limits and the capacity of the banks to support trade.**

Retail and SME lending

210. As we noted earlier, the draft Bill follows the ICB recommendations in providing initially that only deposit-taking and the provision of overdrafts are classified as 'core activities' which, subject to specified exceptions, may only take place within a ring-fence or in banks that have been exempted from the definition of a ring-fenced bank.[302] A further area that might appear to be a "core" activity is lending to individuals and SMEs. Andy Haldane emphasized the importance of these functions, saying that "loans to SMEs, trade finance and mortgages [...] are all activities that I think we would view as needing to remain in continuous service if a bank were to get into trouble".[303]

211. The ICB's final report set out a number of potential problems which might arise if lending was mandated to be provided only by ring-fenced banks:

> 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 [...] 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

301 Ev w176, para 30

302 HM Treasury, *Sound banking: delivering reform*, Cm 8453, October 2012, paras 2.14 and 2.15

303 Q 595

> same product [...] 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 [...] In general then, credit provision is different in nature from products which customers rely on to be able to make everyday payments.[304]

The ICB acknowledged concerns that ring-fenced banks should not be forced out of lending activities:

> 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. Banks need assets to match their liabilities. So while the Commission does not believe that credit 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.[305]

212. The FSA, while not advocating making lending a 'core activity', observed that "where banking groups contain RFBs, they should conduct all of their UK retail and SME lending from those RFBs".[306] Such a requirement would address the concern that ring-fenced banks would become too narrow, while preventing an "undesirable restriction of credit by non-banks".[307]

213. The ring-fence would, however, prevent retail deposits from being used to provide loans other than to non-financial sector borrowers—households, non-financial businesses and the public sector—within the EEA. Such a restriction could, in principle, result in deposits being 'trapped' inside the ring-fence and used, for instance, to fund the purchase of securities issued by EEA governments, rather than making credit available to the private-sector economy. The ICB considered that the risk of this happening was very low:

> The total quantum of UK sterling household deposits is currently approximately £1tn, considerably less than the current stock of loans to the UK non-financial private sector of £1.6tn. So the retail deposits of ring-fenced banks en bloc are much smaller than the UK sterling loans they could hold [...] So ring-fenced banks as a group are unlikely to be over-funded in the medium term, and the system should be flexible enough to be robust to changes in the pattern of saving and borrowing in the economy.[308]

214. The Chancellor of the Exchequer defended the approach of the ICB and the draft Bill in the following terms:

> I don't deny that the provision of credit is an incredibly important function in our society; I just don't think it is the immediate consideration you have. [...] Provision of

304 Independent Commission on Banking, Final Report, September 2011, paras 3.9 to 3.10

305 *Ibid.*, paras 3.11

306 Ev w62

307 Ev w62

308 Independent Commission on Banking, Final Report, September 2011, A3.30 to A3.31

> credit to small businesses is something that can be done by a number of institutions, and a small business can go to a number of different places. Under our reforms, it is possible to have small business lending within the ring-fence, and I suspect that, actually, quite a lot of institutions will want to do that, because they will want to match retail liabilities with retail deposits, but, on the advice of John Vickers, we have given them some flexibility. I think you have to be very clear about what is the absolutely essential thing that has to be operating the next morning. If there is a branch that is not able to give the small business that loan next morning, it is very unfortunate, but I am not sure that it is the absolute, essential, core service that you are seeking to protect that next day.[309]

215. **The Commission considers that it is right in the first instance not to require banking groups with a ring-fenced entity to carry out all lending for SME and retail customers within that entity. This is a provisional conclusion, which should be subject to review in the light of experience. There is a possibility that banking groups will conduct their most profitable lending from outside the ring-fence, where capital requirements will be lower and there will be fewer restrictions on dividend payments, leaving less profitable lending within the ring-fence. This could reduce the commercial strength of the ring-fenced entity. It could also reduce the transparency of the operation of the ring-fence. The Commission recommended earlier that the regulator should monitor and publish a statement on how the ring-fencing rules have been implemented by the industry, with specific consideration being given to which services are provided inside and outside the ring-fence. The Commission has concluded that the development of retail and SME lending outside the ring-fence is a matter for the regulator to monitor as part of its work on this statement.**

Independence and governance of the ring-fenced bank

216. The ICB was virtually silent on corporate governance in its interim report. In response to requests for its views, including from the Treasury Committee,[310] the ICB's final report addressed it briefly. The ICB recommended that, when a ring-fenced bank is part of a wider corporate group, the authorities should be able to isolate that bank and ensure the continuous provision of its services. This should be possible within a matter of days, and should not require solvency support. Furthermore, the ring-fenced bank should be economically separate from the rest of the group. This entailed the following requirements:

- ring-fenced banks should be separate legal entities;
- any company owned fully or in part by a ring-fenced bank should not conduct activities which a ring-fenced bank cannot;
- the ring-fenced bank should have continuous access to any support functions it needs from the rest of the group, irrespective of the latter's health;
- for any payments systems the ring-fenced bank uses, it should be a direct member or should use another ring-fenced bank as an agent;

309 Q 1068

310 Treasury Committee, Nineteenth Report of Session 2010–12, *Independent Commission on Banking*, HC 1069

- the ring-fenced bank should meet its regulatory and disclosure requirements on a stand-alone basis, and transactions with anything other than ring-fenced banks in the same group should be on a third-party basis, with the relevant third-party regulatory limits applying;

- the board and a majority of directors of the ring-fenced bank, including the Chair, should be independent, unless the vast majority of the group's assets were in the ring-fenced bank; and

- the boards of both the ring-fenced bank and the parent should have a duty to maintain the integrity of the ring-fence.[311]

217. Andy Haldane suggested a list of functions that would need to be separate to ensure that a ring-fenced bank is no more exposed to problems elsewhere in the group than it would be to similar problems outside the group:

> The following ingredients are essential if this ring-fence is not to prove permeable: one is entirely separate governance; the second would be entirely separate risk management; the third would be entirely separate balance sheet management, treasury management. We could not have debt issue out of a holding company because its cost would then be the blended mix of the two activities, complete with implicit subsidy. I would have a completely separate remuneration structure. We ought to contemplate completely separate human resourcing if there is indeed this cultural issue that we have been discussing. With those ingredients, I would have a degree of confidence that many of the benefits of full separation could be achieved.[312]

When this list was put to him, Sir John Vickers said: "I would add to it. There needs to be independence of capital and liquidity."[313] The Chancellor of the Exchequer stated his intention to implement this augmented list of requirements: "it is our intention to implement the Haldane principles, with the addition of what John Vickers talked to you about in terms of capital and liquidity".[314]

218. There was broad agreement among respondents that corporate governance was crucial to the success of the ring-fence, but also a broad range of views on what sort of arrangements were appropriate. For example, Martin Taylor stressed the importance of independent membership of the board of the ring-fenced banks:

> The important thing simply is that they should not be people who gain their living from other jobs in the main banking group... These should be people who are outsiders and who don't rely on the bank for any living apart from their director's fee.[315]

There are examples of subsidiary boards being constituted broadly in the manner that Martin Taylor proposed. Douglas Flint explained that at HSBC:

311 Independent Commission on Banking, Final Report, September 2011, p 67-72

312 Q 596 [Andy Haldane]

313 Q 789 [Sir John Vickers]

314 Q 1049

315 Q 399

> All of our major banks have fully independent boards with a substantial majority of non-executive directors. We would have a non-executive board, but a chairman for most of the banks from within the group. We have gone one stage further for the UK—the UK chairman is now a fully independent non-executive director.[316]

219. However, a number of witnesses questioned whether it was necessary, desirable or even feasible to have a large number of independent directors on the board of the ring-fenced banks. Ana Botín claimed that, "with robust governance and with effective regulatory supervision, these subsidiaries can work independently" even though board membership might overlap.[317] Davis, Polk and Wardwell LLP doubted the desirability of an independent board:

> We do not believe that establishing separate, independent boards at the holding company, the ring-fenced bank, and the non-ring-fenced bank will be conducive to effective management of what will remain integrated groups from both a financial reporting and a market perspective. It may be better to consider alternatives, such as including some independent board members, rather than a majority, on the ring-fenced bank's board of directors [...] If a ring-fenced bank is part of a larger banking or financial group, we do not think it is realistic for the board of directors of that bank to be fully independent of the parent company of the group.[318]

The Financial Reporting Council expressed a related fear: "If the board of the ring-fenced bank is separate from the group and separately appointed, it cannot be accountable – directly or indirectly – to the shareholders of the group". [319] Baroness Hogg was sceptical about whether separate governance was even feasible:

> the notion that a ring-fenced bank could have entirely separate governance is wrong, a mistake. I cannot see how a ring-fenced entity could sensibly have entirely separate governance. I think that would create a vacuum of accountability to anyone other than the regulator, and would sever the line of accountability through the parent to the providers of risk capital, and therefore make banks less investable. It would have serious knock-on consequences, as well as creating a vacuum of accountability.[320]

220. Company directors have duties under the Companies Act to promote the success of the company primarily for the benefit of the shareholders. The directors of ring-fenced banks which are wholly owned by larger groups will therefore be legally obliged to act in the interests of their parent. This obligation risks conflicting with the integrity of the ring-fence, for example if the ring-fenced bank has capital or liquidity that the wider group needs elsewhere. Andrew Bailey suggested a possible solution to this:

> The draft Bill should specify that the directors of a ring-fence bank and potentially other appropriate entities in the group should have a statutory objective to ensure the integrity of the ring-fence. This could involve ensuring that the directors have an

316 Q 492

317 Q 489

318 Ev w51, paras 5.1 and 5.3

319 Ev w56

320 Q 707

> obligation to protect the ring-fence bank from contagion from the wider financial system. This would include risks arising from the rest of the banking group.[321]

David, Polk and Wardwell drew attention to how some banks are regulated in the United States:

> An alternative to requiring full independence of a bank subsidiary board is to require directors of an insured bank to take into consideration the interests of stakeholders other than shareholders in discharging their duties. This is, in fact, the approach generally taken with respect to the duties of the directors of insured banks in the United States.[322]

221. HSBC noted that a proliferation of directors' duties was not without cost: 'Whilst it is feasible for directors to be required to manage a number of different objectives, this does make their role increasingly complicated [...] There will also need to be a clear regulatory definition of what is meant by the 'integrity of the ring-fence".[323]

222. **There is likely to be a tension between the integrity of the ring-fence and the duties that directors of ring-fenced banks will owe to the parent company and through them to shareholders. This tension will be present regardless of the whether directors of the ring-fenced bank are employed elsewhere in the group. It is not possible under current company law to create a subsidiary which is entirely independent. The Commission recommends that the Government insert within FSMA a legal duty on boards of directors to preserve the integrity of the ring-fence.**

223. **The Commission further recommends that the Government set out, in its response to this Report, a full account of how directors would be expected to manage the relationship between such a duty and their duties to the shareholders. The Commission considers that an element of conflict between the duties may be unavoidable, and that this will constitute a permanent challenge for any structural solution which falls short of full structural separation.**

224. **In the previous chapter, the Commission recommended that the core minimum requirements for a ring-fence of adequate height should be set out in secondary legislation subject to affirmative resolution procedure, and not be the subject of regulatory discretion. The Commission welcomes the Chancellor of the Exchequer's clear position on the key elements that should be included to ensure the proper independence of a ring-fenced bank. The Commission recommends accordingly that the initial secondary legislation made under proposed section 142H of FSMA (as envisaged in our recommendation in paragraph 139) should give the regulator a duty of ensuring operational independence for the ring-fenced bank in respect of governance, risk management, treasury management, human resourcing, capital and liquidity.**

321 Ev w189

322 Ev w51

323 Ev w 136

Relationship between the ring-fenced bank and the holding company

225. The ICB was not prescriptive about how groups containing ring-fenced banks should be structured, and in particular did not specify whether the ring-fenced bank should be a 'sibling' or a 'child' of the other operating companies in the group. Subsequently, in their evidence to the Commission, both Martin Taylor and Sir John Vickers indicated their preference for a 'sibling' structure, in line with the recommendations of the Liikanen report.[324] Importantly, the FSA stated a clear preference for a 'sibling' structure, in part to ameliorate governance tensions

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

The FSA pointed out that such an approach would enable the authorities to deploy different resolution tools for the two entities, reduce the risk of contagion because the holding company would act as "a firewall" and "help instil market perceptions of credible separation".[325]

226. In contrast, the banks generally did not favour prescription either way on this point. Anthony Jenkins said that, for Barclays 'it would be more practical for us to go with the parent/daughter model'.[326] Ana Botín told us:

227. I don't see why it always has to be a holding company with two sisters. It depends on the weight that the non-ring-fenced bank has in the business. For example, in the case of the Santander group model, most of our business would be within the retail ring-fenced bank.[327]

228. **The Commission found that the arguments for prohibiting a non-ring-fenced bank from directly owning a ring-fenced bank are persuasive. This is a clear and straightforward way to strengthen the ring-fence, and is far better done at the outset. The Commission recommends accordingly that the regulator be given the power to require a sibling structure between a ring-fenced and non-ring-fenced bank, with a holding company. The Commission would expect this power to be exercised.**

Liabilities

229. Which? noted that, in the run up to the implementation of the ring-fence, "there may be a lack of clarity about where possible liabilities for legal or regulatory action will lie if

324 Qq 404, 749

325 Ev w61

326 Q 500

327 *Ibid.*

they crystallise in the future".[328] When asked how legal liability would be allocated between the ring-fenced and non ring-fenced banks for any activity conducted before the split, the Treasury stated:

> Liability for any activity conducted before a banking group is split into a ring-fenced bank and non-ring-fenced bank will remain with the legal entity which was responsible for the activity in question before the split. [...] Banks will have some flexibility about how they implement the ring-fence. It is therefore possible that in implementing ring-fencing a banking group will create new companies, but this would not mean that liabilities for activities such as mis-selling would be transferred to the new entities. If by contrast implementation of a ring-fence led to the dissolution of a company, that company's liabilities would be cancelled. In that case, a creditor, or other third party may be able to restore the company in order to bring a claim against it. However, we would not expect implementation of the ring-fence to involve the dissolution of any company. Legal liability for past action is therefore unlikely to be affected by the introduction of ring-fencing.
>
> A bank's approach to implementing the ring-fence will almost certainly require sanction by court order under Part VII of FSMA, and under the amendments proposed in the draft Bill, any application for approval of a Part VII transfer must be approved by the PRA. The regulator is unlikely to approve any scheme involving the dissolution of a company within a banking group if that would affect any liabilities for mis-selling.[329]

230. **The Commission finds it disconcerting that the Treasury should raise the possibility that the establishment of the ring-fence might lead to the dissolution of a company and the cancellation of its liabilities. The onus should not be on the regulator to prohibit the dissolution of a company. Nor should the onus be on creditors of a company to make a court application to restore the company in order to meet obligations. The Commission recommends accordingly that the regulator be required to set rules to ensure that the creation of ring-fenced and non-ring-fenced entities is not used as an opportunity to shift liabilities or potential liabilities in an artificial way.**

328 Ev w168

329 Ev w194

11 Capital and loss absorbency

Introduction

231. The ICB recommended a package of reforms to make the banking system more stable and make banks easier to resolve. The ring-fence is a part of this package, but it is not sufficient, as discussed in Chapter 6. In addition to the ring-fence, the success of the proposed reforms to the banking system hinges on whether capital and loss absorbency measures can be put in place which reduce the likelihood of banks failing, and ensure that, if banks do fail, the losses from failure are better aligned with the rewards for success.

Bail-in

232. As set out in Chapter 2, the special characteristics of banks necessitate treating them differently from other companies when they are at or close to insolvency. The special resolution regime created in the Banking Act 2009 provides some alternative tools for dealing with failing banks, but as discussed in Chapter 2 the failure of a large and complex bank would pose a considerable challenge for this regime and could pose an unacceptable risk to public funds.

233. This means that a further tool is needed—a so-called 'bail-in regime'. This is a set of legal changes that bestow powers on the resolution authority to put a bank through a special, ultra-fast form of insolvency procedure, imposing losses on bank creditors over a weekend rather than over weeks or months and maintaining the continuity of provision of essential services. This approach was recommended by the ICB and accepted by the Government.[330]

234. There was broad agreement among witnesses that further reforms were necessary to ensure that bank creditors bear losses to preclude the need for the taxpayer to bail out banks in future. Andrew Bailey explained that:

> if you strip it back, all you are really saying about bail-in is that you are asking to deal with the resolution of a bank as you do any other company. Companies get refinanced by their creditors. The point about banks is that, because of the confidence issue, you have to do it very quickly. You only get a weekend to do it. Therefore, you need legislation to effect something.[331]

235. The Bank of England now sees bail-in a central part of its strategy for dealing with failing banks:

> [T]he size and complexity of the books of most global wholesale banks greatly increases the challenge in rapidly separating the critical economic functions in this manner without causing severe systemic disruption... This is what led to the development of the concept of bail-in resolution strategies, in order to ensure that

330 HM Treasury, *Sound banking: delivering reform*, Cm 8453, October 2012 p 15

331 Q 1003

> unsecured creditors are exposed to loss without having over a resolution weekend to split up a bank into critical and other parts that go into liquidation.[332]

236. **An effective and credible bail-in tool would represent a major step towards eliminating the implicit guarantee and ensuring that the costs of resolving a failing bank are not borne by the taxpayer. It is notable that bail-in is at the heart of the resolution strategies currently being designed for large systemically important banks, and will remain important even after the ring-fence is introduced.**

237. One concern about relying on bail-in to make banks resolvable is whether it is realistic to expect that in a crisis the authorities will be willing to exercise their powers to impose losses on creditors. Professor Rosa Lastra warned that bail-in still needed to be shown to be a credible tool:

> bail-in is a very useful instrument and the only problem with it is that it still needs to be tested. It needs to pass the market test of credibility and of not being stigmatised. [...] The [European] Commission, when it was negotiating the Recovery and Resolution Directive, had a group of legal experts discussing the bail-in. It is clear that the 'bail-inable' instruments when bailing in, the trigger points, the credibility and the stigma are issues that need to be resolved.[333]

Jessica Ground also expressed the concern that bail-in "is one of those things that looks fantastic on paper", but that when it came to the choice of "pushing the button", authorities might not be willing to take the risk of triggering a bail-in in a crisis because of the risk of contagion. She added: "Bail-in [bonds] could be very good investments, but whether they are that helpful at the end of the day in dividing up risk and assigning the risk to that group of security holders, I remain less convinced about."[334]

238. Lord Turner noted that regulators were more likely to exercise their bail-in powers when this does not involve imposing losses on other banks:

> this stuff [bail-inable debt] also has to be held outside the banking system. If in those circumstances we press the bail-in button, but we are worried that all this bail-in debt is held by another bank, we will never be willing to do it. We will be terrified that we are just setting off a domino set which is going to keel over. That is a missing bit of it.[335]

239. To make bail-in powers more usable and more credible, it is proposed that banks must hold a certain amount of debt that can easily absorb losses; the next section considers how this might be implemented. As Sir John Vickers explained:

> Can one move to a situation where it is absolutely certain that the bondholders would bear loss? I think that total certainty is, perhaps, not to be had, but I believe that one can increase enormously the chance that bondholders would bear loss, and our proposals were crafted with a view to maximising that probability. You need the

332 Ev w181

333 Q 705

334 Q 710

335 Q 1003

> bail-in power of the regulator and a significant or substantial slab of such debt [...] It needs to be unsecured debt with appropriate maturity and the rest.[336]

240. Some witnesses expressed concern that there would not be sufficient demand for this kind of debt. For example, Jessica Ground said:

> A lot of traditional fixed-income investors are very worried about them because of the potential for bail-in. A lot of equity investors are not natural holders of these [bail-in bonds], because your upside is capped. This is uncharted territory, and the market, as far as I understand it, is very small.[337]

John Grout agreed, indicating that he struggled to identify potential buyers of bail-in debt:

> It looks as though insurers and pension schemes may not be suitable holders of bail-in bonds. That leaves you with hedge funds, wealthy families, sovereign wealth funds—I sort of run out when I get beyond that.[338]

241. Others were more sanguine about the size of the market for loss-absorbing debt. Erkki Liikanen told us that investors would buy the debt in the right conditions,[339] while Paul Tucker said that:

> The point you make about pension funds, and one could say the same about life companies, is whether they should be allowed to own regular senior unsecured bonds issued by banks. I do not see why not, as long as they did not have concentrated exposures. They own corporate bonds, and they sometimes default. Insurance companies and pension funds do not only hold risk-free assets. They lose money on their bond holdings, and their equity portfolios go up and down in value.
>
> It is quite important not to think about the world investor base as completely averse to default risk. When I have talked to some of the biggest asset managers in the world and have put this to them as a question, they have said that they would rather be able to take losses on their bank bond holdings if that helped to insulate them from the mayhem caused by the latest financial crisis, which devastated the value of their overall portfolios.[340]

242. **Concerns remain about the design of a bail-in regime and whether it will provide confidence that the authorities would actually use their powers in the event of a crisis. The new tool risks being of particularly limited utility if the authorities were required to impose losses beyond the holders of specifically "bail-inable" debt and move up the chain to, say, corporate depositors. The legal and economic implications of bailing in a bank's creditors will never be known until it is tried for the first time under stressed conditions, and politicians and regulators will always face pressure to incur the better-understood costs of a taxpayer bailout instead. It should be a requirement that bail-inable debt is held outside the banking system, to reduce contagion risks within the**

336 Q 796

337 Q 716

338 Q 727

339 Q125

340 Q 1169

banking system. The regulator should make early proposals on how best to accomplish this. Uncertainty about the size and nature of market for loss-absorbing debt will also mean that doubts will remain over whether bail-in will function as intended and what its costs will be. Parliament will need assurance that bail-in is not a paper tiger, as will the markets. The Commission recommends accordingly that the Bank of England be subject to a statutory requirement under the new legislation to produce an annual report to Parliament on the development and subsequent operation of bail-in to assist in assessment of its feasibility, which should be required to cover in particular:

- **The quantity of issued debt with characteristics which make it easily subject to bail in;**
- **Whether bail-inable debt is being issued out of the correct corporate entity within a banking group to facilitate the preferred bail-in strategy;**
- **The distribution of holdings of bail-inable bank debt within the rest of the financial system;**
- **The feasibility of mechanisms for bailing in creditors other than long-term unsecured bonds, such as corporate depositors, uninsured household depositors and derivative counterparties;**
- **Progress towards addressing international legal barriers to the recognition of bail-in actions.**

243. It is expected that a bail-in regime will be introduced when the EU Directive on Recovery and Resolution (the 'RRD'), which is currently in draft, is implemented in UK law.[341] Several respondents noted the desirability of seeking agreement on bail-in at a European or international level. For example, Santander told us that:

> Like other UK banks, Santander UK raises its funding in international markets. Therefore, a UK-only statutory bail-in power would not give clarity to market participants, many of whom would be operating outside of the UK's jurisdiction. A bail-in instrument of the kind described in the Government's White Paper can only be viable if it is internationally agreed and implemented.[342]

EU law also means that it would currently be difficult for the UK to implement a bail-in regime unilaterally, because the RRD "will remove some impediments to resolution arising currently from other EU directives".[343]

244. Martin Taylor urged the UK to go it alone should international agreement founder:

> I would certainly recommend to Parliament that, if for any reason the European supervisors lose their nerve on bail-in debt, Britain itself does something. There ought to be an international standard there. A common international standard is also

341 HM Treasury, *Sound banking: delivering reform*, Cm 8453, October 2012, p 5

342 Ev w127

343 Ev w180

> very desirable. If we can do that through the European work, that would be the best answer for that.[344]

245. **The Commission supports the Government's endeavours to implement a bail-in regime in the UK. The Government should also continue to negotiate for a broad bail-in power to be applied across the EU. Bail-in is an important tool for resolving bank failures in a way that prevents the huge costs. The Commission is concerned at the risk that the development of such a tool might be delayed or watered down through negotiations at EU level and, given the size of the financial services sector relative to the UK economy, the Commission believes the Government should act at a UK level in the event of EU discussions not resulting in the desired protection for the taxpayer that bail-in aims to ensure. The Commission recommends that the Government make provision in the forthcoming legislation for bail-in powers at national level which could come into force if the EU proposals were delayed or inadequate, on the understanding that negotiations at European level would need to secure the subsequent removal of any existing or prospective European legal obstacles to the use of a more wider-ranging power at national level.**

PLAC

The main PLAC requirements

246. For a bail-in regime to work, it must be possible for the authorities to impose losses on a bank's creditors without excessive disruption to that bank's operations or to the rest of the market. A deciding factor in whether this is the case is the nature of the bank's liabilities, and in particular whether there is enough unsecured debt of sufficiently long term to cover bail-in requirements. If long-term debt is available to absorb losses, short-term creditors are less likely to risk a run on the bank by demanding their money back.

247. To this end, the ICB recommended that large ring-fenced banks and UK-headquartered global banks issue the equivalent of at least 17 per cent of their risk-weighted assets (RWAs) in the form of primary loss-absorbing capacity (PLAC). RWAs are calculated by multiplying each type of asset on a bank's balance sheet—government bonds, mortgages, derivatives and so on—by a 'risk-weight' (for example, 0 per cent for assets considered to be very safe, like OECD government bonds; and 100 per cent for assets judged to be riskier, such corporate loans), then adding them up. When calculating the 17 per cent requirement, the denominator is the total of RWAs. Therefore the riskier the assets on a bank's balance sheet, the more PLAC a bank needs to issue to achieve the 17 per cent.

248. PLAC is defined by the ICB as:

> those liabilities that can be regarded as constituting the best quality loss absorbing capacity. 'Primary loss-absorbing capacity' is made up of (i) equity; (ii) non-equity capital; and (iii) to reflect the fact that short-term liabilities are less reliable as loss-

344 Q 443

> absorbing capacity, those bail-in bonds with a *remaining* term of at least 12 months.[345]

Banks affected by the ICB's recommendations on capital would also have minimum requirements on the components (i) and (ii) of PLAC above, which would mean that they would have to hold at most 6.5 per cent of RWAs as bail-in bonds to bring total PLAC up to 17 per cent, and in fact more likely 3-3.5 per cent given that most large banks will be subject to additional requirements on equity. The Government has agreed with the ICB's PLAC recommendation, defining PLAC as "regulatory capital and subordinated debt and senior unsecured debt with at least twelve months' term remaining and which the resolution authorities are confident could be bailed in".[346]

249. The Government expects the forthcoming EU Directive on Recovery and Resolution to include a minimum eligible liabilities requirement as an adjunct to the bail-in powers it mandates, which would have a similar effect to a PLAC requirement.[347] In anticipation of this, the draft Bill inserts a new section 142J of FSMA which would give the Government powers to instruct the regulator how to impose debt requirements on banks.[348]

Proposed exemption from PLAC requirements

250. The logic for making UK-headquartered banks hold PLAC over and above the internationally agreed capital requirements is that this provides an extra cushion on which the UK authorities could impose losses if such a bank fails and needs resolving. The Government has argued that it would not be appropriate to impose this additional requirement on the overseas operations of UK headquartered banks "where these do not pose a risk to UK and/or EEA financial stability",[349] because the UK authorities would not be responsible for resolving such entities. They argue that this would be "disproportionate", presumably on the grounds that it would impose an unnecessary cost on such operations that other international banks would not face. The Chancellor of the Exchequer also warned that imposing such a requirement would risk creating the perception that the UK authorities would stand behind overseas operations of UK banks:

> Let us imagine you have a large bank in the UK that has a very large operation in Hong Kong, say. If you say that that bank has to provide loss-absorbing capacity against the failure of the Hong Kong operation then, by the way, the implication is that if the Hong Kong operation fails, we are going to be on the hook for it. I want it to be very clear we are not on the hook for the failure of the Hong Kong operation.[350]

In addition to using the powers in proposed section 142J to define PLAC, the Government also therefore intends to use them to set out the conditions under which UK-headquartered banks are exempted from holding PLAC in excess of international minima against non-EEA assets.

345 Independent Commission on Banking, Final Report, September 2011, para 4.78

346 HM Treasury, *Sound banking: delivering reform*, Cm 8453, October 2012, para 2.57

347 *Ibid.*, para 2.56

348 *Ibid.*, para 2.6

349 HM Treasury, *Banking reform: delivering stability and supporting a sustainable economy*, June 2012, Cm 8356, p 38

350 Q 1100

251. The PLAC exemption was not considered in the ICB's final report, although both Martin Taylor and Sir John Vickers said in their evidence that they accepted the logic of the Government's argument.[351] However, they did warn that care should be taken in designing the conditions for exemption, Martin Taylor warning that "we wait to see whether that is done properly. I would hold feet to the fire on that one, if I were in Parliament."[352]

Exemption from PLAC requirements: burden of proof

252. Sir John Vickers said that, while the correct test for a PLAC exemption was whether a bank's overseas operations were resolvable without posing a risk to UK financial stability or the UK taxpayer, the burden of proof for demonstrating whether that this test had been met ought to lie with the bank rather than the regulator:

> In its December response to our report, the Government made the totally reasonable point that if a bank can demonstrate that it was resolvable, etc [...] it would be disproportionate to place that requirement on the bank. The logic of that seems to me to be impeccable. But note that the onus of proof was on the bank. In the June White Paper, the Government seemed to have changed their position to the onus of proof being on the regulator. I thought that was an unwise step.
>
> In the text preceding the draft legislation in the October document, the Government seem to be somewhere in between their December and June positions. I am not completely sure how to interpret it where it talks about the pros and cons and states that a balance needs to be struck. Again, that is a hard thing to disagree with, but I would flag it up as something to be alert to in the secondary legislation.[353]

253. Barclays also argued that involvement of the host regulator (the regulator in the country where a bank is conducting operations) was key:

> Any exemption of assets held in overseas operations must be subject to very stringent tests which require the 'host' regulator to state unequivocally that the UK is in no way liable if the entity of the relevant bank needs to be independently resolved and that, in such circumstances, the parent bank cannot take steps to rescue that unit that would in any way jeopardise the overall banking group.[354]

254. Standard Chartered, a UK-headquartered bank which conducts the overwhelming majority of its operations abroad, argued that the global PLAC exemption should be at the discretion of the regulator:

> there are instances where the application of the exemption renders the orderly wind-down of an international bank's operations in resolution potentially unworkable. For instance where the exemption has an impact on the UK's reputation or the ability of the home regulator/resolution authority to discharge its obligations to provide a coordinated resolution of a troubled bank. Our view is that the exemption should be

351 Qq 443, 788

352 Q 443

353 Q 788

354 Ev w33

> available for application by the resolution authority on a discretionary basis where these issues are addressed.[355]

Standard Chartered also indicated that it would most likely not take advantage of any exemption, preferring instead a UK-based resolution plan. It stated that:

> it is logical to give the regulatory authorities scope to exempt banks from applying the PLAC requirement to their international activities where they can demonstrate their failure would not pose a risk to the UK's financial stability. Some international banks will choose to take advantage of the exemption whilst others may not. The choice is likely to be partly dependent on the approach to resolution planning each individual bank develops with the Financial Services Authority and Bank of England. For Standard Chartered, we favour a whole bank resolution approach since we believe this would ensure the optimal outcome in the extremely unlikely event that we were to fail.

255. Witnesses from the Bank of England and the FSA agreed that the burden of proof should be on the bank seeking the exemption. Lord Turner said that:

> we are very keen—this is an important point for us on the Bill—that the PRA should not be placed in a position where it has to prove that this exemption from group PLAC creates a risk to the taxpayer; the burden of proof, from our point of view, must be the other way around.[356]

Lord Turner set out two additional conditions he believed should be required before an exemption is granted, using the example of HSBC:

> Secondly, the resolution plan should be agreed with the resolution authorities across the world. We ought to be agreeing it with the Hong Kong Monetary Authority and the Monetary Authority of Singapore. Thirdly, the fact that those authorities have agreed a regional break-up, rather than a group break-up, should be publicly known and publicised so that the creditors of that bank in the UK and in Hong Kong or Singapore are aware of that.[357]

He also argued that under such conditions, it was quite likely that overseas regulators would themselves require additional capital to be held against local operations, once it was fully clear that they would bear responsibility for resolution in the event of a failure:

> the banks involved would not get any benefit from the proposed change to UK law, because I can absolutely predict that we will demand at least 17 per cent of primary loss-absorbing capacity, and so will the HKMA in Hong Kong, the MAS in Singapore and the US authorities.[358]

256. Andy Haldane and Paul Tucker noted that the concept of agreeing a resolution plan with overseas authorities was already part of the international recovery and resolution planning process under the Financial Stability Board. Paul Tucker said: “the UK authorities

355 Ev w151

356 Q 986

357 *Ibid.*

358 *Ibid.*

have an international obligation to ensure that the worldwide group of any UK-domiciled banking group is resolvable. That is not the same as saying we must be the resolver."[359]

257. The Chancellor of the Exchequer did not clarify the Government's position fully, but emphasised that, once a decision had been made, the regulator should not be able to change its position without demonstrating its reasons for doing so:

> We are clear that the firm will have to assure us that the costs of the non-EEA bits of it, were they to fail, would not fall on to the UK taxpayer. [...] However, once they have assured us, what I don't want to have is, hanging over some extremely large and important institutions in our country, a constant threat that that judgment might change, that the regulator might suddenly change its judgment, and that has an almost overnight impact on the business. I think once the firm has assured the regulator, it is then the obligation on the regulator, should it change its mind, to demonstrate that it is right in changing its mind.[360]

Conclusions on the PLAC exemption

258. **Exemptions from PLAC increase the risk that, in a crisis, the UK would need to intervene in respect of overseas operations of a UK-based bank, but would lack the level of PLAC necessary to shield the taxpayer. The Commission recommends that the secondary legislation to be made under to section 142J of the draft Bill place the burden of proof for any exemption from PLAC requirements on the bank seeking the exemption, rather than on the regulator. This would mean that the regulator would only grant an exemption if a bank had demonstrated to the regulator's satisfaction that there was no risk to stability, rather than merely if the regulator could not show that a risk existed, providing a greater level of protection to the taxpayer. This should include the bank showing that the resolution authorities in the areas in which they operate outside the EEA would assume lead responsibility for resolving the operations in those overseas territories in the event of the bank's failure, in order to protect the UK taxpayer. The decision on whether to grant an exemption should be made by the regulator with reference to clear objectives, although in all cases it will need to involve an exercise of judgment by the regulator. Decisions should be subject to the same review and appeals processes as any other decision by the regulator. The existence of exemptions should be publicly disclosed. It will also be important for the regulator to monitor the implications of exemptions in the case of each firm affected on an ongoing basis. We would expect this monitoring to be the subject of regular review by a strengthened Supervisory Board of the Bank of England introduced in accordance with the recommendations of the Treasury Committee.**

Accountability for use of powers relating to loss absorbency

259. Clause 4 of the draft Bill introduces a new provision in proposed section 142J(4(d)) of FSMA which, after an enabling order has been passed, confers a power on the Treasury to issue further directions to the regulator in relation to loss absorbency. The House of Lords Delegated Powers and Regulatory Reform Committee noted that such an order would:

359 Q 1216

360 Q 1099

> confer power on the Treasury to give directions, not subject to any Parliamentary control, to the regulators. This is mentioned, but not justified, [... in] the [Treasury's delegated powers] memorandum. We normally require a full and convincing justification for power which may be used to circumvent Parliamentary control and we were not convinced on this occasion.[361]

260. It is also notable that an order made under section 142J(4(c)) could be used by the Treasury to "require the regulator to consult the Treasury before imposing a requirement in accordance with the order in a particular case".[362] This would appear to create the potential for the Treasury to give itself a role in setting PLAC requirements for individual firms, which if used would appear to conflict with the objective of an independent regulator.

261. When asked why there were no principles in the draft Bill to guide the use of the powers in section 142J, the Chancellor of the Exchequer replied:

> This is a significant economic decision; it is right that Parliament is involved in that decision. It will be set out in the legislation [...] but I think we are entitled as a Parliament to say, first of all, that PLAC will be applied to certain institutions and, secondly, how we define that PLAC. I am clear it has to be equity or tier 1, tier 2 or unsecured longer-term debt. We have set out in the White Paper what we think those requirements are. But again, it comes down to a broader question: do you give complete freedom to the regulators to make decisions that have a very real economic impact on our constituents, or do you ask Parliament to be involved and consulted on that decision? Here we have tried to get the balance right, where Parliament will prescribe certain minimum requirements and hard definitions, and then it will be up to the regulator to go ahead and impose them.[363]

262. **The broad, largely unconstrained powers contained in proposed section 142J of FSMA could be used by the Treasury to set a framework which removes the regulator's discretion over whether to grant a PLAC exemption. There is also a possibility that the Treasury could use the power to intervene in individual decisions on exemptions from PLAC requirements. If this was used to overrule the regulator's decision on individual cases, this would be a highly inappropriate political intervention.**

263. **The Commission accepts that the Treasury should have certain powers to implement the PLAC requirements, and that secondary legislation is the appropriate vehicle: primary legislation is not appropriate for such technical matters, and the changes will in some cases be too important to be left solely to the discretion of the regulator. However, as drafted, these powers are extremely wide-ranging, are subject only to the negative resolution procedure, and need not be deployed with reference to any particular policy objectives. Furthermore, an order made under these provisions may confer a general power to give further directions to the regulator without further parliamentary oversight. This places an unacceptable level of unconstrained power in the hands of the Treasury. The Commission recommends that:**

361 Ev w54

362 Draft Financial Services (Banking Reform) Bill, Clause 4

363 Q 1097

- **the Bill require the powers of direction the Government acquires under proposed section 142J to be exercised with reference to policy objectives stated on the face of the statutory instrument which grants those powers;**
- **the order-making powers under proposed section 142J be subject to the affirmative resolution procedure, rather than the negative resolution procedure, to ensure a greater degree of parliamentary oversight; and**
- **the power under proposed section 142J(4)(d) to "confer power on the Treasury to issue directions to the regulator as to specified matters" be removed from the draft Bill altogether.**

The Commission also notes that the remaining powers of the Treasury to direct the regulator in relation to the implementation of the PLAC requirements will need very careful monitoring.

Depositor preference

The concept of depositor preference

264. When a company goes into insolvency, its creditors queue up to be paid out of the assets remaining in the firm. Preferring one group of creditors means moving them toward the front of this queue. Depositor preference is therefore relative: moving one creditor towards the front necessarily pushes others back. Depositor preference always favouring some depositors at the expense of others. Depositor preference can, in principle, be applied to certain categories of depositors (for example, households or SMEs) or to certain deposits (such as deposits insured through the Financial Services Compensation Scheme (FSCS)).

265. The ICB recommended in their final report that "in insolvency (and so also in resolution), all insured depositors should rank ahead of other creditors to the extent that those creditors are either unsecured or only secured with a floating charge".[364] In the White Paper preceding the draft Bill, the Government consulted on whether certain other categories of debts[365] should be preferred alongside insured deposits.[366] Following the consultation, the Government has decided to propose that only insured deposits should be preferred and proposals to give effect to this are set out in Clauses 7 and 8 of the draft Bill.[367]

266. In the UK, the deposits of households and small businesses up to £85,000 are insured by the Financial Services Compensation Scheme (FSCS), a body funded by the financial services industry with a backstop from the Government. As the Institute for Chartered Accountants pointed out, when only insured deposits are preferred this does not benefit insured depositors themselves:

364 Independent Commission on Banking, Final Report, September 2011, para 4.135

365 Banks' liabilities to their own pension schemes, overseas deposits up to the FSCS coverage limit, and deposits placed by groups such as charities or local authorities.

366 HM Treasury, *Banking reform: delivering stability and supporting a sustainable economy*, June 2012, Cm 8356, consultation question 4

367 HM Treasury, *Sound banking: delivering reform*, Cm 8453, October 2012, para 2.42

> The Financial Services Compensation Scheme protects individual deposits up to £85,000. So the proposals do not affect the position of most individuals. Rather, insured-depositor preference protects those who stand behind the FSCS scheme—the banks and, in some scenarios, HM Treasury.[368]

The uninsured depositor loses at the expense of the FSCS.

Arguments for insured depositor preference

267. Uninsured creditors would currently bear losses at the same rate as insured deposits if a bank failed. However, as the ICB final report pointed out, "insured depositors are not well-placed to exert market discipline on banks, and in any case have no incentive to do so".[369] By moving insured deposits ahead of uninsured depositors in the queue, depositor preference as proposed in the draft Bill concentrates losses on uninsured creditors, "many of whom are better able to exert such discipline by demanding higher returns if a bank pursues riskier activities".[370] The measure is thus intended to create an incentive on uninsured depositors to exercise an influence on the risk profile of banks.

268. If a bank does fail then any costs borne by the FSCS—for example in compensating depositors—are passed on to other banks through the FSCS levy. The ICB final report noted:

> This requires safe, well-run banks that survive a crisis to pay for the failure of risky banks (perhaps over a number of years), and in so doing acts as a channel for contagion. If surviving banks are unable to bear these costs, they will ultimately fall on the taxpayer.[371]

The risk to the taxpayer arises because in practice the FSCS and its members do not have the financial capacity to fund a sizeable resolution up front, so instead are likely to be reliant on a loan from the Treasury. As of April 2012, the FSCS still had obligations to repay the Treasury almost £18bn as a result of bank failures in the recent crisis where it made payouts or funded the transfer of deposits in resolution.[372] Insured depositor preference could reduce the risk to public funds from any loans made to the FSCS by making it more likely that full recovery will be made from the failed bank.

Extending depositor preference beyond insured deposits

269. Giving preference to insured deposits will result in higher rates of loss in insolvency for other liabilities which have been pushed down the creditor hierarchy. As an illustration, in the case of a bank with £10bn of insured deposits and £10bn of other deposits, these would currently rank equally in insolvency. If the bank fails and there are £4bn of losses left over after equity and any subordinated debt has been wiped out, then both the FSCS faces a loss of £2bn and uninsured depositors face a loss of £2bn—20 per cent of their claim. With

368 Ev w70

369 Independent Commission on Banking, Final Report, September 2011, para 4.89

370 *Ibid.*, para 4.89

371 *Ibid.*, para 4.90

372 HC Deb, 16 April 2012, col 2WS [Written Ministerial Statement]

insured depositor preference, all £4bn of losses fall on uninsured depositors who lose 40 per cent of their claim, while the FSCS faces no loss at all.

270. Some witnesses argued for extending preference beyond insured deposits, to categories such as all retail deposits or charities' deposits. A group of charity representatives argued for extending preference to charities' deposits on the grounds that the current proposals would place a greater and inappropriate burden on charities:

> The vast majority of charities manage their finances and risk extremely well, yet most simply do not have the same level of technical banking knowledge and expertise as other creditors of comparable size. Managing increased banking risk is extremely resource-heavy and investing in up-to-the-minute treasury management diverts funds away from frontline services. It is therefore difficult to justify using substantial charitable funds for this purpose, particularly given the challenging funding environment.[373]

They added that the nature of charity funding and banking was unique and that "charities typically hold large amounts on deposit (approximately £18bn across the sector) as they require quick and easy access to cash".

271. Nationwide stated that it had "consistently argued that all retail deposits in all ring-fenced institutions should carry creditor priority, not just those up to the FSCS limit". It added:

> We are doubtful that this would have a material impact on the cost of wholesale funding and believe that the consumer message is much more powerful and comprehensible without qualification.[374]

The Building Societies Association also said that it "continues to support full retail depositor preference, going beyond the FSCS coverage limit".[375]

272. The Treasury stated that it had considered these arguments in coming to its decision, and cited drawbacks of extending depositor preference "such as the dilution of the benefits of preference to the FSCS, and the effect of increasing the exposure of other non-preferred groups to losses in the event the bank fail". It argued that "no group or sector stands out as an exceptional case".[376] It also noted:

> it is expected that FSCS coverage will be extended (under the Proposal for a Directive on Deposit Guarantee Schemes) to include currently uncovered deposits. This will mean that all individuals and most organisations will be eligible for FSCS protection for amounts deposited up to the coverage limit.[377]

Barclays similarly argued that extending to other kinds of deposits was "a wholly inappropriate outcome" for several reasons:

373 Ev w4

374 Ev w95

375 Building Societies Association, Submission to Government Consultation on the Future of Building Societies, para 72

376 HM Treasury, *Sound banking: delivering reform*, Cm 8453, October 2012, para 2.51

377 *Ibid.*, 2.52

> First, it is not equivalent to the insurance protection provided to other depositors, as it will not guarantee payment. Second, it creates a material communication issue with depositors as to the nature of any protection to which they are exposed. Third, in the context of communications, understanding how depositor preference without insurance will work will require significant sophistication on the part of customers. We believe that any expansion of depositor protection should be dealt with best through changes to the relevant insurance schemes and carefully coordinated across at least Europe.[378]

273. An additional reason for banks to oppose the extension of depositor preference is that it is likely to increase their costs. The Treasury impact assessment estimates that insured depositor preference would cost UK banks between £0.3bn and £0.7bn on aggregate each year, as a result of having to pay higher interest rates to funding sources that would find themselves subordinated, such as corporate deposits or unsecured bonds.[379] No estimates have been published by the Treasury of the funding cost implications for banks of extended depositor preference, but this cost could reasonably be expected to be higher because the remaining corporate deposit holders and unsecured bond holders would carry an even greater proportion of losses in the event of failure.

Potential problems with depositor preference

274. The ICAEW argued that many of the creditors who would find themselves subordinated as a result of insured depositor preference were not really the type of creditors who it would be desirable to force losses upon:

> The price of protecting the banks and, possibly, the taxpayer would be borne by institutions such as larger charities, hospitals, schools, local authorities, universities and lawyer/accountants' client money accounts (which often temporarily hold, for example, clients' deposits on house purchases), as well as mid-sized companies. They will not be able to use ring-fenced banks with confidence [...].
>
> There are three ways this could be solved. Firstly, extend the FSCS coverage to all 'end-user' of the banking system. Secondly, extend depositor preference to all end-users. Or, drop the 'depositor preference' proposal altogether.[380]

Which? noted that uninsured retail depositors would include those who have temporary high balances above the £85,000 level:

> It is also clear to us that there are many occasions during a person's life when they need to hold deposits above the level set by the FSCS. These could include house purchase/sale, receiving an insurance pay-out, inheritance or pension lump-sum. We believe that at such times, retail depositors are not well placed to impose market discipline on banks and the loss of a deposit would risk having a catastrophic effect on the individual.[381]

378 Ev w33

379 HM Treasury, *Sound banking: delivering reform*, Cm 8453, October 2012

380 Ev w70

381 Ev w168

275. The Treasury considered that it was appropriate for such depositors to face the risk of losses:

> Where individuals and organisations hold sums beyond the FSCS limit, the Government believes it is right that they should monitor and manage the risk in where they place deposits, as all other unsecured creditors must do (including individuals and small businesses).[382]

276. Sir Mervyn King pointed out that it could be politically difficult for the authorities to impose losses on uninsured depositors, especially those with temporary high balances:

> On any given day you will find thousands of people in that position, and this is when I would understand if you in Parliament stood up and said, "This is deeply unfair." We have no means at present of handling that [...]
>
> If you have a very small bank that fails and only 12 people hold deposits above £85,000, in three different constituencies, I am convinced that the Chancellor will decide not to intervene. If you have thousands of people involved, I think the pressure on the Chancellor will be enormous.[383]

277. RBS expressed the view that depositor preference was "of questionable benefit", and argued that "the preservation of the creditor hierarchy is an important principle agreed by the industry." It went on to suggest that as an alternative:

> deposit guarantee schemes should, as in the EU RRD proposal, be included in a bail-in regime as a senior unsecured creditor, similar to their status in liquidation. This would ensure that the pool of eligible bail-in liabilities is as broad as possible to absorb potential losses.[384]

278. The Bank of England's explanation of how they might expect to resolve a large ring-fenced bank in future also suggested a need to be able to bail in the deposit guarantee scheme,[385] and Paul Tucker also argued for this in a speech in October 2012, saying that bailing in deposit insurers would be a way of ensuring bail-in could work for banks without enough bondholders.[386] HSBC noted that "Depositor preference is [...] inconsistent with the scope for deposit guarantee scheme bail-in",[387] because seniority for the FSCS would mean that it could only be bailed in if uninsured creditors had taken full losses first, otherwise this would represent a departure from the creditor hierarchy. Several witnesses also noted that implementation of depositor preference would require amendment of the Recovery and Resolution Directive, because the draft Directive currently prohibits it.[388]

382 HM Treasury, *Sound banking: delivering reform*, Cm 8453, October 2012, para 2.52

383 Q 1175, Q 1176

384 Ev w108

385 Ev w182, para 11 [Bank of England]

386 Bank of England, Speech by Paul Tucker to International Association of Deposit Insurers Annual Conference, 25 October 2012

387 Ev w137

388 Ev w100, para 14 [Professor Rosa M. Lastra]; Ev w137, para 1.71 [HSBC Holdings]

Conclusions

279. **It is crucial that deposit insurance be designed so as to avoid creating irresistible political pressure for ad hoc extension in the event of bank failure, as was the case in the last crisis. Implementation of the proposal for preference for insured deposits, by increasing prospective losses for others, has the potential to accentuate such pressure. Depositor preference would also appear to be in conflict with one of the resolution strategies favoured by the Bank of England, involving bail-in of the deposit insurance scheme. Both the above points weaken the credibility of the Government's proposal. The Commission considers that the Treasury's case that all non-insured creditors, including charities and small businesses and temporary high deposits of households, would be treated alike in the event of failure, is unconvincing. In view of these problems, the Commission recommends that the Government and Bank of England establish a joint group to prepare and publish a full report on the implications for resolution of depositor preference and of the scope and extent of depositor insurance. This report should, in particular, consider the feasibility of establishing a voluntary scheme of insurance for deposits over £85,000 with arrangements for opt-out. This report should be published at least two weeks before the House of Commons report stage of the Bill.**

Leverage ratios

280. Banks fund their assets (such as mortgages) with a mixture of equity and debt (such as customer deposits and bonds). This chapter has so far addressed proposals relating to the debt that a bank issues. These reforms involving bail-in, loss-absorbing debt requirements and depositor preference are all concerned with how debt-holders are treated when a bank approaches or reaches insolvency. Witnesses acknowledged that the reforms are important and promising, but also that they were untested. There remains a chance that they will fail, in the sense that the authorities will either not be willing or not feel able to impose losses on certain classes of creditors when the time comes.[389]

281. The remainder of this chapter addresses measures relating to equity. Imposing a requirement on the level of equity a bank issues is a more certain and tested safeguarding method. The owners of equity (the shareholders) are the residual claimants on the assets of the bank. They are the first to benefit from any profits and, by the same token, the first to suffer any loss. The more equity a bank has, the more money it can lose before it becomes insolvent: equity is a shock-absorber. The prospect of the shareholders bearing more of the losses from risky investments, rather than shifting them to debt holders (or the State, if the bank is bailed out) should dissuade them from taking too much risk in the first place. Bank equity is therefore a stabilising force in the financial system.

282. Requirements on equity are guided by the Basel process. This is a system of international agreements which sets minimum standards for how banks fund themselves.

389 Qq 705, 710, 727, 728, 731.

The main measure used by the Basel process is "Tier 1 capital", which includes equity and a limited class of other things.[390]

283. Two types of requirement on capital are used in the regulation of banks. The first is setting a minimum ratio of capital to 'risk-weighted assets', which was considered earlier in this chapter. The second is setting a minimum on the total amount of capital as a percentage of total unweighted assets – a 'leverage ratio'. The leverage ratio treats all assets the same rather than attempting to weight them by their relative riskiness.

284. Capital requirements against risk-weighted assets are being tightened considerably by the Basel 3 process. The Basel 3 rules are being implemented in the UK via the draft EU Capital Requirements Directive and Capital Requirements Regulation IV (CRDIV/CRR). The standards being implemented through CRDIV/CRR require that all banks should issue Tier 1 capital of at least 8.5 per cent of total RWAs. They also set a leverage ratio as an additional requirement, requiring that banks fund themselves with a minimum of 3 per cent of Tier 1 capital relative to total (i.e. unweighted) assets.[391]

285. The *leverage* ratio which is based on total assets and the *capital* ratio which is based on RWAs are connected, but not the same. Two banks that had the same ratio of capital to RWAs might easily have different leverage ratios. The bank that had assets judged to be safer, and which therefore had lower risk weights, could have a higher leverage ratio than the bank whose assets were held to be riskier, and which therefore had higher risk weights. If a bank were required to have capital equal to at least 8.5 per cent of its RWA, it would need the average risk rating of its assets to be at least 35 per cent (= 3 divided by 8.5, expressed as a percentage) in order for it also to have a leverage ratio above 3 per cent. The addition of the leverage ratio as a supplement to the capital ratio has the effect of preventing a bank from holding too many assets, even if the assets are judged to be low risk. The assets judged to be low risk do not give rise to a corresponding obligation to issue capital against them. The leverage ratio acts a safety net. If the assets with low risk weightings turn out to be greatly overvalued, an appropriate leverage ratio can ensure that the bank has sufficient capital to absorb the losses.

286. The ICB proposed to raise Tier 1 capital requirements for large ring-fenced banks from 8.5 per cent to 11.5 per cent of RWAs. The Government has agreed to implement this proposal. The ICB also proposed to increase the leverage ratio requirement on these banks by the same proportion, from 3 per cent to 4.06 per cent, so that the backstop has the same effect as under Basel 3. The Government has rejected this latter proposal.

287. Some witnesses questioned whether the Government's decision not to increase the leverage ratio in line with the ICB's recommendation was the right one. One argument against the Government's position was that measures using RWAs are held to be deeply flawed. A robust back-stop was therefore needed. Andy Haldane told us that "both Basel II and Basel III are built on the shakiest of foundations, because on the denominator of that capital ratio is a measure of the assets of the bank, weighted by risk".[392] Setting risk-weights

390 Tier 1 capital includes common shares, retained earnings and other instruments which can absorb losses on a going-concern basis. These other instruments must comply with a range of criteria relating to features such as subordination, coupon payments and redemption. Source: www.bis.gov.uk

391 Strictly speaking, the leverage ratio is calculated using 'exposures' rather than 'assets'.

392 Q 628

is not an exact science: for example, both German and Greek government bonds could be assigned zero risk weights under Basel II, so that a capital requirement based on risk-weighted assets would require no capital at all to be held against either.

288. Another major problem with measures of RWAs is that Basel II and III both allow some banks to calculate their own risk weights using internal models, subject to some constraints. Andy Haldane told us that "choice over those risk weights moved from the regulator to the firm. The firm was then setting its own standards through the risk models".[393] In 2009, the FSA asked banks to evaluate the capital requirements on a common portfolio of assets. According to Andy Haldane,

> the range of reported capital requirements held against this common portfolio was striking. For wholesale exposures to banks, capital requirements differed by a factor of over 100 per cent. For corporate exposures, they differed by a factor of around 150 per cent. And for sovereign exposures, they differed by a factor of up to 280 per cent. Those differences could equate to a confidence interval around reported capital ratios of 2 percentage points or more.[394]

Michael Cohrs echoed this point:

> the FSA sent out a portfolio to its constituents and asked them to risk-weight it. It was pretty simple. I think the expectation was that there would be a very narrow spread among the banks when they came back with this relatively simple portfolio. Lo and behold, it came back and there was a massive spread between the bank that was most conservative and the bank that was most aggressive. Risk-weighted assets are at the heart of the Basel ratio system. Therefore, you just throw your hands up. You start from there and say, "It doesn't really work".[395]

In evidence, Paul Tucker drew attention to the progress being made in improving disclosure of the processes underpinning risk weightings:

> It is very important that banks have to disclose a lot more about where they are taking risks, because what you described plainly happened and could happen again, and the underlying problem is that the asset management industry is not looking at risk-adjusted returns. I think they could fairly say at the moment that it is quite hard to do that when they cannot see what is inside the banks. The industry has come up with a disclosure framework internationally that goes a lot further than anything the regulators have demanded so far, and we and the international community have welcomed that.[396]

289. Sir Mervyn King joined Andy Haldane in cautioning against "relying too much on risk-weighted assets". He said that risk weights were set using an "international process which is very hard to negotiate and therefore extremely inflexible", that risk weights "change over time" and that in a major financial crisis "it is a time when the things you

393 Q 629

394 Bank of England, Remarks by Andrew Haldane, 9 January 2011

395 Uncorrected transcript of oral evidence before Parliamentary Commission on Banking Standards Panel on Regulatory Approach on 11 December 2012, HC 821-i, Q 8

396 Q 1214

thought were risky or less risky turn out not to be". He suggested that the leverage ratio turned out to be "a far better predictor of the institutions that failed in the crisis" than measures of risk-weighted assets.[397]

290. The banks and building societies supported the Government's decision not to increase the leverage ratio. HSBC noted that, "when the proposed increased capital requirements for G-SIBs were announced by the Basel Committee and FSB, they did not recommend any changes to the leverage requirements" and went on to say:

> the original leverage ratio of 3 per cent devised by the Basel Committee was intended to apply across all banks including universal banks. Therefore it was a blended rate recognising that banks hold low risk liquidity pools and mortgages as well as higher risk-weighted corporate and wholesale banking assets. Applying that blended rate to retail ring-fenced banks, with their concentration of lending to lower risk mortgages and with larger tranches of liquid assets, would in and of itself constitute a more onerous standard. To go beyond this would mean that the leverage ratio would becoming a binding capital restriction rather than the backstop measure which the Basel Committee originally intended.[398]

Related to these points is the contention that a 4 per cent minimum leverage ratio would be tighter than international minimum standards, tilting the playing field against UK banks.

291. In opposition to an increase in the leverage ratio it was also pointed out that a leverage cap would hit certain banks and certain forms of lending—i.e. those with low risk weights—particularly hard. Mortgage lenders who conduct what is widely regarded as low risk lending may be disproportionately affected.[399] This applies particularly to building societies, which cannot raise capital quickly and whose assets often have low risk weights. Nationwide contended that one response might be "perversely, to increase our risk taking".[400] Nationwide argued that if the requirement were tightened to 4 per cent, it should be "calibrated based on institutions' risk profiles [...] The key issue therefore is to determine the extent to which a retail ring-fenced bank and a building society have different risk profiles [...] For building societies, we would anticipate it [the leverage ratio] being no more than 3 per cent, otherwise it will become a primary measure".[401] Nationwide suggested that raising the leverage ratio might restrict lending.[402]

292. Sir Mervyn King addressed the issue of whether mortgage lenders would be hit disproportionately, noting that Northern Rock had a "staggering" degree of leverage before it failed, and that "It would not be sensible to allow a mortgage lender to build up to that degree of leverage. It is important to constrain the degree of leverage."[403] Calibrating an otherwise flat leverage ratio requirement for different institutions works against the premise of the simple leverage ratio—that it is a mistake to rely too heavily on judgements

397 Q 1209

398 Ev w131

399 Ev w42, para 11 [Building Societies Association], para 11

400 Ev w92, para 3

401 *Ibid.*, para 6

402 *Ibid.*, para 3

403 Q 1213

about relative riskiness. It is noteworthy that a number of building societies have been taken over or gone into resolution during the present crisis.[404] On the question of propensity to lend, Sir Mervyn King argued that if as a result of increased leverage ratios a bank was "lending less than it otherwise would, it means that we are minimising the risk that something will go badly wrong."[405]

293. In March 2012, following HM Treasury's earlier request, the interim FPC agreed unanimously a statement outlining its advice on potential powers of Direction for the statutory FPC. This included that the FPC should seek powers of Direction over a countercyclical capital buffer, sectoral capital requirements and a leverage ratio. The Government set out its reply to this request in September 2012. Citing consistency with international standards, the Government stated that it intends to provide the FPC with a time-varying leverage ratio tool, but no earlier than 2018 and subject to a review in 2017 to assess progress on international standards.[406] The precise design of the tool will depend on the provisions of the relevant European legislation and will be set out in secondary legislation to be introduced by the Government at the time.[407]

294. **Reliance on capital requirements based on risk weighted assets alone is not sufficient. The leverage ratio is an important part of banks' minimum capital requirements. If a 3 per cent leverage ratio is a backstop when the requirement in terms of RWAs is 8.5 per cent, raising the leverage ratio broadly in line with a higher requirement in terms of RWAs is logical. The Commission is not convinced about the appropriateness of the Government's decision to reject the ICB's recommendation to limit leverage at 25 times rather than 33 times. We believe that high leverage was a significant contributor to the crisis. The Commission considers it essential that the ring-fence should be supported by a higher leverage ratio, and would expect the leverage ratio to be set substantially higher than the 3 per cent minimum required under Basel III. Not to do so would reduce the effectiveness of the leverage ratio as a counter-weight to the weaknesses of risk weighting.**

295. **Determining the leverage ratio is a complex and technical decision, and one which is ultimately best made by the regulator. The FPC cannot be expected to work with one hand tied behind its back. The FPC should be given the duty of setting the leverage ratio from Spring 2013. An early change to the leverage ratio would pose particular problems for some building societies. In view of their special characteristics, the regulator should carefully consider the case for longer transition arrangements for them. Changes to leverage ratios might be mitigated by changes to the tax treatment of debt and equity for banks, a matter to which we will return in our Report in the New Year. We took little evidence on the effects on regulatory arbitrage and passporting held to be a possible consequence of setting higher capital or leverage ratio at a national level than are required under Basel III. We will consider this as part of our wider work on regulatory arbitrage issues in our final Report.**

404 See, for example, "Financial Services Authority confirms Chelsea Building Society merger with the Yorkshire Building Society", FSA press notice 050/2010, 19 Mar 2010

405 Q 1213

406 HM Treasury, *The Financial Services Bill: the Financial Policy Committee's macro-prudential tools*, Cm8434, September 2012

407 *Ibid.*

296. **Simple leverage ratios have the drawback that they incentivise banks to hold the highest-yielding and therefore presumably riskiest assets that they can, and to offload as many lower-yielding and safer assets as they can into other companies. Risk-weighting of assets was introduced as a remedy. Risk-weighting has, however, been unsatisfactory and arguably dangerous in practice. Banks were allowed to set their own risk weights using their own models. Some of the weights were much too low. The zero or low weights attached to government securities have encouraged banks to acquire large amounts of what were in some cases very risky assets. Many governments have an incentive not to address this, because of their need to fund large deficits. Parliament needs to be assured that the work to improve risk-weighting is being given the highest priority. The Commission recommends that the new Bill require the Bank of England to provide an annual assessment to be laid before Parliament of progress of risk-weighting and that the assessment should examine in particular the possible operation of floors for risk-weights, and steps taken with regard to simplification of risk-weights and trading exposures. If a more independent and more skilled Supervisory Board of the Bank of England is established in accordance with the recommendations of the Treasury Committee, it would be important for this Board to provide regular oversight of the work by the Bank of England in this area.**

12 Fees to meet Treasury expenditure

297. Since the onset of financial crisis, the UK authorities have engaged extensively with a range of international bodies such as the Financial Services Board (FSB) and the Basel Committee on Banking Supervision. The responsibility for doing so is shared between the Financial Services Authority, the Bank of England and HM Treasury. Clause 9 of the draft Bill gives the Treasury a power to direct the Prudential Regulation Authority and the Financial Conduct Authority to levy the financial services industry to pay for the future costs of engaging with international bodies such as the FSB. The policy paper accompanying the draft Bill states that "the detail of the organisations which are relevant to this power, and the detail of what expenses can be recovered, will be set out in secondary legislation".[408]

298. The Royal Bank of Scotland and Legal & General expressed disappointment that detailed explanation or an indication of the size of any increase in the levy had not been provided.[409] The Building Societies Association opposed any material levy affecting its members on the grounds that, because international financial stability risks arose typically from large internationally active banks, any levy should fall entirely or primarily on such banks.[410]

299. Clause 9 of the draft Bill refers to "expenses (including any expenses of a capital nature) that are incurred by the Treasury [...] so far as those expenses are in the opinion of the Treasury attributable to functions of the organisation which relate to financial stability or financial services".[411] It could thus be seen as a means of recovering part of the Treasury's running costs relating to the organisation, such as the pay of a civil servant or the costs of flights to its meetings. Such costs, as with such costs in other government departments, would normally fall to be funded from the Consolidated Fund. The Chancellor of the Exchequer and his officials assured the Commission that the provision would be used to fund the direct costs of subscriptions to institutions such as the FSB, rather than to meet the costs of officials assigned to relevant work. John Kingman also indicated that the amounts involved were not great: the UK's subscription to the FSB was currently set at less than £100,000 a year, although it was likely to increase.[412] The Chancellor of the Exchequer added that "since other regulators in the UK levy for the cost of some of their international activity, including on the same institutions, we think it is perfectly reasonable for the Treasury's subscriptions to some of these organisations to also be paid for by the industry".[413]

300. **The Commission accepts the principle that those creating the risks that need to be regulated should bear the costs of regulation, including costs of cooperating with international authorities. If provisions based on Clause 9 are included in the Bill, the**

408 HM Treasury, *Sound banking: delivering reform*, Cm 8453, October 2012, paras 2.61 and 2.62

409 Ev w100; Ev w145

410 *Banking reform : delivering stability and supporting a sustainable economy*, response by the Building Societies Association (BSA)

411 Draft Financial Services (Banking Reform) Bill, Clause 9, new section 410A(2)

412 Qq 1138, 1139

413 Q1137

Commission considers it essential that the Clause be amended to limit the levy to recovery of subscriptions rather than unspecified expenses, so that the provision cannot be used by a future Government to recover part of the Treasury's running costs, such as the salaries of civil servants involved in this work.

Conclusions and recommendations

Conduct of our work

1. The timetable for scrutinising the draft Bill which was arbitrarily dictated by the Government has meant that we have been unable to do justice to all of the issues which arise out of the draft Bill and related policy measures. We are concerned that the Government has constrained the ability of Parliament to conduct full scrutiny of a Bill of such vital importance. (Paragraph 12)

The overall case for separation

2. The Commission finds the evidence that it has received on the benefits for financial stability of some form of separation convincing. The evidence that there has been damage to standards and culture by having these activities side by side, an area not examined by the ICB, is comprehensive and a crucial consideration. There is evidence to suggest that, as well as supporting financial stability and reducing the risk to the taxpayer, separation has the potential to change the culture of banks for the better and to make banks simpler and easier to monitor. These are propositions to which the Commission expects to return in the New Year. (Paragraph 45)

The next banking crisis

3. The characteristics of financial crises and the nexus between banks, politicians and regulators together pose fundamental challenges for the design and implementation of structural separation. Any framework will need to be sufficiently robust and durable to withstand the pro-cyclical pressures in a future banking cycle. Those pressures will include the siren voices of those who contend that structural separation as implemented represents a barrier to financial innovation and growth. Politicians need to face up to the possibility that they may prefer those siren voices to the precautionary approach of regulators, particularly if, once again, it appears that banks are performing alchemy. In the chapters that follow, we consider the approach needed best to ensure that structural separation is able to withstand these challenges. (Paragraph 78)

Structural separation in the first instance

4. There is widespread, but not universal, support for structural separation in some form. However, views in evidence to the Commission about how separation should operate, where a ring-fence should be placed and indeed whether ring-fencing can achieve the desired policy aims, fell well short of consensus. (Paragraph 80)

5. Whatever their views on arguments for and against full separation, which are finely balanced, the majority of witnesses told the Commission that the partial structural separation of the ring-fence would probably bring significant benefits for public policy and for banking. The Commission therefore welcomes the Government's action to bring forward legislation to implement a ring-fence. (Paragraph 93)

6. The ICB's proposals should be the starting point for proposals for legislation for implementation of structural separation. However, that does not mean that they should be the final destination. The current proposals may not be sufficient. In addition to concerns about proprietary trading, the case that a ring-fence will in practice be able to achieve the necessary level of separation remains unproven. The ring-fence may also be tested and eroded over time. The Commission considers it essential that steps are taken to reinforce the ring-fence, and makes specific recommendations to this effect in chapter 9. (Paragraph 94)

7. There is evidence to suggest that proprietary trading, which under the current proposals could still take place within the non-ring-fenced part of banking groups, is an activity which is incompatible with maintaining the required integrity of customer-facing banking and which could have harmful cultural effects if permitted to continue. This was the primary concern of Paul Volcker in suggesting the prohibition of such activity in US banks. (Paragraph 95)

8. The Commission has not considered fully the ramifications and practical issues of supplementing the proposed UK ring-fence with something akin to the Volcker rule. The Commission intends to take further evidence on this in the New Year. The Bill which the Government will shortly introduce provides the appropriate vehicle for establishing the future structural form of the UK banking industry. (Paragraph 96)

9. The Commission will consider further the implications of introducing a prohibition on groups containing a ring-fenced bank from engaging in proprietary trading and, in particular, the contribution such a prohibition could make to the changes needed to banking culture and standards. The Commission expects to report in good time in order that legislative effect to any recommendations can be given as the Bill progresses. (Paragraph 97)

10. Measures to tighten the regulation of UK banks beyond international norms should be assessed for their potential to cause an unwelcome shift of activity abroad. However, concerns about relocation of banks may be over-stated. They should not be allowed to dominate the decision on the measures necessary to remove the implicit guarantee and ensure the banking system serves the UK economy. We will address this in our final Report. (Paragraph 98)

Making banks more resolvable

11. A guarantee, whether implicit or explicit, distorts incentives of managers and creditors, encouraging them to pursue excessive risk and leverage. It also distorts competition, and the allocation of resources, away from smaller banks to those large enough to be regarded as systemic. These problems are not removed simply by limiting guarantees to ring-fenced banks. While ring-fenced banks will carry out the majority of essential economic functions which need protecting, it is important to be clear that it is these functions that enjoy protection and not the bank itself or its shareholders or creditors. There should be no government guarantee of ring-fenced banks, nor perception of one. Neither does ring-fencing mean that risks from non-ring-fenced banks can be ignored, as such institutions will remain systemic and difficult to resolve. The stated aim of public policy, endorsed by the Commission,

should be to reach a position in which a failing bank, whatever side of the ring-fence it may be, can be resolved without risk to financial stability or to public funds. The measures that we have considered in this Report fall well short of fulfilling this aim. The issues of banks which are 'too-big-to fail' and of investment banks in whatever country whose failure would pose systemic risks to the UK banking system are ones which will require further measures and to which the Commission will return in the New Year. (Paragraph 104)

12. A ring-fence alone does not make banks resolvable. Without wider reforms, it is possible that a ring-fence would simply result in one too-big-to-fail bank becoming two such banks, the failure of either of which would require taxpayer support to avoid major disruption. The resolution challenges of non-ring-fenced banks in particular should not be ignored. Of the measures still needed in order to make banks resolvable, ring-fencing and bail-in are the two most important. The draft Bill seeks to deliver a ring-fence and introduces some elements which will support bail-in, although this tool is mostly being delivered through the EU Recovery and Resolution Directive. (Paragraph 107)

Alignment with European initiatives

13. Compared with other EU Member States, the banking sector represents a very large part of the UK economy. It is important that measures to strengthen the stability and resolvability of UK-based banks are put in place on a timetable that best meets the need of UK public policy. The UK cannot wait for or rely on appropriate implementation of the Liikanen proposals. It is desirable to maximise compatibility between the banking reforms to be enacted in the UK and the EU. The task of obtaining agreement across twenty-seven countries might also lead to a long delay in implementation. This could create uncertainty for public policy and for banks. The Commission has therefore concluded that the prospect of EU legislation arising from the Liikanen proposals should not be a determining factor in deciding upon the appropriate timetable for or substance of UK legislation, which should be proceeded with on a timetable that meets the needs of the UK economy. (Paragraph 111)

The Government's legislative approach

14. There is a good case for placing technical detail in secondary rather than primary legislation, in particular because of the importance of "future proofing" to allow a flexible response to developments in the banking sector. However, given the evidence we received about past regulation being too much of a negotiation between banks and regulators, we do not believe that too much of the burden of defining the ring-fence should be left to regulators. It is important that legislation properly equips the regulator with the clarity and authority necessary to maintain the ring-fence. The Commission is concerned that the heavy reliance on secondary legislation leaves open too many questions of significant policy importance. It would be unacceptable if the Commission's work in considering the framework were not matched by adequate scrutiny of the policy detail which follows in secondary legislation. This is not simply a parliamentary issue; it matters most because it creates uncertainty for the regulators who will be charged with making the new framework operational and

for the banks required to operate within it. The Commission considers steps that could be taken to address these concerns through changes to the primary legislation in the next chapter. In the meantime, the Commission welcomes the firm commitment of the Chancellor of the Exchequer given in evidence to the Commission to "faithfully implement" the relevant measures of the ICB Report, subject only to previously identified exceptions. However, Parliament should not be expected to rely on his assurances alone. It is for this reason that the Commission makes specific recommendations about the timetable for parliamentary consideration and scrutiny of the forthcoming primary legislation and the accompanying draft secondary legislation. (Paragraph 122)

15. The absence of secondary legislation has seriously impeded the Commission in discharging the task which we have been set by the two Houses of Parliament. In view of the fact that the Treasury has been committed to publishing the primary legislation to enable effect to be given to the ring-fence since at least May 2012, the Commission finds it regrettable that further thought was not given at an earlier stage to the effects of the timing of draft secondary legislation on the process of pre-legislative scrutiny and the wider process of preparing for implementation. Without further information about the secondary legislation, it is not possible for this Commission to assess with any certainty how faithfully the Bill will give effect to the ICB recommendations. The jury is still out on the question of whether the Bill will implement those recommendations in letter and spirit. (Paragraph 123)

16. The Commission notes the commitment to publish the principal secondary legislation in draft in time for the Commons Committee stage, but considers it inadequate. The Commission strongly recommends that the Government publish the principal secondary legislation giving effect to the ring-fence at the time the Bill itself is published. This is essential to provide a reasonable opportunity for its consideration by regulators and by others directly affected, as well as Parliament. In the absence of their views, parliamentary consideration by relevant Committees and in the two Chambers will inevitably be of very limited value. This would be unacceptable in the case of legislation of such importance. (Paragraph 124)

17. The Commission has not received evidence to call into question the appropriateness of a 2019 deadline for full implementation of the ring-fence. The extended timetable for implementation creates a risk of erosion even before the ring-fence is first put in place. This reinforces the need for a high level of transparency during the implementation phase. In addition, the primary concern of Government, Parliament, regulators and the affected institutions should be on getting the new legislation right. The Commission is not persuaded that immediate introduction of the primary legislation and its passage through the two Houses on a normal timetable would best serve this greater interest, given that much of the substance will reside in secondary legislation which should be available in draft. The Commission strongly recommends accordingly that, if the Government proceeds with publication of the Bill before the February 2013 half-term recess, there be a period of three sitting months between the second reading of the Bill in the House of Commons and the commencement of the Committee stage. The Commission would expect a pause

prior to Committee stage of at least two sitting months even if the Bill is published later than mid-February. (Paragraph 125)

Objectives in primary legislation

18. The ICB final report sets out three, not one, objectives for the ring-fence. These are:

- 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.

The continuity objective does not adequately reflect these. In order to anchor implementation of the ring-fence more securely to the ICB's proposals, the Commission recommends that the Bill as introduced imposes additional requirements under the new section 2BA(4) of FSMA to ensure that in advancing the continuity objective, the PRA must also seek to meet the following requirements as set out in paragraph 1.3 of the policy paper accompanying the draft Bill, namely:

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

The continuity objective must be properly understood as being about protecting the continuity of the provision of core services, not about the continuity of institutions. The regulator seeks clarity about how the continuity objective relates to the other objectives of the regulator when exercising powers in relation to the ring-fence. The Commission will take further evidence and report on this matter in the New Year. (Paragraph 130)

19. In the light of recent revelations the Commission has taken evidence regarding the ability of the ring-fence to protect and enhance standards and culture in the banks and will consider in our final Report whether an additional objective should be considered to address these concerns. (Paragraph 131)

Regulatory judgement

20. It is essential that the new framework for the ring-fence and the secondary legislation and rules that flow from it are not seen by the banks merely as a basis for negotiation. The legitimate role of the judgement of the regulator in implementing the framework must be beyond doubt. The regulator's decision-making, in line with its judgement in pursuit of its objective in relation to the ring-fence, should not require it to identify a specific breach of rules in order to take action to maintain the integrity of

the ring-fence. The Commission considers that it is of paramount importance that the new legislation is drafted in such a way as to make this clear. (Paragraph 133)

Conditions on the exercise of certain delegated powers

21. In addition to the enhanced scrutiny arrangements recommended later in this chapter, the Commission recommends that the Treasury's delegated powers under proposed sections 142A(2)(b) and 142D(2) be tightened. It is insufficient to require only that exemptions from the ring-fence restrictions do not have a "significant adverse effect on the continuity in the United Kingdom of the provision of core services". The fact that this condition is framed as a negative test could too easily allow a series of exemptions cumulatively to weaken and complicate the ring-fence, even if individually these fall short of risking a "significant adverse effect". The provisions should be tightened by requiring that exemptions should be made only if they:

    - do not pose a risk to the continuity objective; and

    - provide a significant economic or financial stability benefit. (Paragraph 135)

Determining the height of the ring-fence

22. The Commission is extremely concerned, as are the regulators themselves, that the key issues determining the height of the ring-fence are proposed to be a matter for determination by the regulator alone. A regulator enforcing rules of its own creation will have less authority in doing so than a regulator giving effect to a clear mandate in legislation with parliamentary authorisation. There is a compelling case for strengthening the regulator's hand when it makes ring-fencing rules through such a mandate. The Commission recommends accordingly that proposed section 142H of FSMA be amended either to define the parameters of the rules to be set by the regulator more fully or to require that secondary legislation made by the Treasury and subject to the affirmative resolution procedure defines the parameters. The objective of this legislation should be to empower the regulator to police and enforce the ring-fence. The Commission considers in chapter 10 what the legislative parameters should be. (Paragraph 139)

Scrutiny

23. The scrutiny arrangements for secondary legislation as specified in the draft Bill are unacceptably weak. Many of the delegated powers may involve significant policy choices, not merely implementation decisions of a technical nature. The Commission recommends that use of each of the delegated powers under proposed new sections 142B(5), 142D(2), 142D(4) and 142E should be subject to the affirmative resolution procedure. (Paragraph 146)

24. The Commission has concluded that the range of powers available to the Treasury under proposed section 142F is unacceptably wide. As a first step, the Commission recommends that the power of the Treasury to give itself further order-making powers be more fully circumscribed. In particular, there should be a requirement

that the power further to delegate under secondary legislation a power to make what might be termed tertiary legislation should be subject to the same parliamentary procedure as the instrument by which the power to make it is delegated. The Commission also recommends that, in the delegated powers memorandum accompanying the Bill itself, the Government set out in more detail the proposed use of each of the additional delegated powers it is seeking in section 142F. (Paragraph 149)

25. The Commission has concluded that a necessary form of parliamentary bulwark against erosion is the creation of a specific statutory provision for enhanced parliamentary scrutiny of the proposed use of delegated powers which have the potential to change the location of the ring-fence in a significant way. This would apply to all uses of the powers referred to in paragraph 146, subject to exceptions for secondary legislation of an urgent nature, which should be subject to the 'made affirmative' procedure. This scrutiny would be undertaken by a small ad hoc joint committee of both Houses of Parliament, to be established on each occasion subsequent to the first use of each delegated power when the Treasury proposes to exercise one of those delegated powers. Although the membership of the joint committee would be determined by decisions of the two Houses, there should be a statutory requirement for the Chairman of the House of Commons Treasury Committee to be an ex officio member of it. (Paragraph 151)

26. The Government would be required to publish its case for the proposed new use of the power, alongside a provisional version of the secondary legislation itself. This provisional version would be subject to public consultation. The ad hoc joint committee would be established at the outset of this consultation phase. It would examine and report on the proposal within a specified period. After that report, the Government could proceed with secondary legislation in the usual way, albeit subject to the affirmative resolution procedure in accordance with the Commission's recommendation in paragraph 146, but would do so in a way that secures far greater transparency about the purpose and likely effect of any changes. (Paragraph 152)

Electrifying the ring-fence

27. There is a strong case for the proposition that full structural separation would be the wisest course to take. As we noted earlier, Sir Mervyn King told us that he had "always felt that total separation was the right way ultimately to go" and that he was "glad that many more people are now coming on board with the idea that a move to some kind of serious separation is the right thing to do". At the very least, it is essential that it remains a possibility. (Paragraph 162)

28. The ring-fence envisaged by the Government may, in the long run, not provide an adequate degree of separation. Nor may it be adequate to buttress banking standards. The role that separation might play in strengthening standards across the banking sector is a matter to which we will return in the New Year. The inadequacies of the framework may become apparent over time, as banks seek to test the strength of the ring-fence. The evidence received by the Commission from the current regulators, and to which we referred in chapter 5, highlighted the pressure which is likely to be exerted on the regulator by banks and by politicians to take steps consistent with

short-term profitability and sectoral development, but inconsistent with the long-term objectives of the ring-fence. Additional powers are essential to provide adequate incentives for the banks to comply not just with the rules of the ring-fence, but also with their spirit. In the absence of the Commission's legislative proposals to electrify the ring-fence, the risk that the ring-fence will eventually fail will be much higher. (Paragraph 163)

29. The regulator already has powers under section 45 of FSMA to require banks to cease certain activities in specified circumstances. The Commission believes that it is necessary to go further. The Commission recommends that the forthcoming legislation add reserve powers to implement full separation. (Paragraph 164)

30. The first reserve power would be a power exercisable in respect of individual companies. A second reserve power would relate to the sector as a whole and would be exercisable in consequences of the review to which we refer in paragraph 171. With regard to the first reserve power, the Bill should include powers for the regulator to take steps that could lead to a specific banking group affected by the ring-fence being required to divest itself fully of either its ring-fenced or its non-ring-fenced bank. The powers would be exercisable only if the regulator had concluded that the conduct of that banking group was such as to create a significant risk that the objectives of the ring-fence would not be met in respect of that bank. In these circumstances the regulator should consider the group's adherence to the principles and spirit of the ring-fence as well as its compliance with the letter of the law. The Commission recommends that the objectives for this purpose should be aligned with those for the relevant work of the regulator set out on the face of the Bill, as amended from the draft Bill in accordance with our recommendation in paragraph 130. (Paragraph 165)

31. The Commission recommendation is of sufficient significance to require a number of limitations and safeguards. First, in order to allow time for the ring-fence to demonstrate its effectiveness, the Commission recommends that the Bill provides that the powers should not be exercisable by the regulator until after the completion of the first independent review of the effectiveness of the ring-fence that we propose in paragraph 171 and that we envisage should be completed less than four years after the ring-fence comes into force. The opportunity of this delay in commencement should also be taken by the Government to secure amendments to European legislation to ensure that the provisions relating to full structural separation are compatible with European law. (Paragraph 166)

32. The review mechanism currently included in the draft Bill is narrow and unacceptably weak. The Commission recommends an annual report from the PRA on the operation of the ring-fence. This is important to provide transparency on any issues arising between the regulator and banks and will give the regulator a vehicle for exposing attempts to game the system, get round or burrow under the ring-fence. The Commission recommends that the Bill be greatly strengthened. It should require a regular review of the effectiveness of the ring-fence across all banks to which the rules apply. The review body's terms of reference should require it to express a view on whether ring-fencing is achieving the objectives set out in legislation, and to assess the case for a move to full separation across the banking sector as a whole. The

terms of reference for the review should be set out in statute, based on the objectives for the ring-fence as laid down in legislation. The review body should have a duty to make recommendations to the regulator and the Treasury about the design and application of secondary legislation and ring-fencing rules. Prior to that review, the Bill should require that the PRA publish a statement which summarises how the ring-fencing rules have been implemented by the industry with specific consideration being given to how the position of the ring-fence has evolved, primarily focusing on what activities and services, in addition to the core activities and core services, sit within the ring-fenced bank and to the type of derivative products are being offered by the ring-fenced banks. The review body should be able to draw upon the work conducted by the regulator as part of its statement on the position as it has evolved by then. If the first review does not lead to full separation, second and subsequent reviews should also draw upon the regulator's accounts of experience in relation to the first reserve power the creation of which the Commission has recommended. Significant use of this reserve power would indicate that full separation across the banking sector would be very likely to be the appropriate step. The independent review should take place within four years of the rules implementing the ring-fence taking effect, and regularly at an interval specified in statute of no more than five years. (Paragraph 171)

33. The review body should be independently-led in order to provide appropriate challenge to the Treasury and PRA, who may otherwise find it difficult to criticise their own involvement in designing the framework. We would expect the body to have a range of backgrounds and views comparable to that of the ICB, although we believe that it should also include a former very senior central banker or regulator. (Paragraph 172)

Derivatives

34. Allowing ring-fenced banks to sell derivatives other than as an agent creates additional prudential and conduct risks. There are genuine concerns that this may lead over time to the sale by ring-fenced banks of more complex and risky products. The larger and more complex the derivative book, the more of a threat it could pose. (Paragraph 191)

35. The effects on consumers of allowing or prohibiting certain derivatives from being sold by ring-fenced banks as principal are uncertain. Banks have argued that a prohibition would result in consumer detriment, but selling derivatives to SMEs has been a highly profitable activity for them and investigations of mis-selling of interest rate swaps demonstrate the risk this poses to trust between banks and their customers; if ring-fenced banks were limited in their ability to provide these products directly it is plausible that the wider market would evolve and that other providers would compete to pick up the business to the benefit of consumers. The control of the sale of derivatives to prevent mis-selling is a matter of fundamental importance, to which the Commission will return in the New Year, but it is far from evident that the use of a structural solution (preventing ring-fenced banks from acting as principal) would be the best tool to deal with this issue. (Paragraph 192)

36. The sale of derivatives within the ring-fence poses a risk to the success of the ring-fence. The Commission has concluded that there is a case in principle for permitting the sale of simple derivatives within the ring-fence. However, such permission would need to be subject to conditions. The first is that there are adequate safeguards to prevent the mis-selling of derivative products within the ring-fence, a matter to which the Commission will return in the New Year. The second is that "simple" derivatives can be defined in a way which is limited and durable, a matter we consider in the next paragraph. The third is that there are limits on the proportion of a bank's balance sheet which is allowed to be taken up by these products. We remain concerned that allowing these products within the ring-fence may be the thin end of a wedge which could undermine the ring-fence. (Paragraph 193)

37. In addition to the elements of a "simple" derivative already identified by the Treasury, it is essential that there is a requirement that the size, maturity and basis of simple products should be limited to hedging the underlying client risk. The definition of 'simple derivatives' must appear in legislation. The Commission recommends that the proposed initial definition should be provided to the Treasury Committee before the Bill has completed its Commons stages. Whatever definition is chosen in the first instance, the banks will argue, as certain banks argued to this Commission, that customers would benefit from broadening the definition. For this reason, the Commission recommends that the regulator be required to report annually to Parliament on the extent and nature of the sale of derivatives within the ring-fence, including the effects of any changes to secondary legislation proposed by a future Government. (Paragraph 194)

38. The Government's proposals to limit the prudential risks arising from derivatives activity, such as limiting net market exposure to a small percentage of capital, are important and necessary. However, this would not limit the absolute volume of derivative activity. A large derivatives portfolio would still pose an unacceptable risk to the stability and resolvability of ring-fenced banks, even if it is supposedly hedged and collateralised. It could also affect the culture of the bank in an undesirable way. The Commission recommends accordingly that the Government impose an additional cap on the gross volume of derivative sales for ring-fenced banks, and on the total value of derivatives used for hedging. The Commission would expect consultation to take place before determining how a gross cap should be measured. (Paragraph 195)

The de minimis exemption

39. A de minimis exemption from ring-fencing for smaller deposit-taking institutions represents a sensible compromise between maintaining financial stability and encouraging new entrants to the banking industry. Although the level of the threshold is ultimately a matter of judgement, the Commission recommends that the considerations to be taken into account by the Chancellor of the Exchequer and his successors in setting or varying the de minimis exemption should appear on the face of the Bill. In addition to the factors that we have recommended in relation to the general power under proposed section 142A(2)(b) in paragraph 135, there should be a specific requirement for a decision imposing or revising a de minimis requirement

to have regard to its effect on competition in retail banking and on new entrants in the market in particular. The Commission also recommends that the regulator be required to report annually to Parliament on developments affecting the appropriateness of the level of the de minimis requirement. (Paragraph 200)

The large deposit exemption

40. The exemption for large deposits makes sense. It is right that holders of large deposits should be required to make an informed decision to hold their deposits in a non-retail bank. (Paragraph 203)

Geographical restrictions

41. The Commission is broadly content with the Government's approach to meeting the ICB's objective of effective geographic limits on the business of ring-fenced banks. In pursuing this primary consideration, however, consideration needs to be given to the effects of the solution devised on UK banks' ability to support trade. It is essential that full consideration is given to the repercussions of the measures proposed. For this reason, the Commission recommends that the Treasury undertakes a full separate consultation exercise on the draft secondary legislation to give effect to geographical restrictions and publish its findings two weeks prior to the House of Commons report stage. The Commission also considers it essential that, when the relevant secondary legislation comes into force, the Treasury monitors and reports to Parliament on its assessment of the trade-off between the direct intended effects of the limits and the capacity of the banks to support trade. (Paragraph 209)

Retail and SME lending

42. The Commission considers that it is right in the first instance not to require banking groups with a ring-fenced entity to carry out all lending for SME and retail customers within that entity. This is a provisional conclusion, which should be subject to review in the light of experience. There is a possibility that banking groups will conduct their most profitable lending from outside the ring-fence, where capital requirements will be lower and there will be fewer restrictions on dividend payments, leaving less profitable lending within the ring-fence. This could reduce the commercial strength of the ring-fenced entity. It could also reduce the transparency of the operation of the ring-fence. The Commission recommended earlier that the regulator should monitor and publish a statement on how the ring-fencing rules have been implemented by the industry, with specific consideration being given to which services are provided inside and outside the ring-fence. The Commission has concluded that the development of retail and SME lending outside the ring-fence is a matter for the regulator to monitor as part of its work on this statement. (Paragraph 215)

Independence and governance of the ring-fenced bank

43. There is likely to be a tension between the integrity of the ring-fence and the duties that directors of ring-fenced banks will owe to the parent company and through

them to shareholders. This tension will be present regardless of the whether directors of the ring-fenced bank are employed elsewhere in the group. It is not possible under current company law to create a subsidiary which is entirely independent. The Commission recommends that the Government insert within FSMA a legal duty on boards of directors to preserve the integrity of the ring-fence. (Paragraph 222)

44. The Commission further recommends that the Government set out, in its response to this Report, a full account of how directors would be expected to manage the relationship between such a duty and their duties to the shareholders. The Commission considers that an element of conflict between the duties may be unavoidable, and that this will constitute a permanent challenge for any structural solution which falls short of full structural separation. (Paragraph 223)

45. In the previous chapter, the Commission recommended that the core minimum requirements for a ring-fence of adequate height should be set out in secondary legislation subject to affirmative resolution procedure, and not be the subject of regulatory discretion. The Commission welcomes the Chancellor of the Exchequer's clear position on the key elements that should be included to ensure the proper independence of a ring-fenced bank. The Commission recommends accordingly that the initial secondary legislation made under proposed section 142H of FSMA (as envisaged in our recommendation in paragraph 139) should give the regulator a duty of ensuring operational independence for the ring-fenced bank in respect of governance, risk management, treasury management, human resourcing, capital and liquidity. (Paragraph 224)

Relationship between the ring-fenced bank and the holding company

46. The Commission found that the arguments for prohibiting a non-ring-fenced bank from directly owning a ring-fenced bank are persuasive. This is a clear and straightforward way to strengthen the ring-fence, and is far better done at the outset. The Commission recommends accordingly that the regulator be given the power to require a sibling structure between a ring-fenced and non-ring-fenced bank, with a holding company. The Commission would expect this power to be exercised. (Paragraph 228)

Liabilities

47. The Commission finds it disconcerting that the Treasury should raise the possibility that the establishment of the ring-fence might lead to the dissolution of a company and the cancellation of its liabilities. The onus should not be on the regulator to prohibit the dissolution of a company. Nor should the onus be on creditors of a company to make a court application to restore the company in order to meet obligations. The Commission recommends accordingly that the regulator be required to set rules to ensure that the creation of ring-fenced and non-ring-fenced entities is not used as an opportunity to shift liabilities or potential liabilities in an artificial way. (Paragraph 230)

Bail-in

48. An effective and credible bail-in tool would represent a major step towards eliminating the implicit guarantee and ensuring that the costs of resolving a failing bank are not borne by the taxpayer. It is notable that bail-in is at the heart of the resolution strategies currently being designed for large systemically important banks, and will remain important even after the ring-fence is introduced. (Paragraph 236)

49. Concerns remain about the design of a bail-in regime and whether it will provide confidence that the authorities would actually use their powers in the event of a crisis. The new tool risks being of particularly limited utility if the authorities were required to impose losses beyond the holders of specifically "bail-inable" debt and move up the chain to, say, corporate depositors. The legal and economic implications of bailing in a bank's creditors will never be known until it is tried for the first time under stressed conditions, and politicians and regulators will always face pressure to incur the better-understood costs of a taxpayer bailout instead. It should be a requirement that bail-inable debt is held outside the banking system, to reduce contagion risks within the banking system. The regulator should make early proposals on how best to accomplish this. Uncertainty about the size and nature of market for loss-absorbing debt will also mean that doubts will remain over whether bail-in will function as intended and what its costs will be. Parliament will need assurance that bail-in is not a paper tiger, as will the markets. The Commission recommends accordingly that the Bank of England be subject to a statutory requirement under the new legislation to produce an annual report to Parliament on the development and subsequent operation of bail-in to assist in assessment of its feasibility, which should be required to cover in particular:

   - The quantity of issued debt with characteristics which make it easily subject to bail in;
   - Whether bail-inable debt is being issued out of the correct corporate entity within a banking group to facilitate the preferred bail-in strategy;
   - The distribution of holdings of bail-inable bank debt within the rest of the financial system;
   - The feasibility of mechanisms for bailing in creditors other than long-term unsecured bonds, such as corporate depositors, uninsured household depositors and derivative counterparties;
   - Progress towards addressing international legal barriers to the recognition of bail-in actions. (Paragraph 242)

50. The Commission supports the Government's endeavours to implement a bail-in regime in the UK. The Government should also continue to negotiate for a broad bail-in power to be applied across the EU. Bail-in is an important tool for resolving bank failures in a way that prevents the huge costs. The Commission is concerned at the risk that the development of such a tool might be delayed or watered down through negotiations at EU level and, given the size of the financial services sector relative to the UK economy, the Commission believes the Government should act at

a UK level in the event of EU discussions not resulting in the desired protection for the taxpayer that bail-in aims to ensure. The Commission recommends that the Government make provision in the forthcoming legislation for bail-in powers at national level which could come into force if the EU proposals were delayed or inadequate, on the understanding that negotiations at European level would need to secure the subsequent removal of any existing or prospective European legal obstacles to the use of a more wider-ranging power at national level. (Paragraph 245)

PLAC

51. Exemptions from PLAC increase the risk that, in a crisis, the UK would need to intervene in respect of overseas operations of a UK-based bank, but would lack the level of PLAC necessary to shield the taxpayer. The Commission recommends that the secondary legislation to be made under to section 142J of the draft Bill place the burden of proof for any exemption from PLAC requirements on the bank seeking the exemption, rather than on the regulator. This would mean that the regulator would only grant an exemption if a bank had demonstrated to the regulator's satisfaction that there was no risk to stability, rather than merely if the regulator could not show that a risk existed, providing a greater level of protection to the taxpayer. This should include the bank showing that the resolution authorities in the areas in which they operate outside the EEA would assume lead responsibility for resolving the operations in those overseas territories in the event of the bank's failure, in order to protect the UK taxpayer. The decision on whether to grant an exemption should be made by the regulator with reference to clear objectives, although in all cases it will need to involve an exercise of judgment by the regulator. Decisions should be subject to the same review and appeals processes as any other decision by the regulator. The existence of exemptions should be publicly disclosed. It will also be important for the regulator to monitor the implications of exemptions in the case of each firm affected on an ongoing basis. We would expect this monitoring to be the subject of regular review by a strengthened Supervisory Board of the Bank of England introduced in accordance with the recommendations of the Treasury Committee. (Paragraph 258)

52. The broad, largely unconstrained powers contained in proposed section 142J of FSMA could be used by the Treasury to set a framework which removes the regulator's discretion over whether to grant a PLAC exemption. There is also a possibility that the Treasury could use the power to intervene in individual decisions on exemptions from PLAC requirements. If this was used to overrule the regulator's decision on individual cases, this would be a highly inappropriate political intervention. (Paragraph 262)

53. The Commission accepts that the Treasury should have certain powers to implement the PLAC requirements, and that secondary legislation is the appropriate vehicle: primary legislation is not appropriate for such technical matters, and the changes will in some cases be too important to be left solely to the discretion of the regulator. However, as drafted, these powers are extremely wide-ranging, are subject only to the negative resolution procedure, and need not be deployed with reference to any

particular policy objectives. Furthermore, an order made under these provisions may confer a general power to give further directions to the regulator without further parliamentary oversight. This places an unacceptable level of unconstrained power in the hands of the Treasury. The Commission recommends that:

- the Bill require the powers of direction the Government acquires under proposed section 142J to be exercised with reference to policy objectives stated on the face of the statutory instrument which grants those powers;
- the order-making powers under proposed section 142J be subject to the affirmative resolution procedure, rather than the negative resolution procedure, to ensure a greater degree of parliamentary oversight; and
- the power under proposed section 142J(4)(d) to "confer power on the Treasury to issue directions to the regulator as to specified matters" be removed from the draft Bill altogether.

The Commission also notes that the remaining powers of the Treasury to direct the regulator in relation to the implementation of the PLAC requirements will need very careful monitoring. (Paragraph 263)

Depositor preference

54. It is crucial that deposit insurance be designed so as to avoid creating irresistible political pressure for ad hoc extension in the event of bank failure, as was the case in the last crisis. Implementation of the proposal for preference for insured deposits, by increasing prospective losses for others, has the potential to accentuate such pressure. Depositor preference would also appear to be in conflict with one of the resolution strategies favoured by the Bank of England, involving bail-in of the deposit insurance scheme. Both the above points weaken the credibility of the Government's proposal. The Commission considers that the Treasury's case that all non-insured creditors, including charities and small businesses and temporary high deposits of households, would be treated alike in the event of failure, is unconvincing. In view of these problems, the Commission recommends that the Government and Bank of England establish a joint group to prepare and publish a full report on the implications for resolution of depositor preference and of the scope and extent of depositor insurance. This report should, in particular, consider the feasibility of establishing a voluntary scheme of insurance for deposits over £85,000 with arrangements for opt-out. This report should be published at least two weeks before the House of Commons report stage of the Bill. (Paragraph 279)

Leverage ratios

55. Reliance on capital requirements based on risk weighted assets alone is not sufficient. The leverage ratio is an important part of banks' minimum capital requirements. If a 3 per cent leverage ratio is a backstop when the requirement in terms of RWAs is 8.5 per cent, raising the leverage ratio broadly in line with a higher requirement in terms of RWAs is logical. The Commission is not convinced about the appropriateness of the Government's decision to reject the ICB's recommendation to limit leverage at

25 times rather than 33 times. We believe that high leverage was a significant contributor to the crisis. The Commission considers it essential that the ring-fence should be supported by a higher leverage ratio, and would expect the leverage ratio to be set substantially higher than the 3 per cent minimum required under Basel III. Not to do so would reduce the effectiveness of the leverage ratio as a counter-weight to the weaknesses of risk weighting. (Paragraph 294)

56. Determining the leverage ratio is a complex and technical decision, and one which is ultimately best made by the regulator. The FPC cannot be expected to work with one hand tied behind its back. The FPC should be given the duty of setting the leverage ratio from Spring 2013. An early change to the leverage ratio would pose particular problems for some building societies. In view of their special characteristics, the regulator should carefully consider the case for longer transition arrangements for them. Changes to leverage ratios might be mitigated by changes to the tax treatment of debt and equity for banks, a matter to which we will return in our Report in the New Year. We took little evidence on the effects on regulatory arbitrage and passporting held to be a possible consequence of setting higher capital or leverage ratio at a national level than are required under Basel III. We will consider this as part of our wider work on regulatory arbitrage issues in our final Report. (Paragraph 295)

57. Simple leverage ratios have the drawback that they incentivise banks to hold the highest-yielding and therefore presumably riskiest assets that they can, and to offload as many lower-yielding and safer assets as they can into other companies. Risk-weighting of assets was introduced as a remedy. Risk-weighting has, however, been unsatisfactory and arguably dangerous in practice. Banks were allowed to set their own risk weights using their own models. Some of the weights were much too low. The zero or low weights attached to government securities have encouraged banks to acquire large amounts of what were in some cases very risky assets. Many governments have an incentive not to address this, because of their need to fund large deficits. Parliament needs to be assured that the work to improve risk-weighting is being given the highest priority. The Commission recommends that the new Bill require the Bank of England to provide an annual assessment to be laid before Parliament of progress of risk-weighting and that the assessment should examine in particular the possible operation of floors for risk-weights, and steps taken with regard to simplification of risk-weights and trading exposures. If a more independent and more skilled Supervisory Board of the Bank of England is established in accordance with the recommendations of the Treasury Committee, it would be important for this Board to provide regular oversight of the work by the Bank of England in this area. (Paragraph 296)

Fees to meet Treasury expenditure

58. The Commission accepts the principle that those creating the risks that need to be regulated should bear the costs of regulation, including costs of cooperating with international authorities. If provisions based on Clause 9 are included in the Bill, the Commission considers it essential that the Clause be amended to limit the levy to recovery of subscriptions rather than unspecified expenses, so that the provision

cannot be used by a future Government to recover part of the Treasury's running costs, such as the salaries of civil servants involved in this work. (Paragraph 300)

Formal Minutes

Wednesday 19 December 2012

Members present:

Mr Andrew Tyrie MP, in the Chair

The Lord Bishop of Durham
Mark Garnier MP
Baroness Kramer
Rt Hon Lord Lawson of Blaby
Andrew Love MP
Rt Hon Lord McFall of Alcluith
Rt Hon Pat McFadden MP
John Thurso MP
Lord Turnbull KCB CVO

******

Declarations of interest, by members of the Commission, relating to the Commission's work were made on 24 July 2012 and 8 November 2012.

Draft Report (*First Report*), proposed by the Chair, brought up and read.

Ordered, that the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 300 read and agreed to.

Summary agreed to.

Resolved, That the Report be the First Report of the Commission to each House.

Ordered, That the Chair make the Report to the House of Commons and that Lord Lawson of Blaby make the Report to the House of Lords.

Ordered, That embargoed copies of the Report be made available (Standing Order No. 134 of the House of Commons).

The following written evidence was ordered to be reported to the House of Commons for publication on the internet.

Association of Corporate Treasurers
Bank of England
Rt Hon George Osborne MP, Chancellor of the Exchequer
Federation of Small Businesses
Financial Services Authority
HM Treasury
HSBC Holdings
Intellect
Legal & General
new economics foundation
Santander
Standard Chartered Bank
Vedanta Hedging
Virgin Money
Which?

******

[Adjourned to a day and time to be fixed by the Chair.

Witnesses

Witnesses who have given evidence to the Commission are listed below. Transcripts of this oral evidence and other oral evidence taken by the Commission's panels is available at www.parliament.uk/bankingstandards.

Wednesday 12 September 2012

Sir David Walker

Wednesday 17 October 2012

Paul Volcker

Monday 22 October 2012

Erkki Liikanen, Chair, High-level Expert Group on structural bank reforms established by the European Commission, Governor of the Bank of Finland and member of the Governing Council of the European Central Bank

Wednesday 24 October 2012

Sir Donald Cruickshank

Thursday 25 October 2012

Martin Wheatley, Managing Director, Consumer and Markets Business Unit, Financial Services Authority

Monday 29 October 2012

Professor John Kay, Visiting Professor of Economics, London School of Economics, and Fellow of St John's College, Oxford

Wednesday 31 October 2012

Martin Taylor, Chairman of Syngenta and former member of the Independent Commission on Banking

Monday 5 November 2012

Ana Botín, Chief Executive Officer, Santander UK, **Douglas Flint**, Chairman, HSBC, and **Antony Jenkins**, Chief Executive Officer, Barclays

Wednesday 7 November 2012

Andy Haldane, Executive Director for Financial Stability, Bank of England

Thursday 8 November 2012

Professor Rosa Lastra, Professor in International Finance and Monetary Law, Queen Mary, University of London, **Dorothy Livingston**, Chair, Banking Reform Working Group, Law Society of England and Wales and Consultant,

Herbert Smith Freehills LLP, and **Bob Penn**, Partner, Allen & Overy

Monday 12 November 2012

Sir John Vickers, Former Chairman of the Independent Commission on Banking

Tuesday 13 November 2012

Stephen Hester, Group Chief Executive, RBS, **António Horta-Osório**, Group Chief Executive, Lloyds Banking Group, and **Peter Sands**, Group Chief Executive, Standard Chartered Bank

Monday 19 November 2012

Andrew Bailey, Managing Director, Prudential Business Unit, Financial Services Authority and **Adair Turner**, Baron Turner of Ecchinswell, Chairman, Financial Services Authority

Wednesday 21 November 2012

Rt Hon George Osborne MP, Chancellor of the Exchequer, **Rt Hon Greg Clark MP**, Financial Secretary to the Treasury, **John Kingman**, Second Permanent Secretary, HM Treasury, **Sophie Dean**, Deputy Director Banking Reform Bill Team, HM Treasury

Thursday 22 November 2012

Andy Haldane, Executive Director, Financial Stability, Bank of England, **Sir Mervyn King**, Governor, Bank of England and **Paul Tucker**, Deputy Governor, Financial Stability, Bank of England

Monday 3 December 2012

Sir James Crosby, former Chief Executive, HBOS, 2001 to 2005, **Andy Hornby,** former Chief Executive, HBOS, 2006 to 2008

Tuesday 4 December 2012

Lord Stevenson of Coddenham, former Chairman, HBOS, 2001 to 2009

List of published written evidence

Written evidence published by the Commission regarding pre-legislative scrutiny of the draft Financial Services (Banking Reform) Bill is listed below. This and other evidence taken by the Commission and its Panels is available at www.parliament.uk/bankingstandards.

1	Allen & Overy LLP	Ev w10
2	Association of British Insurers	Ev w16
3	Association of Corporate Treasurers	Ev w171
4	Bank of England	Ev w180, Ev w197
5	Barclays Bank	Ev w26
6	British Bankers' Association	Ev w35
7	Building Societies Association	Ev w41
8	Rt Hon George Osborne MP, Chancellor of the Exchequer	Ev w1, Ev w191
9	Charity Finance Group, Charities Aid Foundation, the Association of Chief Executives of Voluntary Organisations and the National Council for Voluntary Organisations	Ev w43
10	Davis Polk & Wardwell London LLP	Ev w46
11	Delegated Powers and Regulatory Reform Committee, House of Lords	Ev w53
12	Federation of Small Businesses	Ev w188
13	Financial Reporting Council	Ev w55
14	Financial Services Authority	Ev w57, Ev w188
15	Hermes	Ev w63
16	HM Treasury	Ev w1, Ev w173
17	HSBC Holdings	Ev w128
18	ICAEW	Ev w67
19	Intellect	Ev w141
20	Law Society of England and Wales	Ev w71
21	Legal & General	Ev w145
22	Lloyds Banking Group	Ev w84
23	Nationwide Building Society	Ev w92
24	new economics foundation	Ev w184
25	Nomura	Ev w96
26	Prof Rosa Lastra, Queen Mary, University of London	Ev w98
27	Royal Bank of Scotland Group	Ev w100
28	RBS Pension Trustee	Ev w113
29	Santander UK	Ev w121
30	Schroders	Ev w116
31	Standard Chartered Bank	Ev w149
32	TheCityUK	Ev w114
33	United Food and Commercial Workers Union	Ev w117
34	Vedanta Hedging	Ev w189
35	Virgin Money	Ev w152
36	Which?	Ev w162