Final Report
Recommendations

September 2011

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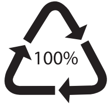

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This document is also available from our website at
http://bankingcommission.independent.gov.uk/

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

Produced by the Domarn Group, London.

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List of acronyms

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

Executive summary

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

Aims of reform

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

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

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

Financial stability

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

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

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

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

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

Loss-absorbency: principles

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

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

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

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

Under the international agreement known as Basel III, banks will be required to have equity capital of at least 7% of risk-weighted assets by 2019, while risk weights have also been tightened. As a backstop, there is a proposal to limit leverage to thirty-three times. Recent

further proposals from the Financial Stability Board and the Basel Committee on Banking Supervision are to increase risk-weighted capital requirements by up to 2.5% for global systemically important banks (G-SIBs), with provision for a further 1% for banks whose systemic importance grows yet more. These increases to capital requirements will not only improve banks' ability to absorb losses, but will also make them less vulnerable to liquidity problems, which are often a symptom of concerns about solvency. Basel III also includes specific proposals requiring banks to hold more liquid assets, to make them better able to withstand any temporary problems in accessing liquidity in the market.

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

Structural reform: principles

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

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

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

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

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

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

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

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

Structural reform: practical recommendations

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

The Commission's analysis of the costs and benefits of alternative structural reform options has concluded that the best policy approach is to require retail ring-fencing of UK banks, not

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

Scope of ring-fence

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

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

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

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

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

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

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

Strength of ring-fence

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

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

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

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

Loss-absorbency: practical recommendations

The principles of loss-absorbency discussed earlier – notably the need for much more equity and for debt to be capable of absorbing losses in resolution – can now be applied to the structural reform recommended by the Commission. There are three broad questions. What type of loss-absorbing capacity should be required? How much of it? And where in the

banking group should it be held? In most sectors of the economy such questions have purely market-determined answers. The potentially calamitous consequences of uncontrolled bank failures make regulatory baselines necessary for banks.

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

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

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

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

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

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

Financial stability reforms work together

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

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

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

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

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

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

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

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

Risks to the fiscal position

The Commission's terms of reference call for attention to be paid to risks to the fiscal position of the Government. The biggest risk is from the possibility of future crises; the value of the Government stakes in banks is an important but secondary consideration. For the reasons given above, the financial stability reforms recommended in this report should curtail risks to

the public finances. The probability of government intervention being needed should be much reduced by greater loss-absorbency and curtailed risk-taking incentives. The form of intervention, if still needed, should involve resolution, not financial rescue. If, in the last resort, public funds had to be deployed, the scale of any such support should be greatly diminished by the proposed reforms.

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

UK competitiveness

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

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

Timescales

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

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

framework for the supply of credit to businesses and households in the UK economy. And improved financial stability would be good for investment in the economy.

Competition

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

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

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

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

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

Improving prospects for a strong and effective challenger

In the light of further evidence, the Commission confirms its view that the prospects for competition in UK retail banking would be much improved by the creation of a strong and effective new challenger by way of the Lloyds divestiture. (The required RBS divestiture has already taken place.) Since the currently proposed divestiture has important limitations, its

substantial enhancement would be desirable. This is not simply a question of the number and quality of divested branches, or of the related share of personal current accounts, which at 4.6% is at the low end of the range associated with effective competitive challenge in the past. The funding position of the divested entity is also important for competitive prospects. In particular, unless remedied, its large funding gap – i.e. high loan-to-deposit ratio – would blunt the incentive of the divested entity to compete effectively as a credit provider, and might raise its funding cost base, thereby weakening its ability to compete generally. The Commission therefore recommends that the Government seek agreement with Lloyds to ensure that the divestiture leads to the emergence of a strong challenger bank.

Improving switching and consumer choice

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

Securing pro-competitive financial regulation

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

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

The question of reference to the Competition Commission

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

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

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

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

Conclusion

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

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

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

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

Chapter 1: Introduction

Background

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

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

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

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

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

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

Box 1.1: Aims and Principles

Aims

The Commission's recommendations aim to:

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

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

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

Principles

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

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

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

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

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

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

Outline of this report

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

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

PART I – FINANCIAL STABILITY

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

PART II – COMPETITION

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

PART III – RECOMMENDATIONS

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

GLOSSARY AND ANNEXES

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

PART I: FINANCIAL STABILITY
Chapter 2: Overview

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

The Commission's approach

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

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

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

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

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

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

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

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

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

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

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

Structure

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

2.7 First, it would *make it easier to resolve banks which get into trouble, without the provision of taxpayer support*. Resolution is the process whereby the authorities seek to manage the failure of a bank in a safe and orderly way that minimises any adverse impact on the rest of the financial system and the wider economy. In general, resolution requires the separation of different banking functions. Without *ex ante* separability, which ring-fencing would provide, it is doubtful that this could be done *ex post*. Moreover, resolution needs to achieve different things for different activities: it is vital for the

economy and customers that there is continuous provision of some services; for others, the aim is rather to manage the wind-down of those activities, particularly to limit any general loss of confidence in the financial system which might result. It is imperative that both objectives are seen to be achievable without bank creditors or shareholders getting taxpayer bail-outs. Separating activities where objectives differ makes this easier, especially because those services whose continuous provision is essential tend not to be those whose complexity makes resolution difficult.

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

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

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

Efficiency objections

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

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

Why not separate completely?

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

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

Practicability objections

2.15 The third broad category of objections to ring-fencing relates to practicability. This is best addressed once the proposed ring-fence design has been described. Suffice it to say at this point that the Commission is satisfied that its recommended approach is workable. Indeed, practicability is a benefit of ring-fencing – as simpler entities,

ring-fenced banks would be easier to monitor, supervise and manage than universal banks, other things being equal.

Loss-absorbency

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

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

The Basel III baseline

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

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

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

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

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

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

The 'super-equivalence' objection

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

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

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

Why not impose much higher standards?

2.24 The final objection to consider is the opposite of those discussed above – that the UK should impose much higher standards than those proposed internationally, even with the G-SIB surcharge added. As will be apparent from above, the Commission has considerable sympathy with this point of view, and its recommendations on loss-absorbency have been informed by it. For example, the Commission's

recommendations would give scope for requiring a 13% equity-to-RWAs ratio on large retail banks, plus additional capital and long-term unsecured debt. However, for the following reasons, the Commission is not recommending still higher equity requirements.

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

An overview of the reform package

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

HBOS

Why did it fail?

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

How might the reforms have helped?

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

Lehman Brothers

Why did it fail?

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

How might the reforms have helped?

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

Northern Rock[1]

Why did it fail?

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

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

How might the reforms have helped?

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

RBS

Why did it fail?

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

How might the reforms have helped?

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

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

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

Chapter 3: Retail ring-fence

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

Purpose of the ring-fence

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

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

The purpose of the retail ring-fence is to isolate those banking activities where continuous provision of service is vital to the economy and to a bank's customers in order to ensure, first, that this provision is not threatened as a result of activities which are incidental to it and, second, that such provision can be maintained in the event of the bank's failure without government solvency support. A retail ring-fence should be designed to achieve the following objectives at the lowest possible cost to the economy:

- *make it easier to sort out both ring-fenced banks and non-ring-fenced banks which get into trouble, without the provision of taxpayer-funded solvency support;*
- *insulate vital banking services on which households and SMEs depend from problems elsewhere in the financial system; and*
- *curtail government guarantees, reducing the risk to the public finances and making it less likely that banks will run excessive risks in the first place.*

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

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

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

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

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

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

Location of the ring-fence

Principle 1: Mandated services

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

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

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

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

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

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

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

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

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

3.13 Thus, the first ring-fence principle is:

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

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

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

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

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

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

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

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

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

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

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

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

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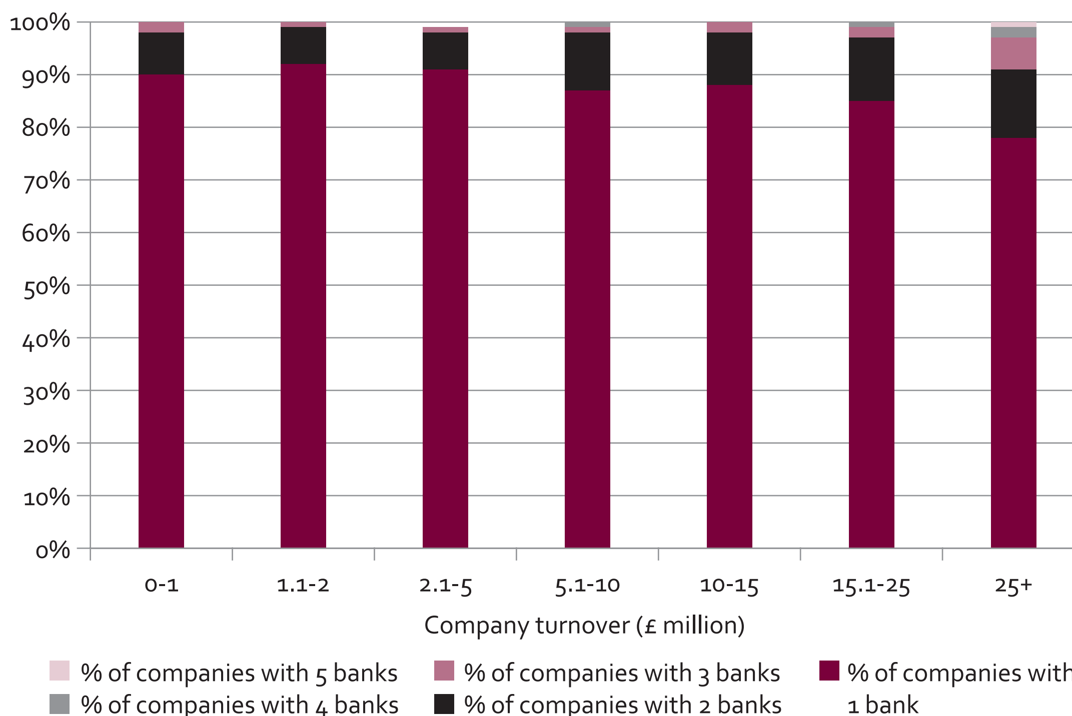
15 An additional complication is that reforms have been proposed which would extend coverage of the Financial Services Compensation Scheme (FSCS) to non-financial corporate customers of all sizes (see European Commission, July 2010, *Proposal for a Directive on Deposit Guarantee Scheme*. Available at: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

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



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

Principle 2: Prohibited services

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

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

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

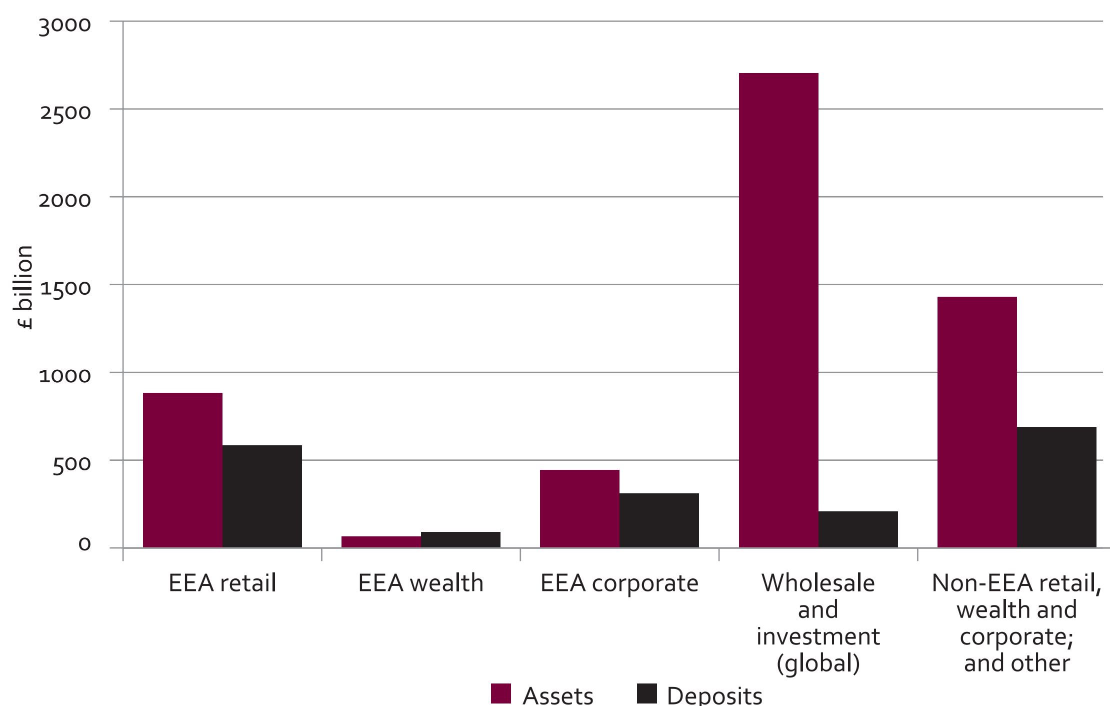
After outlining the size of different parts of the banking sector in Box 3.1, this section considers each of these questions in turn and against the objectives of the ring-fence. It then outlines in detail the division between retail and wholesale/investment banking which the Commission believes is most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

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

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

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

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

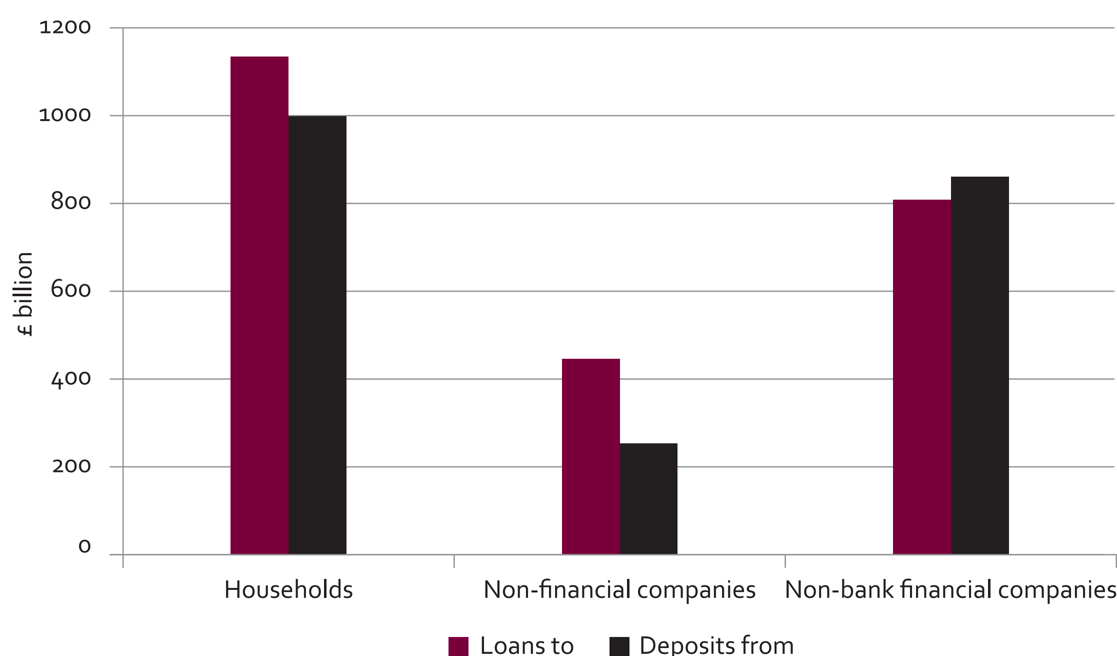


Source: Company accounts, Commission estimates.

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

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

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



Source: Bank of England, Commission estimates.

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

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

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

Should credit provision to individuals and SMEs be prohibited?

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

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

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

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

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

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

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

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

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

- services which are not integral to the direct intermediation of funds or the provision of payments services should not be provided by ring-fenced banks since they introduce unnecessary risk and complicate the resolution of a failed bank, increasing the likelihood that the bank would be bailed out; and
- in order to minimise the costs of structural reform proposals, it is important not to constrain, without any flexibility, both sides of a bank's balance sheet. Doing so could create an inefficient mismatch between assets and liabilities.

Should wholesale and investment banking activities be prohibited?

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

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

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

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

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

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

Should accepting deposits from large companies be prohibited?

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

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

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

- arguably, if large organisations were *prevented* from depositing with ring-fenced banks there would be strong political pressure at times of stress to ensure continuity of service provision for other types of bank;[28]

- allowing some non-retail deposit funding into the ring-fenced bank would, in combination with the Commission's proposals for depositor preference and bail-in, improve the resolvability of the ring-fenced bank as these liabilities increase loss-absorbing capacity; and

- some diversity of funding base may be positive for the stability of the ring-fenced bank.

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

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

28 Indeed, it could be argued that there would be political pressure to provide continuity of service for large corporate deposits in any case and this could lead to bail-outs of non-ring-fenced banks. However, large corporate depositors can and should ensure that their banking arrangements are secure. This is an important source of market discipline and ring-fencing should make it politically easier to ensure such discipline is imposed in future.
29 See Page 7, CBI, 2011, *CBI Response to the Independent Commission on Banking Interim Report.* Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Confederation-of-British-Industry.pdf.
30 This risk was highlighted in RBS, 2011, *Response to Interim Report.* Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/RBS_response_ICB_Interim_Report_public_final_v2.pdf.

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

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

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

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

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

Should lending to large companies be prohibited?

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

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

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

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

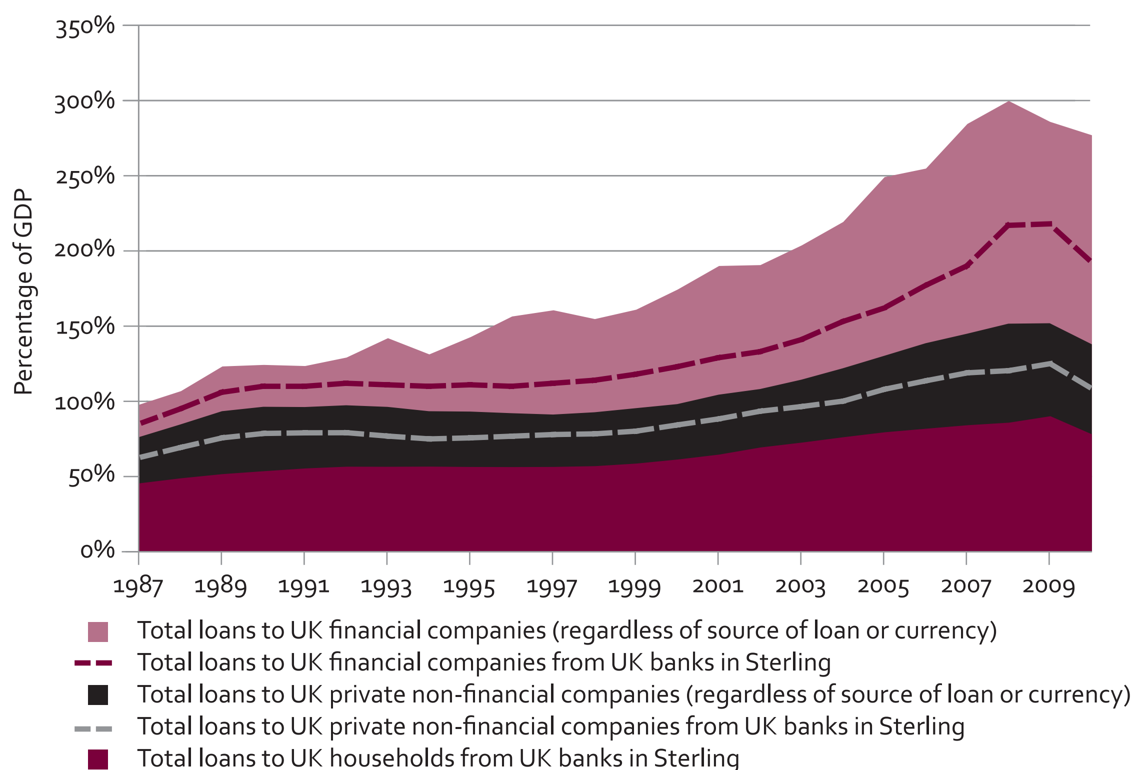
34 Page 1, J.P. Morgan, 2011, *UK Bank Ring-Fencing Proposals Survey*.
35 This was highlighted by the Association of Corporate Treasurers (ACT) in their response to the *Interim Report*. “We see the mobilisation of individual deposits to provide loans to businesses of all sizes as a key social benefit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

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

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

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

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



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

Design details and definitions

3.39 Thus, the second ring-fence principle is:

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

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

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

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

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

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

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

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

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

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

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

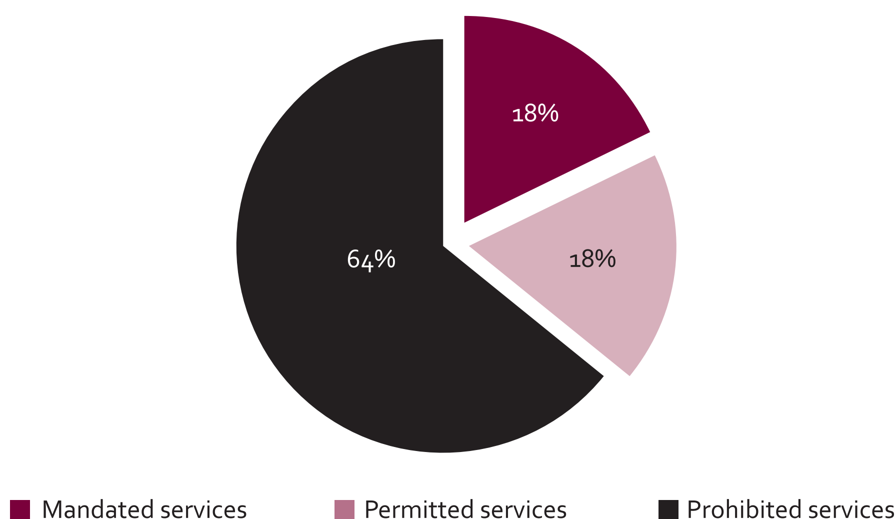
e) the purchase or origination of derivatives or other contracts which would result in a requirement to hold regulatory capital against counterparty credit risk; and

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

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

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

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[2] LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Lloyds.pdf.

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

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

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

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

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

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

Box 3.3: Existing definitions of financial institutions

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

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

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

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

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

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

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

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

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

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

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

Principle 3: Ancillary activities

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

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

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

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

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

Box 3.4: Risk management functions in other sectors

Building societies

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

Insurance companies

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

Utilities

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

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

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

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

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

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

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

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51 A bank can simply, for example, invest in high quality liquid assets.

52 One appropriate such safeguard would be a limit on gross secured exposures in line with that proposed later for intra-group limits (see Paragraph 3.87).

53 The taking of wholesale deposits is not strictly part of a bank's treasury function, but it is a form of wholesale funding which is considered in general terms here.

54 As discussed later it would be important that liquidity regulations applied on a 'solo basis'. In other words, ring-fenced banks should be required to comply with them as standalone entities. Application only to a whole banking group (or some subset of the group containing entities other than ring-fenced banks) would undermine the objectives of the ring-fence.

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

3.57 Thus, the third ring-fence principle is:

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

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

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

Height of the ring-fence

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

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

Why not full separation?

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

3.60 Two key arguments are made for full separation.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Principle 4: Legal and operational links

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

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

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

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

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

3.74 Thus, the fourth ring-fence principle is:

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

As a result:

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

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

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

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

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

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

64 Moodys, 2011, *UK Treasury Support for Ring-fencing Proposals is Credit Negative for Banks*. Available at: http://www.moodys.com/research/Moodys-UK-Treasury-support-for-ring-fencing-proposals-is-credit?lang=en&cy=global&docid=PR_220985.

65 For example, the ring-fenced bank could directly own all the relevant infrastructure, or the infrastructure could be placed in a subsidiary which was bankruptcy-remote from the rest of the group.

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

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

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

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

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

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

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

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

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

Principle 5: Economic links

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

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

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

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

Box 3.5: US regulation of transactions within banking groups

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

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

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

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

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

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

69 See Box 3.5 for details of US legislation on intra-group transactions.
70 Note that the restrictions outlined in Paragraph 3.39 on providing *services* to financial companies are not intended to prevent ring-fenced banks from being exposed to other banks or financial companies within the same group. Rather, the relevant constraint on intra-group exposures is by way of third-party limits.

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

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

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

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

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

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

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

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

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

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

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

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

i. one is the Chair; and

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

79 'Common control' means control as defined for the purpose of a 'holding company' under the Companies Act 1985.
80 It was such an involuntary obligation that forced the charitable Wedgwood Museum Trust into administration following the failure of the broader Wedgwood group (see: http://www.museumsassociation.org/museums-journal/news/26042010-wedgwood-museum-trust-in-administration).
81 House of Commons Treasury Committee, 2011, *Independent Commission on Banking, Nineteenth Report of the Session 2010-12*. Available at: http://www.parliament.uk/documents/commons-committees/treasury/CRC%20HC%201069%20-%20Nineteenth%20Report%20-%20ICB.pdf.

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

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

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

82 See Byatt, I., 2005, Managing water for the future: the case of England and Wales, in Trottier, J. and Slack, P. eds., *Managing Water Resources Past and Present*, Oxford: OUP.

83 The approved persons regime applies to individuals holding certain functions in most businesses regulated by the FSA. The regime aims to ensure that only individuals who are fit and proper can carry out specified functions in banks and imposes personal obligations on them in relation to the business' compliance with regulatory requirements. For more information, see: http://www.fsa.gov.uk/Pages/Doing/Regulated/Approved/persons/index.shtml.

84 I.e. in technical terms those requirements arising under Pillar 2 or from regulatory stress tests.

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

The structure of banking groups

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

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

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

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

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

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

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

Chapter 4: Loss-absorbency

Introduction

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

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

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

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

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

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

- Should banks have much more equity? – this section considers whether the best response is to require banks to have much more equity.
- Loss-absorbing debt – this section looks at how the loss-absorbency of debt can be increased (including by making other debt bear losses ahead of ordinary deposits).
- How much loss-absorbing capacity do banks need? – this section addresses the question of how much loss-absorbing capacity banks should be required to have.
- Recommendations – this section sets out the Commission's recommendations for improving banks' loss-absorbing capacity.

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

Overview

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

Bank funding

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

Leverage

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

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

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

Bank A		Bank B	
Deposits 70 / Bonds 20 / Equity 10	Bank A has 100 assets, funded by 70 deposits, 20 bonds and 10 equity.	Deposits 70 / Bonds 25 / Equity 5	Bank B has 100 assets, funded by 70 deposits, 25 bonds and 5 equity.
	Leverage is 100/10 = 10		Leverage is 100/5 = 20
	If the value of the assets rises to 101, the equity gains 1 in value.		If the value of the assets rises to 101, the equity gains 1 in value.
	Return on equity: 1/10 =10%		Return on equity: 1/5 =20%

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

Implicit government support

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

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

Differential tax treatment of debt and equity

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

Shareholder reluctance to issue more equity

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

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

Loss-absorbing debt

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

Resolution

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

1 This is the 'debt overhang' problem.

Recovery

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

Capital requirements

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

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

Asset risk weights

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

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

Box 4.2: Basel III capital requirements

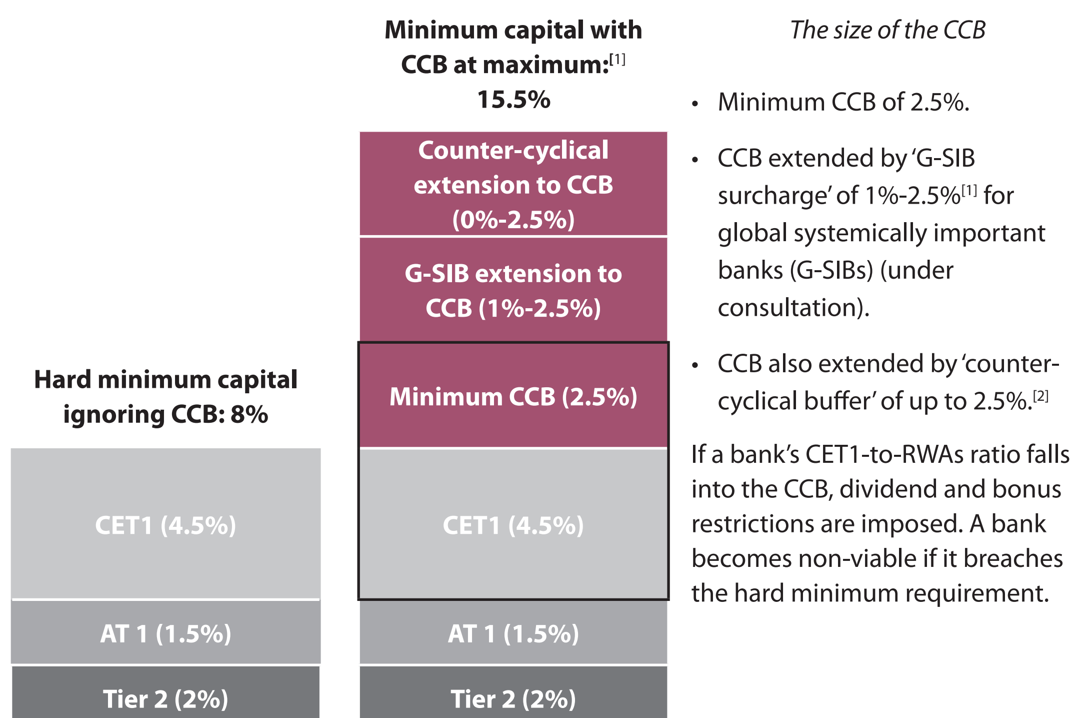
This box summarises the Basel III rules on capital. Banks have until 2019 to meet fully these new rules. The rules define three types of capital, described in Table 4.1.

Table 4.1: Three types of capital under Basel III

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

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

Figure 4.1: Capital requirements



The size of the CCB

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

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

Box 4.2: Basel III capital requirements (continued)

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

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

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

Liquidity requirements

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

Building societies

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

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

From basic principles to practical recommendations

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

Should banks have much more equity?

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

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

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

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

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

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

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

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

State	Equity level	Description
Operating freely	Equity level above hard minimum and CCB	With equity above both the hard minimum level and the CCB, the bank operates freely. Losses fall on **equity**.
In recovery	Equity level above hard minimum, but in CCB	If the bank falls into the CCB, some restrictions will be imposed on discretionary distributions such as dividends and bonuses, but the bank can otherwise operate normally. The bank is in 'recovery'. Losses fall on **equity**. If the bank has any **contingent capital**, this may also suffer losses (through write-down or conversion).
In resolution	Equity level below hard minimum level	If a bank is put into resolution, losses fall first on **equity**; after the equity is wiped out further losses fall on **loss-absorbing debt** including non-equity capital. The resolution authorities may write down or convert loss-absorbing debt sufficiently to 'create' new equity,[2] so the bank is re-capitalised. They will also have other options (which will include putting the bank into an insolvency process).
In insolvency	Equity level below zero	

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

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

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

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

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

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

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

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

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

Box 4.4: A worked example of higher equity requirements

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Recommendation on minimum equity requirements

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

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

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

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

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

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

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

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

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

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

Table 4.2: Illustrative calibration of the ring-fence buffer

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

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

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

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

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

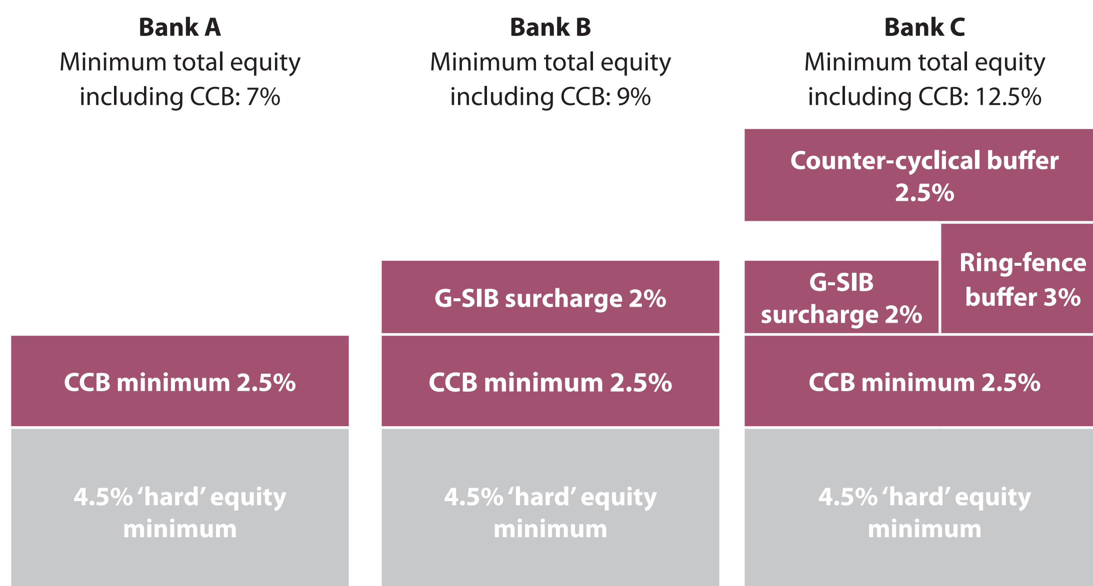
4.47 The Commission recommends that the ring-fence buffer should also extend the CCB. The rationale for the ring-fence buffer overlaps to some extent with the rationale for the G-SIB surcharge, i.e. requiring larger banks to have more equity to reflect the greater social costs of their failure. So the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

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

Box 4.5: Determining the size of the capital conservation buffer

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

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



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

4.48 For banks' CCBs to provide effective pre-resolution loss-absorbing capacity which can be used without immediately raising concerns about a bank's viability, it is important that the market does not regard them as simply extending the hard minimum equity requirement. The authorities should make it clear that they do not consider the CCB as

doing so, and give due regard to this when conducting stress-testing. If market perception will drive a bank to do all it can to avoid dipping into the buffer, it is likely to reduce lending to do so, if necessary. If a significant part of the banking system is similarly affected and responds in the same way at the same time, a system-wide contraction in the supply of credit could result – even with the banking system well-capitalised. Hence the importance of communication from the authorities on this point.

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

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

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

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

Box 4.6: International benefit of UK financial stability

The IMF recently observed that "the stability and efficiency of the UK financial sector is a global public good, requiring the highest quality supervision and regulation".[1] In making its recommendations for financial stability, the Commission has paid close attention to the international context and believes that, in going beyond the Basel III minimum standard, its proposals will benefit other economies as well as the UK's, especially elsewhere in Europe.

Making banks safer in one country is good for others. Problems are less likely to arise in – or be transmitted or even amplified by – banking systems that are better capitalised. Hence the imperative for the international community to establish clear minimum standards, below which countries agree not to go. (Such minimum standards, if applied rigorously, also guard against lobbying by domestic vested interests seeking looser regulation.)

The BCBS's proposals for additional capital requirements on G-SIBs are accordingly based on such banks' potential to create "cross-border negative externalities".[2] The BCBS emphasises that its proposed requirements represent a minimum level, and that if national jurisdictions wish to impose higher requirements for their banks, they are free to do so.

The EC, in its draft legislative proposal for CRD IV, takes a different approach – 'maximum harmonisation'.[3] While the draft appears to allow some degree of flexibility in practice, one of its principles is that EU countries may not go beyond the common minimum standard and make their banks safer.

In the context of capital standards for banks, maximum harmonisation lacks economic logic. In stopping countries making their banks safer than under the minimum standard, it stops them from benefiting other EU member states and Europe as a whole. The financial stability problem to be addressed, like pollution control, is one of *negative* cross-border externalities. It would be a strange environmental policy that required countries not to control pollution more than some centrally set amount.

There are perfectly good reasons why some EU member states wish to go beyond international minimum capital standards. Their banking systems, including exposures to global financial markets, are by no means the same. Moreover, national taxpayers bear the fiscal consequences if banks fail with inadequate loss-absorbing capacity (and will continue to do so indirectly even if suggestions to shift this burden onto a European bail-out fund gain any traction).

For all these reasons, maximum harmonisation is not the right approach to capital standards for banks. Rather, the international community should focus on robust capital standards for banks, especially for those with systemic importance, and national jurisdictions wishing to go further should indeed be free to do so.

[1] IMF, 2011, *United Kingdom Spillover Report for the 2011 Article IV Consultation and Supplementary Information*. Available at: http://www.imf.org/external/pubs/ft/scr/2011/cr11225.pdf.

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

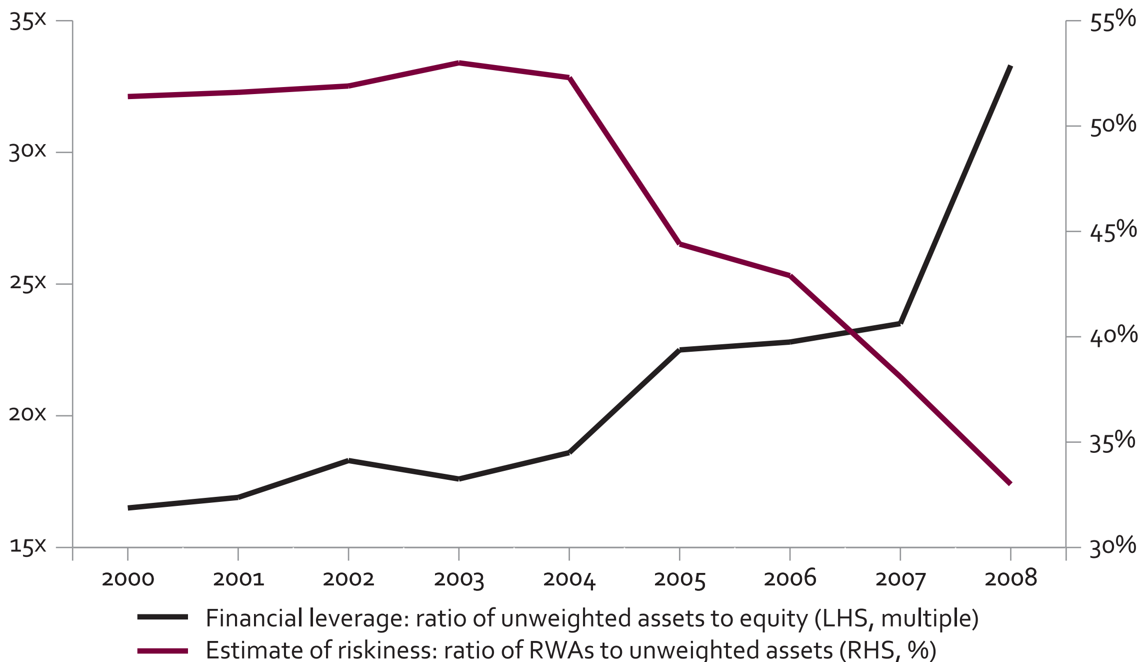
[3] EC, 2011, *Proposal for a Regulation of the European Parliament and of the Council on Prudential Requirements for Credit Institutions and Investment Firm*: Available at: http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm.

Leverage ratio

4.52 So far, the discussions in this chapter on the appropriate minimum level of equity funding for banks have focused on calibrating equity against RWAs. Compared to simple asset measures, risk weights contain information (albeit imperfect) about the riskiness of assets. Basing capital requirements on RWAs rather than unweighted assets therefore provides better incentives with regard to risk-taking. For this reason, RWAs should remain as the primary determinant of loss-absorbing capacity.

4.53 As explained in the *Interim Report*, however, the use of RWAs in this way incentivises banks to manipulate the risk-weighting of assets in order to minimise capital requirements. This is especially problematic as internal ratings-based models that sophisticated banks typically use to determine risk weights require the exercise of a considerable degree of judgement. Whether for this or other reasons, recent history shows that relying on risk weights alone for determining how much capital should be held against assets has led to banks not holding enough. In the run-up to the crisis, while the aggregate financial leverage of the four largest UK-headquartered banks was increasing, the riskiness of their assets, as measured by risk weights, was falling (see Figure 4.3). Subsequent events have shown that those lower risk weights underestimated the true riskiness of important asset classes.

Figure 4.3: Ratio of risk-weighted assets to unweighted assets falls as financial leverage increases (aggregated for the four largest UK-headquartered banks)[29]



Source: Company accounts of Barclays, HSBC, LBG and RBS; Commission analysis.

29 Note also that the change in accounting standards from UK Generally Accepted Accounting Practices to International Financial Reporting Standards in 2005 and the introduction of Basel II – which had the effect of reducing asset risk weights in many cases – are both likely to have had an impact here.

4.54 This suggests that loss-absorbing capacity should not be calibrated solely with reference to risk-weighted assets. A number of respondents to the *Interim Report* made this point, supporting the use of minimum leverage ratios of loss-absorbing capacity to unweighted assets.[30] And the Basel III rules include a proposal for the ratio of Tier 1 capital to total assets to be monitored against a benchmark of 3%, with a view to a binding minimum leverage ratio being put in place from 2018.

4.55 Such ratios act as a complement to, not a substitute for, capital requirements based on RWAs. While relying solely on RWAs means that if risk weights are set too low, too little capital is held against a bank's assets, relying solely on a leverage ratio requires banks to hold no more capital against more risky assets than against less risky ones, incentivising them to take more risk. Imposing capital requirements based on RWAs together with a minimum leverage ratio requires more capital to be held against riskier assets, with the safeguard of a leverage ratio to prevent risk weights falling too low.

4.56 On the basis of the arguments laid out above, the Commission supports the use of leverage ratios as a backstop, and recommends that all UK-headquartered banks should be required to operate with a minimum Tier 1 leverage ratio of at least 3% (and would favour international agreement on a higher ratio). Further, all ring-fenced banks should meet this requirement on a solo basis.[31]

4.57 In Paragraph 4.39 the Commission recommended that the 7% Basel III baseline for the ratio of equity to RWAs be increased to 10% for large ring-fenced banks. This would also increase the Basel III baseline for the ratio of Tier 1 capital to RWAs from 8.5% to 11.5%.[32] In order that the leverage ratio provides an equally robust backstop for large ring-fenced banks it should be increased proportionately from 3% to (11.5/8.5) x 3% = 4.06%. As discussed in Paragraph 4.43, an abrupt change in regulatory requirements when a bank crosses a size threshold should be avoided by increasing the minimum leverage ratio from 3% to 4.06% on a sliding scale as the RWAs-to-UK GDP ratio increases from 1% to 3%.

4.58 The Commission's view is that international regulations should supplement the G-SIB surcharge with a gradated version of the minimum leverage ratio, to avoid the perverse outcome of systemically important banks being able to operate at the limit with a lower average risk weight than other banks. But consistent with the Commission's view that capital requirements applying to the wholesale/investment banking activities of UK banks need not exceed international standards (conditional upon credible resolution plans and effective loss-absorbing debt), it is not proposed that UK G-SIBs (i.e. G-SIBs headquartered in the UK) be required to have a higher minimum leverage ratio than that agreed internationally, other than for their ring-fenced banks.

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30 See, for example, Barclays, 2011, *Barclays Response to Interim Report*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Barclays.pdf.

31 All ring-fenced banks within a banking group could meet this requirement on a sub-consolidated basis (see Paragraph 4.45 for more detail on this).

32 Including the CCB.

4.59 Absent arbitrage risks, as with risk-weighted equity requirements, the Commission would be minded to require higher minimum leverage ratios both for ring-fenced banks and non-ring-fenced banks.

Loss-absorbing debt

4.60 As set out in the 'Overview' section of this chapter and in line with the *Interim Report*, bank debt needs to be made effectively loss-absorbing. Exposing bank liabilities to loss would sharpen market discipline, curtailing incentives for excessive risk-taking, and the greater the capacity of bank liabilities to absorb loss in resolution, the more remote is the need for taxpayer support.

4.61 A major problem in the recent crisis was that many bank liabilities could only be exposed to loss in insolvency – and governments were not prepared to allow systemically important banks to go into insolvency.

Bail-in

4.62 If bank debt is to be made loss-absorbing, a mechanism is therefore needed to impose losses on failure without requiring banks to go into insolvency. Whether, and how, this should be done is a topic of ongoing debate in international forums. Earlier this year the EC completed a consultation on a proposed framework for bank recovery and resolution[33] that included a consideration of the imposition of losses on bank creditors in resolution but short of insolvency – so-called 'bail-in'. A draft legislative proposal is expected shortly. In addition, the Financial Stability Board (FSB) published a consultation document[34] on resolution in July 2011 which called for authorities to put bail-in powers in place within their resolution regimes.[35] The Financial Services Authority (FSA) has also recently published a consultation paper[36] which included a discussion on bail-in.

4.63 As recognised in these consultations, in addition to the difficulty of putting systemically important banks into insolvency, there are further constraints to imposing losses on certain types of liability. A number of issues are as follows.

- Imposing losses on secured debt[37] would fundamentally undermine the concept of taking security under English law.[38]

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33 EC, 2011, *Technical Details of a Possible EU framework for Bank Recovery and Resolution*. Available at: http://ec.europa.eu/internal_market/consultations/2011/crisis_management_en.htm.
34 FSB, 2011, *Effective Resolution of Systemically Important Financial Institutions*. Available at: http://www.financialstabilityboard.org/publications/r_110719.pdf.
35 Note that a number of jurisdictions – including the UK (discussed in Paragraph 4.75 below), US, Germany and Denmark – already have some powers in place that allow the authorities to impose losses on the creditors of a failed bank.
36 FSA, 2011, *CP11/16: Recovery and Resolution Plans*. Available at: http://www.fsa.gov.uk/pubs/cp/cp11_16.pdf.
37 Including liabilities that are collateralised under derivatives or repurchase agreements.
38 Imposing losses on any excess over the value of the assets against which security is taken would be less problematic.

- Most ordinary deposits are insured by the Financial Services Compensation Scheme (FSCS),[39] so losses imposed on them would largely fall to the FSCS. The FSCS is funded by other banks, but effectively operates with a taxpayer-funded backstop – so losses either act as a channel for contagion from a failed bank to other banks, or are picked up by the taxpayer.

- Imposing losses on derivatives counterparties would prompt them to close out their contracts (where this is permitted under the terms of their contracts). This process is likely to exacerbate losses for the shareholders and other creditors of the failing bank. More damaging could be the disruption to financial markets, including as a result of indirect losses to other market participants resulting from a fire sale of collateral and consequential adverse market and confidence effects. There may also be systemic risks involved in imposing losses on 'central counterparties',[40] or in other circumstances where market participants rely on the use of collateral and 'close-out netting' to control their mutual exposures.

- Similarly, imposing losses on short-term unsecured debt and uninsured deposits may – depending on the extent to which such liabilities are regarded as loss-bearing *ex ante* – cause significant disruption to funding markets, and act as a channel for contagion from a failing bank to other, previously healthy financial institutions.

- Imposing losses on long-term unsecured debt is more straightforward. (Indeed 'Tier 2 capital' mandated by the Basel III rules takes this form – see Box 4.2.)

4.64 The *Interim Report* included an analysis of various options for improving the loss-absorbency of debt through the use of both contingent capital and bail-in, and described how they could work to improve a bank's ability to absorb loss.

4.65 Contingent capital is debt that is designed to convert into equity (contingent convertible capital instruments, or 'cocos') or be written down on some trigger – for example, a bank's equity-to-RWAs ratio falling below a certain level – while a bank is still viable. This recapitalises a bank under stress, with the aim of leaving it able to continue to function as a healthy, going concern.

4.66 Bail-inable debt acts in a similar way to contingent capital, by recapitalising a bank through the conversion of debt into equity or through debt write-down. However, unlike with contingent capital, this occurs when a bank is put into resolution, and so would require intervention by the regulator. While its effect may be to allow some of

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39 The FSCS currently insures the first £85,000 of any eligible person's (individuals and some small firms) deposit at any insured firm. This provides at least two significant social benefits. First, depositors are much less likely to 'run' from a bank at the first sign of stress. Further, because deposits are low risk, they can be used as a means of settlement.

40 Where two parties transact through a central counterparty (CCP), the CCP enters into a contract with each, either to avoid the parties having to contract directly with each other, or to replace an initial contract made between them. This allows parties to enter into the contract on the agreed terms but without having to take credit risk on each other.

a bank's operations to continue as a going concern, it may simply facilitate a solvent wind-down in resolution.

4.67 Responses to the *Interim Report* revealed a broad range of opinion on these topics. Some respondents – including several banks[41] – saw bail-in as a potentially valuable resolution tool, citing the fact that increasing the loss-absorbency of debt would reduce the need for bail-outs. But concern was expressed that failure to achieve absolute clarity about how a bail-in regime would work could lead to mis-pricing of risk in the market. There was disagreement about the range of liabilities to which any bail-in regime should apply – arguments cited included some of the points raised in Paragraph 4.63 above – but widespread agreement that bail-in should only occur at the point of non-viability,[42] not before.

4.68 Other respondents[43] expressed concerns that widespread use of bail-in would have a negative impact on the market for bank debt.

4.69 On contingent capital, a number of respondents also thought that there would not be sufficient demand for such instruments. There was additional concern about its complexity – in particular, the design of the 'trigger' for putting losses on the holders and the potential for de-stabilising 'death spirals'.[44] Some respondents, however, were supportive of contingent capital. Some of the banks thought that these instruments might have a role to play in restoring capital adequacy under stress, as a form of pre-resolution loss-absorbing capacity. Among those in favour of contingent capital, there was agreement that if the Commission were to make recommendations in this area, it should not seek to be prescriptive on design; such details should be left to the market.

4.70 Another widely-expressed concern on both bail-in and contingent capital was that when dealing with systemically important banks in a financial crisis, in practice the resolution authorities would not be able to use these instruments to absorb losses as intended. This might be because the holders of the instruments would themselves be systemically important, so that imposing losses on them would simply mean that they would have to be bailed out, instead of (or maybe even as well as) the banks. Or it might be that requiring bank investors to take losses would disrupt wholesale funding markets – including by triggering a 'run' on uninsured deposits – at a time of systemic fragility, risking contagion to other financial institutions.

41 See, for example, RBS, 2011, *Response to Interim Report*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/RBS_response_ICB_Interim_Report_public_final_v2.pdf.
42 I.e. the point at which the bank is no longer viable without intervention by the authorities, and so is put into resolution.
43 See, for example, F&C Investments, 2011, *Response by F&C Investments*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/FC-Investments.pdf.
44 The market response to the fact that a bank was nearing the trigger point could have a negative impact on the bank, hastening its deterioration, increasing the likelihood of the trigger being activated and actually undermining financial stability – hence 'death spiral'. The nature of any such dynamic effects would be heavily influenced by the design of both the trigger and the way in which losses were distributed between existing shareholders and holders of the contingent capital should the trigger be activated.

4.71 As is clear from the above, a theme running through several of the responses was a concern that the use of bail-in and (in particular) contingent capital would risk increasing complexity and uncertainty, with adverse consequences.

4.72 On contingent capital, the Commission does not rule out the prospect of such instruments usefully augmenting a bank's loss-absorbing capacity. In the absence of clear evidence and any general consensus on how they would be designed and what their impact would be, however, the Commission makes no recommendations on their mandatory use.

4.73 On bail-in, however, the Commission takes a different view. Some of the significant complications associated with contingent capital instruments are less of an issue with bail-in. There is likely to be less of a concern about possible death spirals. By the time a bank is near the bail-in trigger – i.e. the point of non-viability – it will be well on the way to failure, and the authorities already have the power to put a failing bank into resolution. Further, contingent capital has the ambitious aim of bolstering the position of a struggling bank, enabling it to continue as a viable, going concern. The more modest purpose of bail-in is to be used – quite possibly as one of a suite of tools – in the orderly resolution of a failed bank. A well-designed bail-in tool could provide clarity on where losses would fall (and how a bank might be re-capitalised) in resolution. Most persuasively, if the social cost of a systemically important bank going into insolvency is intolerable, there needs to be some mechanism for imposing losses on liabilities in resolution (otherwise they benefit from a government guarantee). This by definition is what bail-in provides.

4.74 How should a bail-in tool be designed? Bearing in mind the difficulties with making certain liabilities absorb losses (as discussed in Paragraph 4.63), the key question is how to strike the right balance between providing an appropriate level of certainty to the market about how such a tool would be used, and allowing an appropriate level of flexibility to the resolution authorities.

4.75 The UK's existing Special Resolution Regime[45] (SRR) for dealing with failing banks may result in creditors bearing losses in resolution, for example through the use of the partial property transfer power to separate assets from liabilities, but the SRR powers are not specifically designed to allow the resolution authorities to impose losses on creditors. This gives rise to a number of difficulties. In particular, the resolution authorities do not have a flexible means of imposing losses on creditors in all resolution scenarios, and the SRR does not provide *ex ante* information to the market as to how losses will in fact be distributed. This may make it less likely that bank debt will be regarded as credibly loss-absorbing, which may in turn make it more difficult for the authorities to make creditors bear loss in resolution.

45 The Banking Act 2009 created a 'Special Resolution Regime' which gives the UK authorities a number of resolution tools for dealing with distressed banks and building societies.

4.76 Accordingly, the Commission recommends that the SRR should be supported by giving the resolution authorities *two* complementary bail-in powers available for use in resolution.

4.77 First, the authorities should have a 'primary bail-in power' to impose losses in resolution on a set of pre-determined liabilities that are the most readily loss-absorbing. This should include the ability to be able to write down liabilities to re-capitalise a bank (or part thereof) in resolution.[46] As described in Paragraph 4.63, the class of (non-capital) liabilities that bears loss most readily is long-term unsecured debt. The Commission's view is therefore that all unsecured debt with a term of at least 12 months *at the time of issue* – 'bail-in bonds'[47] – should be subject to the primary bail-in power. Bail-in bonds should have specific risk disclosure acknowledging this. To the extent possible, the contractual provisions of any foreign law governed bail-in bonds should expressly make such debt subject to the primary bail-in power.

4.78 It is useful at this stage to introduce the concept of 'primary loss-absorbing capacity', being 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-absorbing capacity,[48] those bail-in bonds with a *remaining*[49] term of at least 12 months.[50]

4.79 Second, the authorities should have a 'secondary bail-in power' that would allow them to impose losses on all unsecured[51] liabilities beyond primary loss-absorbing capacity (again, including the ability to write down liabilities to re-capitalise a bank) in resolution, if such loss-absorbing capacity does not prove sufficient.

4.80 These bail-in powers should add to the other resolution powers that the authorities have at their disposal. Note in particular that any re-capitalisation of a bank through bail-in would most likely be one aspect of the resolution of a failed bank that may also involve the use of other resolution powers, such as property transfers. Bail-in should not simply be regarded as a tool to be used in isolation to re-capitalise a failed bank without further remedial action.

4.81 These powers should be designed in order to minimise both any disparity in the treatment of equally-ranked creditors and any adverse market impact, while still

46 For building societies, unless a form of fully loss-absorbing capital instrument that can be issued to external investors is developed, using bail-in for re-capitalisation is unlikely to be an option.
47 So Tier 2 capital instruments and contingent capital instruments are both likely to be bail-in bonds.
48 Because they need to be re-paid in the short-term, at which point their value as loss-absorbing capacity disappears.
49 Any unsecured debt with a term of at least 12 months *on issue* is a bail-in bond, and remains subject to primary bail-in until it matures. However, a bail-in bond only counts as primary loss-absorbing capacity at any time if it has at least 12 months' term *remaining*.
50 *Excluding* any instruments where there is any doubt about whether they are bound by the primary bail-in power, e.g. foreign law governed debt where it is not clear that the debt is subject to the bail-in power.
51 Liabilities secured with a floating charge only should also be subject to the secondary bail-in power.

providing the resolution authorities with sufficient flexibility. Appropriate safeguards should be put in place to achieve this objective. In particular, the creditor hierarchy should be respected, subject to the effective subordination in resolution[52] of bail-in bonds to other (non-capital) liabilities as a result of the primary bail-in power. In order to achieve this, the resolution authorities should also have the power to wipe out (or massively dilute) bank capital in resolution, if necessary.

4.82 As described above, some respondents to the *Interim Report* thought the authorities would not, in practice, be able to bail in creditors of a systemically important bank in a systemic crisis. Yet shareholders (and holders of some other capital instruments) in financial institutions took significant losses in the recent crisis, and holders of bonds issued by non-financial companies do not expect to be bailed out if they suffer losses. In these cases it is well-understood that investors are buying risk-bearing instruments, for which they are getting a return. There is no reason why investors in bank debt should not also be exposed to loss.

4.83 The Commission's view is not only that this is the correct approach, but also that investors[53] and rating agencies are increasingly regarding bank debt as risk-bearing. Specifically identifying in advance a set of liabilities – bail-in bonds – that would take losses in resolution before other non-capital liabilities, reinforces the point that such liabilities are truly risk-bearing. Credibly establishing *ex ante* the risk-bearing nature of bank debt would make it easier for authorities to put a bank into resolution and ensure creditors bear losses should the need arise.

4.84 Applying a bail-in power to liabilities other than bail-in bonds is more complex. In particular, there may be legal difficulties in applying it to foreign law governed contracts and financial contracts with close-out netting rights protected by the Financial Collateral Arrangements Directive.[54] Neither the entering of a bank into resolution, nor actions taken by the resolution authorities in exercising their resolution powers, should be triggers for the activation of termination or cross-default contractual provisions. Achieving this would be likely to require amendments to standard form financial contracts, and to the Financial Collateral Arrangements Directive. Measures to address these issues would clearly have to be co-ordinated internationally.

4.85 For as long as complexities such as those discussed in Paragraph 4.63 remain, there may be justification for further separating out the order in which non-capital liabilities can be required to absorb losses in resolution, beyond the primary/secondary bail-in distinction recommended above. One specific area in which the Commission

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52 To minimise differences between the creditor hierarchy in resolution and the creditor hierarchy in insolvency, it may also be appropriate to make bail-in bonds subordinate to other non-capital unsecured liabilities in insolvency.

53 As suggested by, for example, Investment Management Association, 2011, *Investment Management Association Response to Interim Report*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Investment-Management-Association.pdf.

54 *Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on Financial Collateral Arrangements.* Available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2002:168:0043:0043:EN:PDF.

recommends action is depositor preference. This is discussed from Paragraph 4.88 onwards.

4.86 The bail-in powers recommended here apply in resolution, but the SRR only specifies a mechanism for *deposit-taking institutions* to be put into resolution.[55] Not all entities within a banking group will necessarily be deposit-takers. Yet it is quite possible that such entities may conduct significant amounts of financial services activity – in particular, trading activities – the disorderly insolvency of which would come at a high social cost.[56] Appropriate measures – analogous to the bail-in powers discussed above – should therefore be put in place for such entities, to address any such risk (whether through extension of the SRR to cover such entities, or otherwise). The same point applies to entities that are not in a banking group.

4.87 The Commission's recommendations on primary and secondary bail-in powers (discussed above) and depositor preference (discussed below) would each require changes to banks' creditor hierarchies. This raises the question of whether liabilities already in issue should be exempted from these measures – so-called 'grandfathering'. Bearing in mind that the resolution authorities already have powers under the SRR to impose losses on creditors (subject to certain safeguards), the complexity of treating liabilities differently with reference to when they were issued, that market participants are in any case increasingly regarding long-term unsecured debt as risk-bearing and that putting in place legislation to effect these recommendations would inevitably take some time, the Commission's view is that grandfathering existing liabilities is not necessary.

Depositor preference

4.88 Paragraph 4.63 above noted how most ordinary deposits are insured by the FSCS, so losses imposed on depositors would largely fall to the FSCS. As discussed in the *Interim Report,* to the extent that insured deposits, and so the FSCS, rank *pari passu* with other creditors, this creates two problems.

4.89 First, insured depositors are not well-placed to exert market discipline on banks, and in any case have no incentive to do so. Yet they are required to take losses (reimbursed by the FSCS) at the same rate as other senior unsecured creditors, many of whom are better able to exert such discipline by demanding higher returns if a bank pursues riskier activities. The incentives of other unsecured creditors to exert market discipline are blunted by the fact that they rank *pari passu* with deposits.

4.90 Second, should the FSCS need to make a pay-out, it can levy other deposit-taking institutions to recover any amounts it pays out. 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.

55 The parent company of a bank can also be taken into temporary public ownership.
56 Lehman Brothers provides an example: it was technically a broker-dealer, rather than a bank.

4.91 One possible solution to these problems would be for the FSCS to levy premiums calibrated for each institution on the basis of its level of riskiness and the size of its insured pool of deposits. A draft proposal from the EC for revisions to the Deposit Guarantee Scheme Directive[57] put forward in July 2010 did provide for the premiums to be risk-based, but under this proposal the mandatory amount of any pre-funding would have been severely limited, significantly undermining the disciplining effect. Even if risk-based premiums could be accurately calibrated, it is not clear that a pre-funded scheme which is ultimately state-backed would be the best solution.

4.92 'Preferring' insured deposits by moving them above other unsecured liabilities in the creditor hierarchy provides a market-based solution to these problems. Moving insured depositors up the creditor hierarchy shifts risk borne currently by the FSCS (and so other deposit-takers and potentially the taxpayer) on to market counterparties (the holders of liabilities that would become subordinated to preferred deposits) who can exert market discipline.

4.93 As described in the FSB's recent consultation paper on resolution,[58] depositor preference is already in place in a number of jurisdictions around the world, including Australia, Argentina, China, Hong Kong, Switzerland and the US, although the scope of the preference differs. For example, Hong Kong limits the preference to the insured amount, whereas preference in the US applies to all deposits that are payable in that country (and so will not cover deposits at foreign branches of US banks, unless those deposits are expressed to be payable in the US). Four general categories of depositor preference (and a discussion on the topic) are set out in the FSB paper; they are summarised in Box 4.7.

Box 4.7: Different forms of depositor preference

General depositor preference gives preference to all deposits of a deposit-taking institution, irrespective of their deposit insurance eligibility or the location where the deposits are booked or payable.

National depositor preference gives preference to deposits booked and payable within the domestic jurisdiction and does not extend to deposits booked and payable at foreign branches.

Eligible depositor preference gives preference to all deposits of depositors who meet the eligibility requirements for deposit insurance coverage (i.e. all classes of deposit covered by the scheme ignoring any limits on insurance).

Insured depositor preference covers only insured deposits. The uninsured amount of a deposit is treated as an unsecured senior creditor claim.

57 See EC, 2010, *Proposal for a Directive on Deposit Guarantee Scheme*. Available at: http://ec.europa.eu/internal_market/bank/docs/guarantee/20100712_proposal_en.pdf. The European Council and the European Parliament have subsequently developed separate texts which each propose a different level of pre-funding.
58 FSB, 2011, *Effective Resolution of Systemically Important Financial Institutions*. Available at: http://www.financialstabilityboard.org/publications/r_110719.pdf.

4.94 The *Interim Report* considered arguments for ranking insured deposits above other unsecured creditors in insolvency ('insured depositor preference' in Box 4.7). It also raised the question of whether other deposits should be preferred.

4.95 Reactions to the proposal for depositor preference have been mostly positive – although some respondents said it should cover all deposits, not just insured ones – and one bank[59] has suggested that depositor preference could increase loss-absorbing capacity.

4.96 There were some respondents[60] to the *Interim Report,* however, who were against depositor preference. One concern expressed was that it would encourage imprudence in commercial depositors, though limiting the scope of preference to insured deposits would largely mitigate this. Another concern was that it would increase the cost of bank funding; however, if this is indicative of a more appropriate and commercial distribution of risk, it is to be welcomed. Further, it is clear that some market participants take the view that *de facto* depositor preference already exists, so to some extent banks' cost of funding may already reflect it. The fact that any obligations owed by banks to their pension funds would be subordinated to insured deposits was also raised. However, this too could be regarded as a good thing to the extent it incentivises banks' pension funds to discipline risk-taking.

4.97 Preferring depositors would incentivise the holders of other liabilities to apply sharper discipline to banks, but would also be likely to encourage them to seek to protect their position by, for example, re-characterising their liabilities as deposits (so as to benefit from the preference) or taking security. The first problem is dealt with by limiting preference to insured deposits. The second remains a risk, but can be mitigated by the authorities monitoring the level of 'asset encumbrance' – i.e. restrictions on the extent to which a bank's assets would be available to meet the claims of unsecured creditors in insolvency – of banks' balance sheets. (Monitoring of asset encumbrance is an important issue in its own right, independently of the link to depositor preference raised here.)

4.98 For the reasons outlined above, the Commission recommends that insured deposits should be moved above other unsecured creditors and above floating charge holders in the creditor hierarchy.[61] The Commission's view is that (as with its other recommendations on loss-absorbing capacity) insured depositor preference should apply to building societies as well as to banks. Building societies currently have a

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59 HSBC, 2011, *Interim Report – Submission from HSBC*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/HSBC-Response-to-ICB-Interim-Report_Redacted-Version1.pdf.

60 See, for example, The Law Society, 2011, *Response by The Law Society of England and Wales* (available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Law-Society.pdf) and Santander UK, 2011, *Santander UK plc Submission to the Independent Commission on Banking* (available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Santander.pdf).

61 This preference applies in insolvency. But any imposition of losses in resolution should respect the creditor hierarchy, so that insured deposits also rank ahead of other unsecured liabilities (and those secured by a floating charge only) in resolution.

different creditor hierarchy to banks; the implications of this for depositor preference are discussed in Box 4.8.

Box 4.8: Building societies and depositor preference

Building societies are owned by their members – savers and borrowers – instead of by external shareholders. As a consequence, savers' deposits generally rank below other liabilities in the creditor hierarchy. However, the vast majority of building society deposits are – like deposits in banks – insured by the FSCS. This means that in the event a building society fails and the FSCS makes a pay-out to depositors, it would rank *below* wholesale creditors. This is lower than the *pari passu* ranking the FSCS currently has with wholesale creditors in banks, and so exacerbates the problems discussed above.

Legislation – the 'Butterfill Act' – currently allows for an order to be made to change the creditor hierarchy so that creditors and depositors would rank *pari passu* in the winding up of a building society,[1] but this has not yet been implemented.

Concerns have been raised that going beyond the Butterfill Act and moving deposits in one step from junior to other creditors to senior to them might adversely impact on the ability of building societies to raise funds other than through insured deposits. However, in its response to the *Interim Report*, Nationwide – the largest building society – said that ranking depositors above wholesale funding "is not considered likely" to affect the basis on which wholesale funds have been made available to it, or to the rating agencies grading of this funding.[2] The Building Societies Association, in its response, said that "changes to the seniority of creditors should be applied simultaneously to all institutions across the market".[3]

[1] Section 2 of the Building Societies (Funding) and Mutual Societies (Transfers) Act 2007.

[2] Nationwide, 2011, *Nationwide Building Society's response to the Independent Commission on Banking*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Nationwide.pdf.

[3] Building Societies Association, 2011, *Submission by the Building Societies Association*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Building-Societies-Association.pdf.

4.99 The Commission does not see a very clear-cut case for expanding the scope of depositor preference beyond insured deposits, although it accepts that arguments can be made either way. The principal argument for extending insurance to cover all deposits is that it would reduce the risk of a run by wholesale depositors (and retail depositors, to the extent uninsured).[62] The main argument against is that it would reduce the incentives of these depositors to exert market discipline. There is an unavoidable tension between the two.

4.100 Insured depositor preference should apply to all deposits covered by the FSCS insurance. Reforms have been proposed that would extend FSCS coverage to all

62 Although this is mitigated by having primary loss-absorbing capacity – including bail-in bonds – which is subordinated to all deposits.

non-financial corporate customers.[63] Should these reforms be implemented, FSCS coverage could then include deposits in banks that are not ring-fenced banks, although such banks are likely to have only a very small proportion of insured – and so preferred – deposits.[64]

4.101 One of the objectives of preferring insured deposits is to reduce the likelihood and size of an FSCS pay-out. HM Treasury can recover from the FSCS[65] any expenses incurred by the public purse in connection with the operation of the SRR *up to* the level of losses that the FSCS would have incurred in insolvency. Insured depositor preference would reduce the likely exposure of the FSCS in insolvency, and so reduce the extent to which resolution costs can be passed on to the FSCS, and so ultimately be recovered from the industry. If the policy objective is to ensure that resolution expenses can be recovered from the industry, additional measures would be needed to achieve this.

How much loss-absorbing capacity do banks need?

4.102 In the 'Should banks have much more equity?' section of this chapter, the Commission set out its recommendation for the minimum equity-to-RWAs ratios for ring-fenced banks, and for any wholesale/investment banking operations of UK banks. In that section the Commission also made clear that both ring-fenced banks and wholesale/investment banking operations should have loss-absorbing capacity beyond equity – i.e. loss-absorbing debt.

4.103 The 'Loss-absorbing debt' section of this chapter examined the potential for loss-absorption by different types of bank non-equity liabilities. It noted that, as set out in Box 4.2, the Basel III rules require all banks to hold capital of at least 3.5% of RWAs, on top of minimum equity requirements. Beyond capital, that section concluded that the type of liability that would serve best as loss-absorbing capacity would be long-term unsecured debt designed to bear loss in resolution ahead of other (non-capital) liabilities – bail-in bonds. That section also set out the Commission's recommendation that the resolution authorities have a primary bail-in power to ensure that bail-in bonds absorb losses before other non-capital liabilities, and a secondary bail-in power to distribute further losses among remaining unsecured liabilities.

4.104 However, the practicability of the authorities imposing losses in all resolution scenarios on all non-capital liabilities other than bail-in bonds is unclear. This section therefore investigates whether banks should have to hold a minimum amount of bail-in bonds.

63 See EC, 2010, *Proposal for a Directive on Deposit Guarantee Scheme*. Available at: http://ec.europa.eu/internal_market/bank/docs/guarantee/20100712_proposal_en.pdf.
64 The expectation is that if these reforms to FSCS coverage were implemented, the vast majority of insured deposits would be held within the ring-fence, as nearly all insured deposits would be held by individuals and SMEs.
65 Subject to the FSCS being able to fund itself by levying deposit-taking institutions.

4.105 One response to this question would be to mandate that a large proportion of non-capital bank funding should be bail-in bonds. The effect of this, however, would be to limit banks' ability to raise others types of funding which may be socially beneficial – in particular, deposits.[66] Requiring banks to issue very high volumes of bail-in bonds may increase their cost of funding for other reasons – for example, if banks are required by regulation to issue a certain volume of specific types of liability for which there is weak demand, they may have to offer more attractive pricing in order to attract investors, so pushing up their average cost of funding. As discussed above, a higher cost of bank funding may (to some extent) be passed through to borrowers.

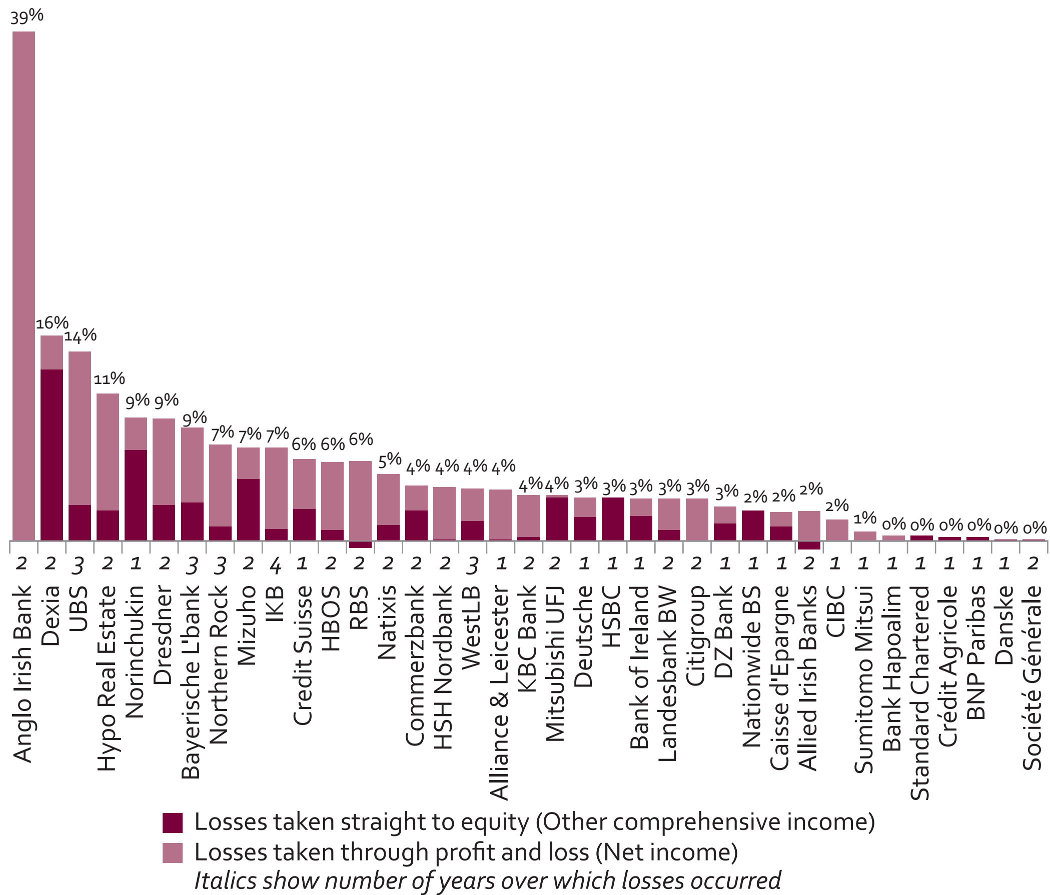
4.106 This suggests a trade-off between increasing the ability of banks to absorb losses on failure, and setting requirements for banks that may result in higher costs being passed through to borrowers or restrict the extent to which banks can issue other liabilities that are socially desirable. Calibrating this trade-off will necessarily involve a degree of judgement.

4.107 In the absence of studies on the optimal amount of broader loss-absorbing capacity (as opposed to equity) that banks should hold, the best way to inform this judgement is to consider directly the range of losses that have been suffered by banks in previous financial crises.

4.108 Figure 4.4 shows cumulative losses over the period 2007-2010 suffered by a range of loss-making banks in the recent financial crisis, measured as a percentage of RWAs at the beginning of the period. This shows that loss-absorbing capacity of 39% of RWAs would have been required to enable Anglo-Irish Bank (the bank that made the greatest cumulative loss over the period) fully to absorb the losses it suffered. Much less loss-absorbing capacity – 16% of RWAs – would have been sufficient for every other bank in the sample.

66 Some bank creditors – such as retail depositors – want bank liabilities that have a fixed value and bear very little or no risk. In particular, it is useful to have some bank liabilities that are sufficiently low risk that they can be used as a means of settlement.

Figure 4.4: Losses suffered by banks in the crisis as a percentage of RWAs (2007-2010)

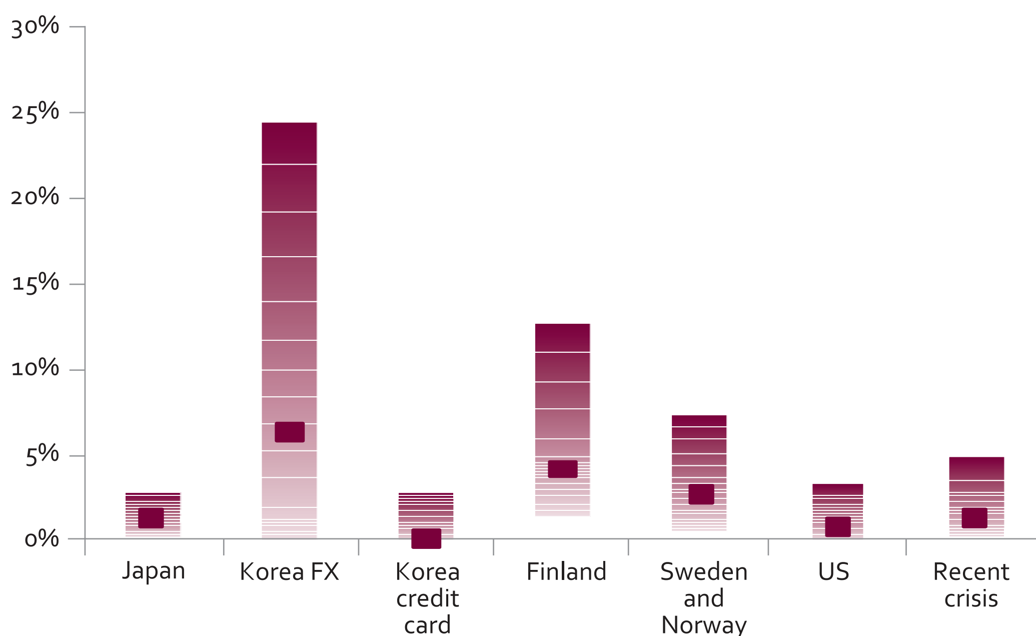


Source: Bankscope, Commission calculations.[67]

4.109 Figure 4.5 illustrates cumulative peak losses that have been suffered by banks in a number of recent financial crises. For each crisis, it shows the range of cumulative losses *excluding* the 5% of banks who made the smallest loss and the 5% of banks who made the largest loss. So 24% of RWAs of loss-absorbing capacity would have been sufficient to absorb the losses of 95% of the banks in the sample in every one of the crises. (The BCBS paper from which this graph is taken explains that the greatest cumulative loss suffered by any of the banks in the sample was 29% of RWAs – so 29% of RWAs of loss-absorbing capacity would have been required to absorb fully the biggest cumulative loss in the sample.)

67 The sample includes banks that suffered the largest gross losses in the crisis (as listed on the Bloomberg 'WDCI' page) and which also suffered losses net of earnings over at least one year during the period. The losses shown in Figure 4.4 are calculated cumulatively (over a period of up to four years) as the maximum decline in the book value of bank equity, expressed as a percentage of RWAs at the beginning of the period. They represent the sum of realised losses (which reduce 'net income') and unrealised losses (which reduce 'other comprehensive income'). 'Other comprehensive income' relates predominately to unrealised gains or losses on 'available for sale' securities. To the extent that some of the unrealised losses in Figure 4.4 may be offsetting previous unrealised gains, the impact of these losses on bank viability may appear overstated.

Figure 4.5: Range of losses suffered by banks in historical crises as a percentage of RWAs[68]



Source: BCBS.[69]

4.110 Taken together, Figures 4.4 and 4.5 indicate that loss-absorbing capacity in the range of 16% to 24% of RWAs would have been sufficient to absorb fully the losses suffered by nearly all the loss-making banks in the most recent financial crisis and in the other financial crises covered by Figure 4.5. Caution is required in using these distributions side-by-side in this way, because the data come from a large number of banks in different countries over an extended time period, and so will have been determined under different accounting and regulatory regimes. In particular, there is likely to have been considerable variation in the methodologies used to calculate risk weights. Nonetheless, other distributions support the broad picture.

4.111 It is not possible accurately to calibrate the benefit – in terms of enhanced financial stability – of requiring banks to hold primary loss-absorbing capacity in the range of 16% to 24% of RWAs. It is possible to examine the cost. If this can be shown to be very low, even a small financial stability benefit would justify imposing such a requirement.

68 Losses for a bank were calculated by defining the start of the crisis as the first year in which a bank incurred a net loss, and the end of the crisis as the last year in which a bank incurred a loss, with 'loss' being net income after tax but before distributions. For each bank in the sample, the ratio of cumulative losses to RWAs (measured in the year before the crisis) is calculated. This provides an estimate of the losses incurred by the bank during the crisis. Each shaded band shows five percentage points of the distribution across banks between the 5th and 95th percentiles. The squares show the median cumulative peak losses for each crisis.
69 BCBS, 2010, *Calibrating Minimum Regulatory Requirements and Capital Buffers: A Topdown Approach*. Available at: http://www.bis.org/publ/bcbs180.pdf.

4.112 There are at least a couple of ways of investigating the cost of imposing higher levels of primary loss-absorbing capacity.[70] First, it is likely to be the case that the (privately) cheapest way for a bank to increase its primary loss-absorbing capacity is to issue bail-in bonds to replace (some) existing funding. Making long-term unsecured debt bail-inable makes it able to bear loss on bank failure, rather than benefit from a government guarantee. One approach is therefore to say that the cost of requiring a bank to issue effectively loss-absorbing debt to replace existing funding simply comes from the removal of the implicit government guarantee.[71] This guarantee is a distortive subsidy. In the absence of a justification for it, the social benefit of removing this distortion will outweigh any social costs.

4.113 Second, it is nonetheless likely to be the case that making bail-inable debt credibly loss-absorbing and subordinated to other liabilities would make it more expensive privately for banks. It is not possible to say with certainty how much more expensive, nor indeed the extent to which bail-in may already be priced in to the cost of bank debt. But suppose that making senior unsecured debt bail-inable increases its price by 100 bps.[72] If such debt was bail-inable this would make other liabilities less risky and so make them cheaper.[73] Even ignoring this, a 100 bps increase in the price of bail-inable debt would mean that increasing primary loss-absorbing capacity by 1% of RWAs would increase a bank's average cost of funding by just 0.5 bps.[74]

4.114 Applying the Commission's recommendations on the ring-fence buffer alongside the Basel III rules implies that the biggest UK G-SIBs and large UK ring-fenced banks would be required to have a total capital-to-RWAs ratio of around 13% (ignoring any counter-cyclical capital buffer).[75] To reach the mid-point of the 16%-24% range identified in Paragraph 4.110 would therefore require a further 7% of primary loss-absorbing capacity by RWAs. The approaches set out above can be used to examine the likely social cost of this.

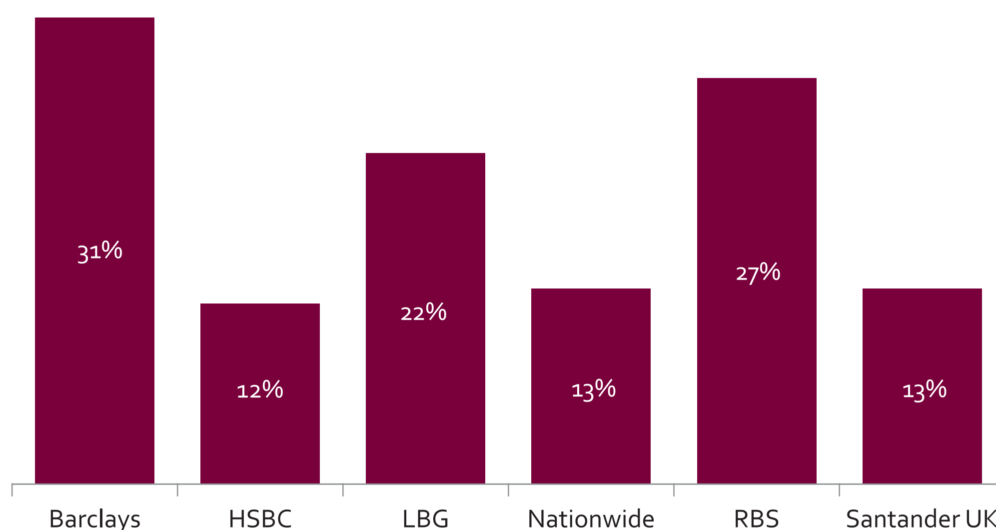
4.115 The first approach implies a zero social cost – making (more) bank funding effectively loss-absorbing simply removes a distortive subsidy. The second approach illustrates how requiring a bank to increase its primary loss-absorbing capacity by 1% of RWAs might increase the bank's average cost of funding by no more than 0.5 bps. An additional 7% of RWAs therefore implies an increase of no more than 3.5 bps in the average cost of funding, *if* this addition is achieved by making unsecured debt explicitly bail-inable. This would not have any material social cost.

70 See Chapter 5 and Annex 3 for further discussion and more detail.
71 As long as liabilities which serve some other socially useful purpose – such as retail deposits – are not displaced.
72 Annex 3 references two estimates of the likely increase in long-term wholesale funding spreads as a result of curtailing the implicit government guarantee or making senior unsecured debt bail-inable. 100 bps is the higher of the two.
73 See Paragraph 4.9 for an explanation of why requiring a bank to issue more subordinated funding can be expected to have limited impact on its *average* cost of funding.
74 Assuming an average risk weight of 50%.
75 The largest UK G-SIBs will need 9.5% of equity to RWAs under the Basel III G-SIB surcharge proposals (still under consultation) and the Commission recommends that large UK ring-fenced banks have at least 10% of equity to RWAs (see Paragraph 4.39). Both sorts of banks will need 3.5% of further capital to RWAs under Basel III.

4.116 Further, increasing the amount of primary loss-absorbing capacity a bank has would make all other non-capital liabilities (other than insured deposits) safer, and therefore cheaper. This should offset any additional cost of the further primary loss-absorbing capacity. If there is a full offset, the additional private cost would be zero (as would be the social cost).

4.117 Moreover, the six biggest UK banking groups all *already* have sufficient senior unsecured term debt in issue to make up the 7% of RWAs in this way, as illustrated in Figure 4.6. This debt can *already* be required to bear loss under the SRR. So it could be argued that introducing a primary bail-in power and requiring systemically important banks to have bail-in bonds of at least 7% of RWAs imposes no additional cost on banks at the moment. It simply provides a clearer framework for resolution authorities to use in requiring burden-sharing from creditors should a bank fail, and ensures that in the future banks maintain at least the same amount of readily bail-inable debt as they currently have.

Figure 4.6: Stock of senior unsecured term debt[76] as percentage of RWAs (2010)



Source: Barclays,[77] company accounts, Commission calculations.

Recommendations on minimum primary loss-absorbing capacity

4.118 These arguments indicate that requiring systemically important banks to hold primary loss-absorbing capacity up to 20% of RWAs would come at low social cost. However, the Commission's recommendations to improve banks' loss-absorbing capacity should not be considered in isolation. Among other reforms, implementing the retail ring-fence together with the use of recovery and resolution plans would improve bank resolvability, reduce the implicit government guarantee and so curb excessive

76 Term debt excludes trading liabilities, deposits, secured creditors and short-term (<1 year) debt.
77 See Page 37 of Barclays, 2011, *Barclays Response to Interim Report*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Barclays.pdf.

risk-taking. The implementation of the Basel III liquidity regulations by the FSA will improve banks' ability to withstand funding disruptions. Macro-prudential regulation should mitigate the extent to which banks are exposed to (and are likely to amplify) the economic cycle. It is not possible to calibrate precisely the incremental benefit to financial stability from requiring banks to hold a minimum amount of primary loss-absorbing capacity in addition to these other reforms. Accordingly, the Commission recommends that large UK ring-fenced banks and the biggest UK G-SIBs be required to hold primary loss-absorbing capacity of at least 17% of RWAs which can be increased by a further buffer of up to 3% of RWAs for a bank to the extent that its supervisor has doubts about its resolvability. This 'resolution buffer' – discussed in more detail below – would provide additional loss-absorbing capacity, and incentivise banks to improve the ease with which they could be dealt with on failure.

4.119 Primary loss-absorbing capacity of at least 17% of RWAs would have been sufficient to cover the losses of nearly all the loss-making banks in the crises referred to in Figures 4.4 and 4.5. The argument can be made that much less loss-absorbing capacity would have been required to cover the average losses of loss-making banks in crises. While this is undoubtedly true, the goal is not to enable the UK's largest banks to be resolvable without risk to the taxpayer in the face of *average* losses. Much more protection is needed than that. Furthermore, in the face of losses that do not wipe out a bank's loss-absorbing capacity, the more 'spare' loss-absorbing capacity a bank has, the more easily and safely it can be resolved. For example, with primary loss-absorbing capacity of 17% of RWAs, a bank could suffer losses of 9% of RWAs, and still have loss-absorbing capacity of 8% of RWAs – the Basel III 'hard' minimum capital requirement. Such a bank should be readily resolvable.

4.120 As discussed in Paragraph 4.43, an abrupt change in regulatory requirements when a bank crosses a size threshold should be avoided. The minimum ratio of primary loss-absorbing capacity to RWAs required of a ring-fenced bank should therefore be increased from 10.5% (the minimum amount of primary loss-absorbing capacity required under the Basel III rules)[78] to 17% on a sliding scale as the RWAs-to-UK GDP ratio increases from 1% to 3%. For G-SIBs, the increase from 10.5% to 17% should be calibrated on a sliding scale as the G-SIB surcharge increases up to 2.5%.[79] For an entity which is *both* a ring-fenced bank and in a banking group that is a G-SIB, the larger requirement should apply.

4.121 For UK G-SIBs, this recommendation should apply both to the group as a whole and to individual UK-domiciled banks[80] within that group. This means, for example, that within a UK universal banking group any ring-fenced bank and any (UK) non-ring-fenced bank would need to meet any requirement to have primary loss absorbing capacity (as set out above) separately.

78 I.e. the minimum regulatory capital requirement (including the capital conservation buffer).
79 The calibration of the G-SIB surcharge from 1%-2.5% is still under consultation. Should this change, the sliding scale described here would need to be amended accordingly.
80 All ring-fenced banks within a banking group could meet this requirement on a sub-consolidated basis (see Paragraph 4.45 for more detail on this). Subject to this, the requirement should be applied on a solo basis to UK-domiciled banks within the group.

4.122 It is important for both ring-fenced banks and non-ring-fenced banks to meet this requirement on a solo basis. Banks that are not ring-fenced may have significant trading operations, which are particularly difficult to deal with in resolution. So it is important that primary loss-absorbing capacity is located in such banks to aid with resolution. Ring-fenced banks conduct particularly important economic functions that need to be continuously provided. As discussed in Chapter 3, some respondents to the *Interim Report* have claimed that this might increase the perception that ring-fenced banks and their liabilities are likely to attract government support if in stress. This confuses the protection of a ring-fenced bank's important banking *activities* and the protection of its *creditors*. Ring-fenced banks should have primary loss-absorbing capacity to ensure that the continuous provision of important banking activities can be maintained, if necessary by imposing losses on creditors – not by guaranteeing them. This is reinforced by the ability of the authorities to use the secondary bail-in power to require liabilities other than capital and bail-in bonds – such as short-term funding and uninsured deposits – to bear losses. (Note also that using the secondary bail-in power in the resolution of ring-fenced banks may be more straightforward than in the resolution of non-ring-fenced banks, as there are likely to be far fewer liabilities that are subject to netting and close-out provisions protected by the Financial Collateral Arrangements Directive.)

4.123 A minimum primary loss-absorbing capacity requirement should be regarded as a buffer, rather than a hard minimum. (Imposing it as a hard minimum might result in a G-SIB with 16.5% of primary loss-absorbing capacity – much of which could be equity – being put into resolution. This would obviously not be desirable.) The consequences for falling below the minimum should therefore not be a breach of regulatory threshold conditions. Instead, restrictions should be imposed on a bank's ability to pay out discretionary distributions such as dividends and bonuses (as happens when a bank falls into its CCB – see Box 4.2). If a bank's ratio of primary loss-absorbing capacity to RWAs falls below the minimum, this means the bank can continue to operate[81] (although its supervisor would no doubt expect to see evidence of a management plan demonstrating how the bank would restore its level of primary loss-absorbing capacity in due course).

4.124 The Commission recommends that this requirement for minimum primary loss-absorbing capacity of 17% of RWAs apply to the biggest UK-headquartered G-SIBs and all large UK ring-fenced banks (and, on a sliding scale, some smaller banks). Unless this proposal is adopted internationally, however, the Commission does not recommend that the UK subsidiaries of non-UK-headquartered G-SIBs should need to meet this requirement (unless those subsidiaries are themselves UK ring-fenced banks). The Commission takes this view on the assumption that the UK taxpayer would not have any significant exposure to such an institution. Were this to be in doubt, the question would need to be revisited.

81 As long as the bank has not otherwise become non-viable.

Resolution buffer

4.125 As above, the Commission's view is that the biggest UK G-SIBs and large ring-fenced banks should be required to hold primary loss-absorbing capacity of at least 17% of RWAs. Much of this is likely to be in the form of capacity that absorbs losses only post-resolution – i.e. equity below the hard minimum requirement, non-equity capital and bail-in bonds.[82] The purpose of such loss-absorbing capacity is to facilitate resolution, in particular by providing a substantial buffer that takes losses before there is any risk to the public purse. However, banks will differ in their ease of resolvability, and they will not all pose the same degree of risk to the taxpayer.

4.126 Accordingly, the *Interim Report* raised the question of whether among systemically important banks, minimum loss-absorbing capacity requirements should differ. As discussed above, some respondents to the *Interim Report* said that banks did not need more loss-absorbing capacity. Among those who said banks did need more, there was support for imposing higher requirements on systemically important institutions.[83]

4.127 The indicators proposed to be used to calibrate the G-SIB surcharge are likely to be closely correlated with resolvability, and so will address this issue to some extent (although the G-SIB surcharge is primarily designed to provide additional *going-concern* loss-absorbency for G-SIBs). The BCBS consultation document on the G-SIB surcharge acknowledges, however, that supervisory judgement may have a role to play in supporting the indicator-based approach used to set the G-SIB surcharge. In particular, the point is made that "national supervisors could impose higher capital surcharges beyond the additional loss absorbency requirements for G-SIBs that do not have an effective and credible recovery and resolution plan."[84] Supervisory judgement is also likely to be useful in determining the appropriate primary loss-absorbing capacity requirements of ring-fenced banks (as described above), which would otherwise be set with reference to size only.

4.128 The Commission therefore recommends that supervisors should have a broad discretion to increase the required minimum ratio of primary loss-absorbing capacity to RWAs of a UK G-SIB, or of a bank that is required to have a ring-fence buffer, by up to 3 percentage points[85] above 17% (or applicable lower level indicated by Paragraph 4.120). This discretion should extend to determining (i) how much additional primary loss-absorbing capacity, if any, is required (up to 3% of RWAs); (ii) the form it must take; and (iii) which entities in a group the requirement should apply to, and whether on a (sub-)consolidated or solo basis. In reaching a determination, the factors that a supervisor should consider include:

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82 Although to the extent that any non-equity capital or bail-in bonds are designed as high-trigger contingent capital instruments, they should absorb loss pre-resolution.
83 See, for example, Hermes, 2011, *Response to Interim Report.* Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Hermes.pdf.
84 Footnote 16, Page 11, BCBS, 2011, *Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement.* Available at: http://www.bis.org/publ/bcbs201.pdf.
85 This does not imply that they *should* do so. Nor does it imply that they should not be able to go further than this in the exercise of any broader discretionary powers.

- the complexity of a bank's structure and activities, which could be expected to affect its amenability to effective supervision;
- the availability and likely effectiveness of available resolution tools for reducing the impact of a bank's failure;
- any evidence that a bank is benefiting from an implicit government guarantee (for example, through receipt of a 'support rating' – i.e. its credit rating is higher than it otherwise would be because of assumed government support); and
- more generally, a bank's contribution to systemic risk, its resolvability and the level of risk posed to the UK taxpayer in resolution.

The implementation of the retail ring-fence would clearly improve the resolvability of UK banks, but it would not be sufficient in isolation. Having a resolution buffer as described here would incentivise banks further to address any resolution challenges; however, a resolution buffer should in no way be seen as a substitute for a robust recovery and resolution plan.

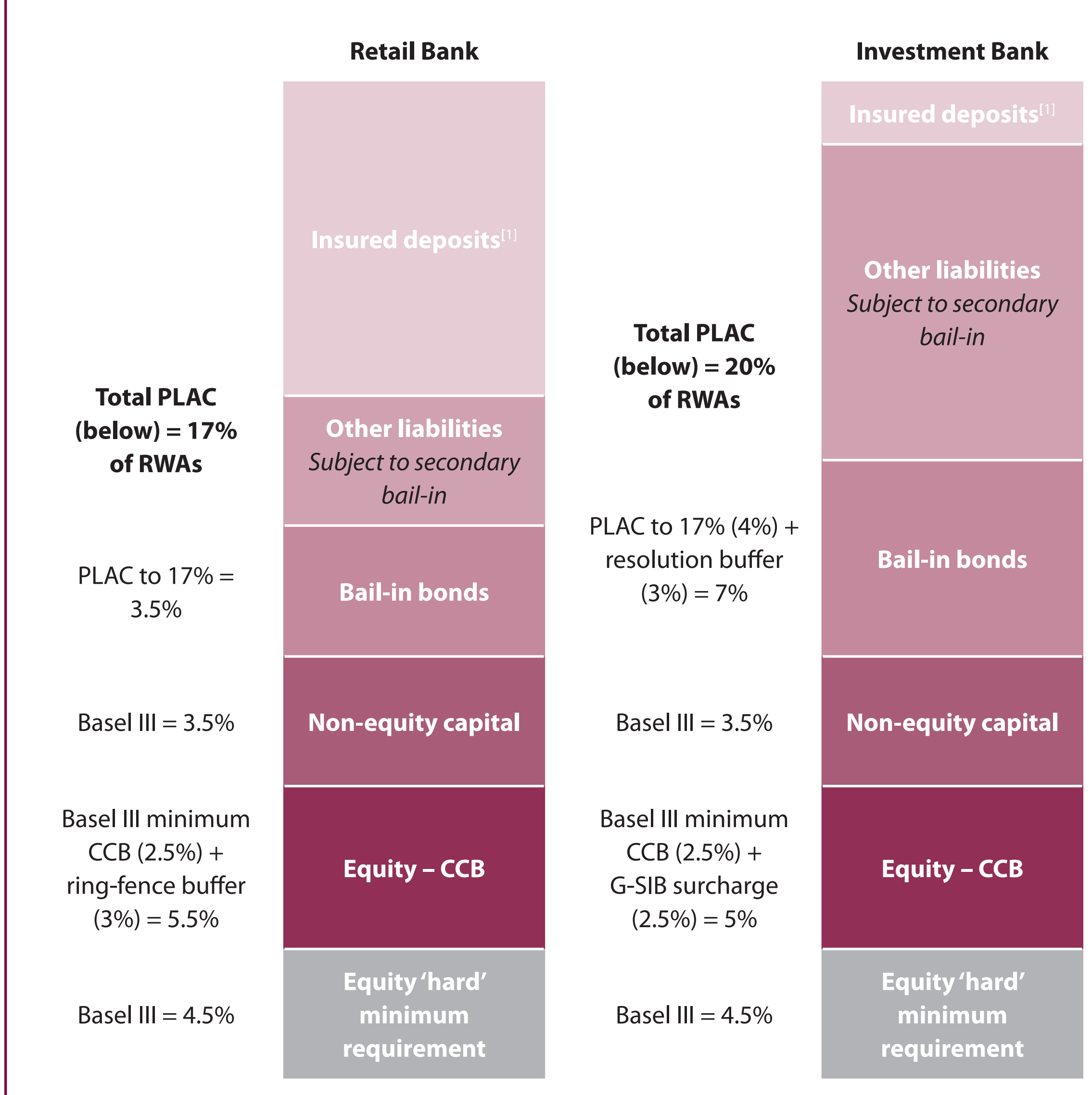
4.129 There may be additional net benefits in increasing primary loss-absorbing capacity requirements across the board for the biggest UK G-SIBs and large ring-fenced banks up to (and possibly beyond) 20% of RWAs. However, the higher requirements are set, the less clear it is that such benefits continue to accrue. Rather than recommending a minimum ratio of primary loss-absorbing capacity to RWAs of 20% for all such banks, the Commission's judgement is that requiring more than 17% should be based on a bank-specific assessment which should include consideration of the factors listed above.

4.130 The resolution buffer should act to extend the minimum amount of primary loss-absorbing capacity that a bank is required to have. Accordingly, the sanction for failure by a bank to meet this buffer (as long as it continues to meet all other capital requirements) should be restrictions on its ability to make discretionary distributions (as discussed in Paragraph 4.123).

4.131 The Commission's recommendation that the biggest UK G-SIBs and large ring-fenced banks be required to have a minimum ratio of primary loss-absorbing capacity to RWAs of 17% to 20%, together with the other recommendations set out in this chapter, would make banks more resilient and make it easier to resolve them at minimum risk to the taxpayer. A simple illustration of how these recommendations might provide loss-absorbing capacity for use in resolution is set out in Box 4.9.

Box 4.9: Illustration of loss-absorbing capacity available in resolution

Consider two banks, 'Retail Bank' and 'Investment Bank'. Retail Bank is a large ring-fenced bank (with a ring-fence buffer of 3% of equity to RWAs) that is part of a UK G-SIB (with a G-SIB surcharge of 2.5% of equity to RWAs – this is smaller than the ring-fence buffer, and so not counted). It has no resolution buffer. Investment Bank is a non-ring-fenced bank, also part of a UK G-SIB (with a G-SIB surcharge of 2.5% of equity to RWAs). Investment Bank is required by its supervisor to have a resolution buffer (set at 3% of bail-in bonds). Under the Commission's recommendations, the equity (hard minimum and CCB), non-equity capital and bail-in bonds (together, 'primary loss-absorbing capacity', or PLAC) that Retail Bank and Investment Bank would be required to have are shown below (not shown to scale). It is assumed that PLAC requirements that exceed capital requirements are met with bail-in bonds. All requirements are given as a percentage of RWAs.



Box 4.9: Illustration of loss-absorbing capacity available in resolution (continued)

In resolution, losses will fall first on any remaining equity. Non-equity capital would bear losses next, then bail-in bonds. If further loss-absorbing capacity (beyond 17% of PLAC for Retail Bank, 20% of PLAC for Investment Bank) was required to absorb losses or re-capitalise some or all of a bank's operations, the secondary bail-in power could be used to bail-in other liabilities, including uninsured depositors. This example does not assume that Retail Bank and Investment Bank are in the same G-SIB group. If they were, they could nonetheless be resolved separately as a consequence of being required to meet minimum loss-absorbency standards on a solo basis.

[1] Insured deposits are also technically subject to secondary bail-in, but are in any case preferred. Investment Bank may not in fact have any – see Paragraph 4.100.

Recommendations

4.132 Equity

- Ring-fenced banks with a ratio of RWAs to UK GDP of 3% or more should be required to have an equity-to-RWAs ratio of at least 10%.
- Ring-fenced banks with a ratio of RWAs to UK GDP in between 1% and 3% should be required to have a minimum equity-to-RWAs ratio set by a sliding scale from 7% to 10%.

4.133 Leverage ratio

- All UK-headquartered banks and all ring-fenced banks should maintain a Tier 1 leverage ratio of at least 3%.
- All ring-fenced banks with a RWAs-to-UK GDP ratio of 1% or more should have their minimum leverage ratio increased on a sliding scale (to a maximum of 4.06% at a RWAs-to-UK GDP ratio of 3%).

4.134 Bail-in

- The resolution authorities should have a primary bail-in power allowing them to impose losses on bail-in bonds in resolution before imposing losses on other non-capital, non-subordinated liabilities.
- The resolution authorities should have a secondary bail-in power to enable them to impose losses on all other unsecured liabilities[86] in resolution, if necessary.

86 Liabilities secured with a floating charge only should also be subject to the secondary bail-in power.

4.135 Depositor preference

- 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.

4.136 Primary loss-absorbing capacity

- UK G-SIBs with a 2.5% G-SIB surcharge, and ring-fenced banks with a ratio of RWAs to UK GDP of 3% or more, should be required to have primary loss-absorbing capacity equal to at least 17% of RWAs.

- UK G-SIBs with a G-SIB surcharge below 2.5%, and ring-fenced banks with a ratio of RWAs to UK GDP of in between 1% and 3% , should be required to have primary loss-absorbing capacity set by a sliding scale from 10.5% to 17% of RWAs.

4.137 Resolution buffer

- The supervisor of any (i) UK G-SIB; or (ii) ring-fenced bank with a ratio of RWAs to UK GDP of 1% or more, should be able to require the bank to have additional primary loss-absorbing capacity of up to 3% of RWAs if, among other things, the supervisor has concerns about its ability to be resolved at minimum risk to the public purse.

- The supervisor should determine how much additional primary loss-absorbing capacity (if any) is required, what form it should take, and which entities in a group the requirement should apply to, and whether on a (sub-)consolidated or solo basis.

Chapter 5: Economic impact and implementation

Introduction

5.1 This chapter examines the potential economic impact of the reforms, drawing upon more detailed material contained in Annex 3.

5.2 First, it discusses the economic benefit of the reforms. The package of banking reforms set out in the previous chapters is designed to reduce the probability and impact of financial crises in the future, while safeguarding the banking system's ability to perform its key functions and maintaining the UK's competitiveness in financial services. This would bring significant economic benefits, in terms of higher GDP. The economic benefits lie not just in fewer and less costly crises, but also in the curtailment of implicit guarantees that may distort economic activity. Thus the reform package would have further benefits, not captured by a simple GDP metric, including more stable and more balanced growth.

5.3 Second, it discusses the economic costs of ring-fencing and loss-absorbency. It is important at the outset to distinguish between (i) costs to affected banks and (ii) costs to the economy as a whole. The Commission's focus is the economy as a whole. Where costs to banks would go up, it does not necessarily follow that there would be an equivalent – or indeed *any* – cost to the economy as a whole. In particular, where affected banks' costs of funding rise because of the curtailment of an implicit guarantee or tax shield, the costs to taxpayers would fall equivalently, as they would benefit from a smaller contingent liability and lower tax burdens. These would not therefore represent an increase in costs to the economy, but a transfer (which is also desirable for incentives and fairness) within the economy. Some other costs of reform do not represent transfers, and are therefore potentially costs to the economy as a whole. The available evidence indicates that the costs to affected banks would be considerably higher than the costs to the economy as a whole (the so-called 'social costs'). It is the costs to the economy as a whole (including the banks) that must be compared against the benefits.

5.4 Third, it offers some quantifications of the economic costs and benefits, and their net impact on the economy. All such quantifications should be treated with caution, but nonetheless they indicate that, in GDP terms, the benefits to the economy of the reforms should exceed the costs by a very large margin.

5.5 Fourth, this chapter examines in more detail the impact of the reforms on the competitiveness of the UK financial services sectors and the wider economy, on the Government shareholdings in UK banks, as well as on the pace of recovery.

5.6 Finally, it considers implementation issues including timing and transition.

Economic benefits of reform

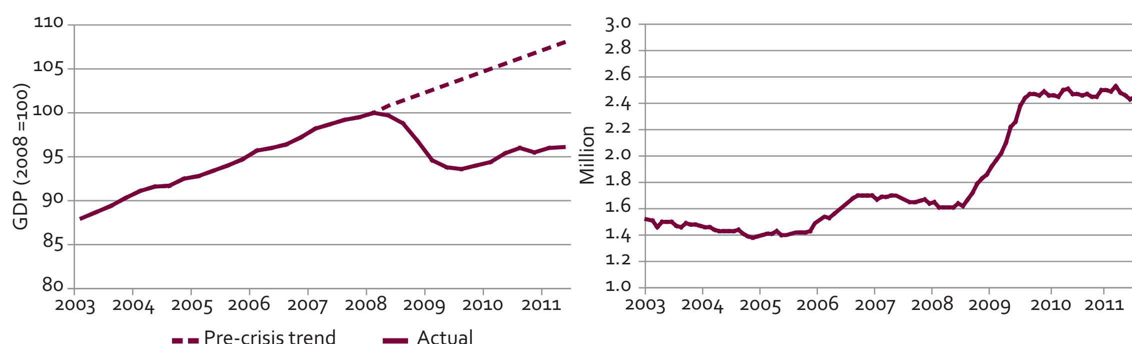
5.7 The principal benefits of the reforms would be to reduce the costs of future financial crises to the UK economy. These costs arise because financial crises interrupt, or threaten to interrupt, the key services which banks provide: the provision of payments services, transforming savings into loans and enabling customers to manage risks. The reforms have the further benefit of reducing distortions in credit allocation that arise from any implicit subsidies of banks considered 'too big to fail'. Moreover, financial stability is good for business investment.

5.8 The costs of financial crises are typically very large and go far beyond the direct costs of bank bail-outs. An extensive survey by the Basel Committee on Banking Supervision (BCBS) gives a range of estimates of 19%-163% of annual GDP for the net present value cost to output from financial crises, with a median estimate of 63%. The same study estimates that financial crises occur approximately every twenty to twenty-five years (4% to 5% of years).[1] So a financial crisis occurring every twenty years or so, costing 63% of GDP, is equivalent to losing about 3% of GDP a year. Put another way, if the level of GDP were the only thing that mattered, it would be worth paying an insurance premium of 3% of GDP per annum if doing so would eliminate a 5% annual chance of an event causing damage equivalent to 60% of GDP on average.

5.9 These magnitudes are consistent with the impact of the recent crisis in the UK and elsewhere, even though the full costs will not be known for many years. In the UK, national output is still around 4% below its pre-recession peak, and 10% below its previous trend, as shown in Figure 5.1. Unemployment has risen by more than 800,000. Even allowing for some moderation of prior trend, the cumulative GDP loss is likely to be at least 25% of annual GDP already, and depending how soon and how strongly growth rebounds, the eventual loss could well be a multiple of this. Looking elsewhere, deepened concerns about the economies and fiscal positions of a number of Eurozone countries have once more highlighted the vulnerability of many of these countries' banking systems, and their potential to contribute to further economic instability.

1 BCBS, 2010, *An Assessment of the Long-term Economic Impact of Stronger Capital and Liquidity Requirements*. Available at: http://www.bis.org/publ/bcbs173.pdf.

Figure 5.1: UK output (left) and unemployment (right) 2003 – 2011



Source: Office for National Statistics, Commission calculations.

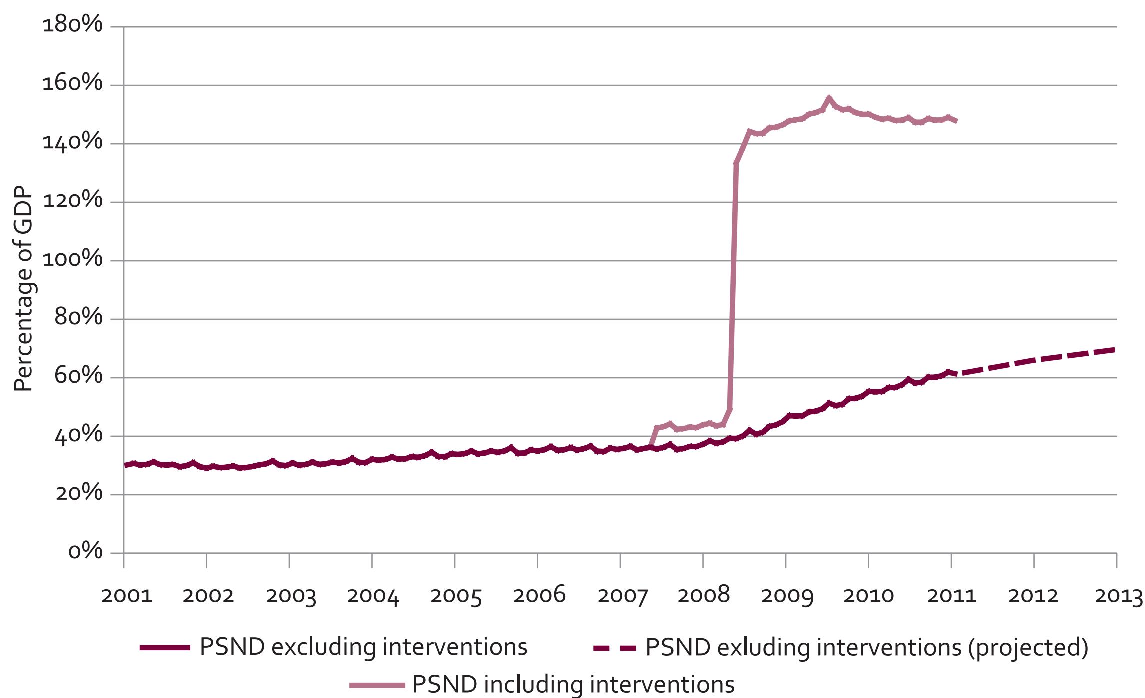
5.10 Governments naturally wish to avoid these costs – and mitigate the major impact recessions have on the public finances – and therefore tend to intervene strongly when financial crises arise. This can create a further, direct risk to the public finances, which is particularly acute in the UK given that UK bank balance sheets are more than four times larger than annual GDP. If the cost of bailing out a failing banking system becomes too big for the public finances to bear, a 'too big to fail' problem becomes one of 'too big to save'. On top of, and exacerbating, the GDP effect, therefore, are costs and risks arising from stretched public finances.

5.11 Government commitments to shore up the banking system can come at the expense of weakening the creditworthiness of the state itself. When the Irish Government announced a guarantee of all bank liabilities in 2008, market perceptions of the probability of banking defaults dropped, but the cost of insuring against the default of the Government's debt rose at the same time, reflecting an increased probability of a sovereign debt crisis. Initial market reactions to the bank bail-outs in the UK were similar, and the Irish experience suggests that, had the position of the UK banks been worse, they may have been big enough to generate a similar problem in the UK.[2]

5.12 Even where governments are able to cope with the immediate costs of banking bail-outs, the growth in public indebtedness that follows financial crises (both from the bail-outs themselves, and from the lost tax revenues and higher unemployment benefits that occur during recessions) can create a serious drag on growth. Historically, ratios of public debt to GDP in excess of 90% have been associated with growth rates on average 1% lower than in lower debt countries.[3] Figure 5.2 below shows how the UK's public indebtedness has grown since the start of the crisis. The recent experience of a number of European countries demonstrates how the combination of high debt and low growth can ultimately create the conditions for sovereign debt crises.

2 See Paragraph A3.60 in Annex 3 for more details of UK and Irish CDS spreads.
3 Reinhart, C. and Rogoff, K., 2010, Growth in a time of debt, *American Economic Review,* 100(2), pp. 573-78.

Figure 5.2: UK public sector net debt (PSND) 2001 – 2013

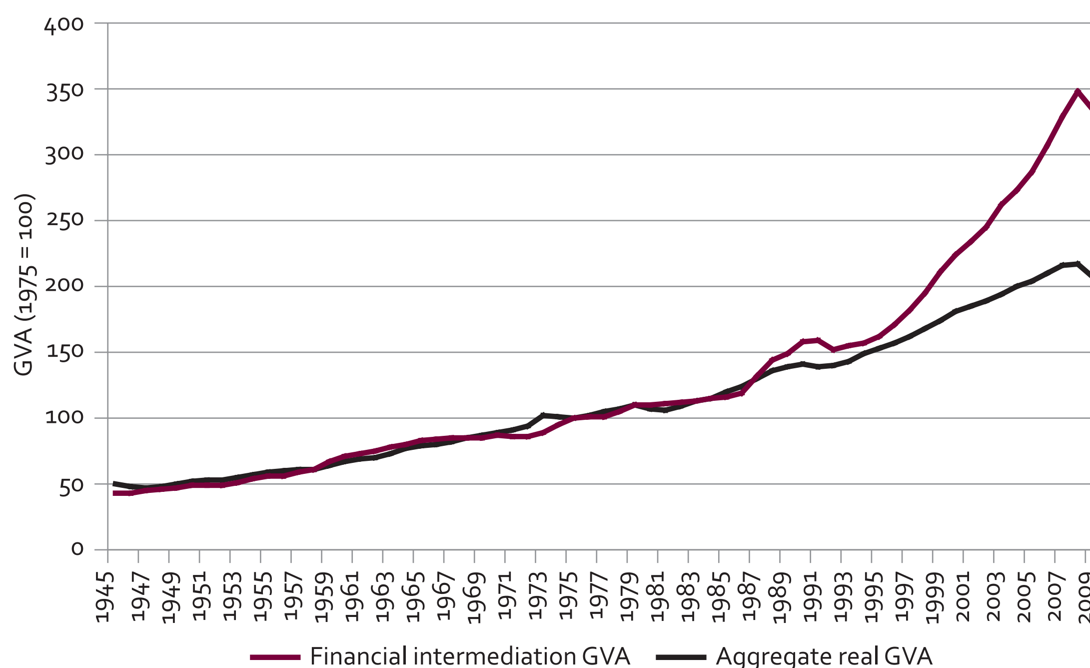


Source: Office for National Statistics, Office of Budget Responsibility, Commission calculations.

5.13 No-one can estimate with any precision the likelihood of or prospective damage caused by future crises, and their frequency and nature in the past might be a poor guide to the future. Indeed, there are plausible reasons to believe that, without sufficient reform, the impact of future crises would be worse than those in the past, particularly for the UK.

5.14 First, the ratio of financial intermediation to UK output, having been broadly stable since the start of the twentieth century, increased by about 60% between the 1980s and the crisis (see Figure 5.3). It therefore appears likely that, in the absence of reform, just as financial services have grown in relation to GDP, so the scale of risk arising from the financial system may well be greater than in the past.

Figure 5.3: Financial intermediation and aggregate gross value added compared

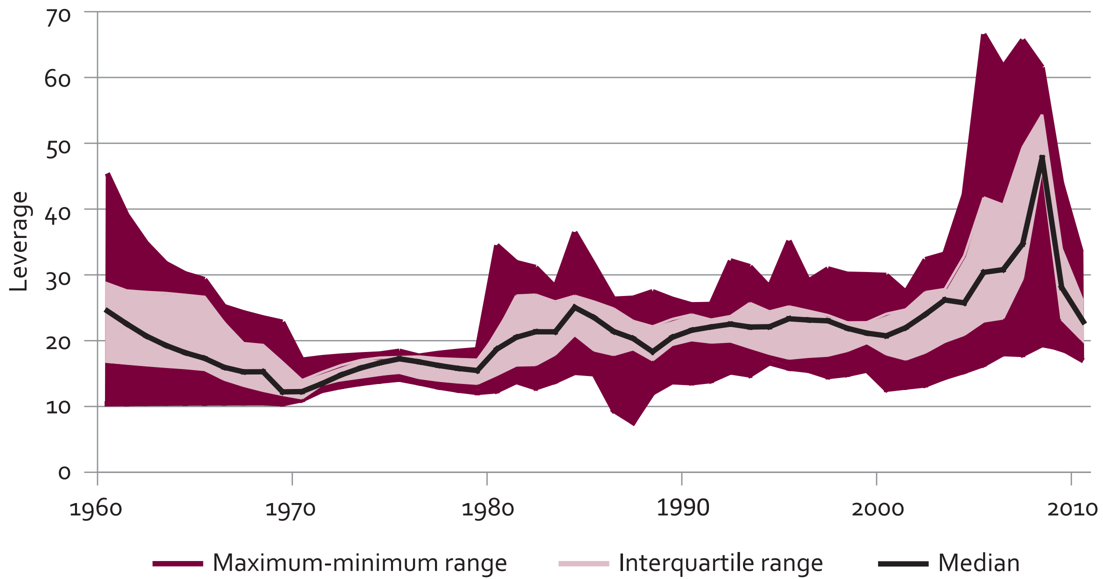


Source: Bank of England[4]

5.15 Second, over the last decade or so UK banks became much more fragile – first as leverage grew, then as the crisis hit – and at greater risk of contagion from problems elsewhere in the world. Banks used to be much better capitalised (e.g. as measured by leverage, see Figure 5.4) than they became in the years preceding the crisis, when UK banks' ratios of assets to equity rose to over 40 from historic levels of around 20. Much of the strengthening of loss-absorbency (through international requirements and the recommendations in this report) relative to the situation in the last decade is therefore restoration of historic norms. Similarly, the very substantial expansion of UK banks into international and wholesale markets, and the growth in exposure to other financial companies, is a relatively recent phenomenon (for example, see Figure 5.5 and Figure 3.4 in Chapter 3). Just as greater capital requirements are in important respects a restoration of the loss-absorbency that the banking system used to have not long ago, seen from this point of view ring-fenced banks would have much in common with UK banks for much of the 1980s and 1990s.

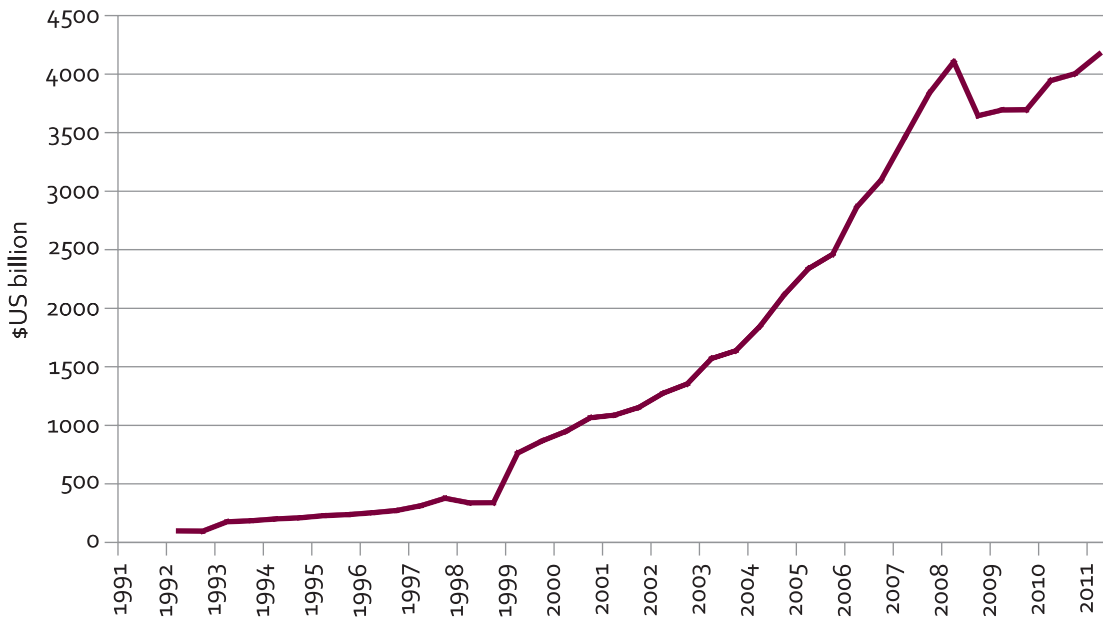
4 Office for National Statistics; Mitchell, B.R., 1988, *British Historical Statistics*, Cambridge: CUP; Feinstein, C.H., 1972, *National Income*, *Expenditure and Output*, Cambridge: CUP; and Bank of England calculations, cited in Haldane, A., Brennan, S. and Madouros, V., 2010, What is the Contribution of the Financial Sector: Miracle or Mirage?, in Turner, A. et al., *The Future of Finance: The LSE Report*, London: LSE.

Figure 5.4: UK banks' historic leverage[5]



Source: Bank of England[6]

Figure 5.5: Consolidated foreign claims of UK headquartered banks



Source: Bank for International Settlements Consolidated Banking Statistics

5.16 In sum, the economy is more exposed than before the past decade to risks from the financial system because of the growth of financial services, yet banks have become less able to bear risk.

5 Ratio of assets to shareholders' claims.

6 Bank of England, 2010, *Financial Stability Report, December 2010, Issue 28* (updated, with some restatements for 2009 data). Available at: http://www.bankofengland.co.uk/publications/fsr/2010/fsrfull1012.pdf.

5.17 Aside from the question of how good a guide the cost of past crises is to the cost of future ones, it is worth noting that insuring against breakdown of the fundamental financial infrastructure of the market economy has value far beyond GDP effects. Economic volatility is damaging, not least to the public finances, and can lead to serious adverse social consequences, such as elevated unemployment that may then become structural. The benefits of limiting financial crises therefore exceed the effects on the present value of average GDP.[7]

5.18 In addition to the higher GDP that comes from financial stability, the recommendations would deliver a further economic benefit by curtailing implicit subsidies, which, in addition to unduly encouraging risk-taking, have the potential to distort the balance of economic activity in the UK.

5.19 The Commission is recommending a combination of measures that would reduce the costs and risks of financial crises by:

- 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.

5.20 The structural component for the reform package is ring-fencing (as detailed in Chapter 3). This has benefits in relation to all three points above. Ring-fencing imposes discipline on both the ring-fenced and non-ring-fenced segments of a banking group by clarifying that the debt of each will be loss-absorbing in the event of failure.

5.21 The ring-fence provides a substantial degree of insulation for UK retail banking from external shocks and losses that would otherwise be consequent upon them. Ring-fenced banks would provide a more stable supply of credit to households and businesses in the economy, based in good part on a large pool of stable retail deposits. If, nevertheless, severe conditions caused government to seek to support the flow of bank credit to the economy but without solvency support to individual banks, that could be conducted in a much more targeted and effective manner with ring-fencing than without.

5.22 Second, ring-fencing requires the maintenance of self-standing reserves of capital and loss-absorbing debt to cope with shocks that may arise domestically (notwithstanding macro-prudential regulation) or be transmitted internationally. Those reserves may not be depleted below safeguard levels to bolster capital in wholesale/investment banking. Third, ring-fencing greatly enhances resolvability, as discussed below. All this helps curtail the implicit government guarantee and therefore curbs incentives for undue risk-taking. Moreover, ring-fencing does this without undermining the competitiveness of UK banks engaged in international wholesale/investment banking

7 See, for example, Barlevy, G., 2005, The cost of business cycles and the benefits of stabilization, *Federal Reserve Bank of Chicago Economic Perspectives*, 29(1), pp. 32-49.

because it facilitates targeted enhancement of domestic stability in conjunction with the application of international standards in international markets. In the absence of the ring-fence, there would be a strong case for much higher capital requirements generally, potentially undermining UK banks' competitiveness.

5.23 With respect to non-structural measures that bear directly on loss-absorbency, the first issue is equity capital. There is likely to be a large gap between the privately optimal and socially optimal levels of bank equity capital. There are a number of reasons for this.

- First, bank bankruptcies impose costs on the economy as a whole that are not borne by the creditors and equity holders. The difference between private and social costs motivates a need for regulation to ensure that the risks of bank bankruptcy are lowered beyond those which would be optimal for the banks themselves, down to levels which take account of the wider costs to the economy. This can be achieved by requiring changes to banks' capital structures in order to lower the probability that banks suffer losses sufficiently high as to threaten bankruptcy.

- Second, the differential tax treatment of debt and equity creates a private incentive for banks to use as much of the former as possible, economising on (the tax consequences of) the latter despite its more socially valuable loss-absorbing and stability benefits.

- Third, this incentive is further increased by the implicit government guarantee for bank debt (unlike equity), which widens the cost differential further. The value of this guarantee is uncertain – annual estimates range from £6bn to £40bn – and the Commission continues to believe it is likely to be in excess of £10bn per year, as discussed in the *Interim Report*.

- Finally, banks' disincentive to issue equity is compounded by the 'debt overhang' problem: that the benefits of issuing more equity accrue in part to debt holders (because downside risk diminishes), weakening shareholders' incentives to provide more equity even when it would be beneficial for the capital structure of the firm as a whole.[8]

5.24 The incentives of banks are therefore strongly and undesirably tilted away from equity finance. There is no good public policy reason for this. On the contrary, the superior loss-absorbency characteristics of equity, together with social costs of bank failure, argue for a tilt the other way. This of itself is a reason to require banks to fund themselves with more equity. The Commission believes that desirable levels of equity for systemically important banks are 10% of risk-weighted assets (RWAs) at the very least. With risk weights often no greater than 50%, this is consistent with leverage in excess of 20. There is a strong case for leverage ratios significantly below this level, and therefore for an equity ratio in excess of 10%.

8 Myers, S.C., 1977, Determinants of corporate borrowing, *Journal of Financial Economics*, 5(2), pp. 147-175.

5.25 The Commission's recommendations on loss-absorbency go far beyond equity, however. They also aim to make bank debt effectively loss-absorbing, in a way it has proven not to be in the recent past. This would be achieved through bail-in powers and by preferring insured depositors, both of which would make it easier for the authorities to distribute losses amongst shareholders and creditors rather than shareholders and taxpayers. In order to ensure that sufficient loss-absorbing debt and equity is held by banks to reduce any risks to the taxpayer to an acceptable (i.e. very low) level, systemically important banks should be required to hold a minimum of 17%-20% of 'primary loss-absorbing capacity', which could be met with equity, other capital, and/or long-term unsecured debt (bail-in bonds).

5.26 With respect to resolution, when banks do get into trouble, the improved resolvability resulting from ring-fencing means that the authorities would not be required to provide solvency support in order to ensure the continuity of vital banking services, and it would improve the ability to resolve those functions where continuity is not essential. Separability of functions is widely recognised as a necessary first step to improved resolvability of complex banking institutions and ring-fencing ensures it. Ring-fencing is complemented in this respect by the recommendations on loss-absorbency. Higher equity requirements, depositor preference and more effectively loss-absorbing debt would make failure less likely, both due to better monitoring of risk by shareholders and particularly creditors (see more below), and because more equity would also make it easier for banks to recover when facing losses. And where banks did still fail, the measures would reduce the collateral damage by reducing the size of the potential exposure for taxpayers and better enabling banks to be resolved in an orderly manner. An exploration of how these benefits would address failures of all kinds of banks, including wholesale/investment banks, is set out in Box 2.1 in Chapter 2.

5.27 The Commission's recommendations would also better align the private incentives of providers of bank equity capital and debt to monitor and manage risk-taking by banks. Bank debt holders have an asymmetric exposure (unlike shareholders) to the downside rather than the upside. The recommendations would sharpen incentives for monitoring and market discipline by removing a cushion from the downside that comes from the possibility that government will step in to bail out banks while keeping creditors largely whole. The ability both to separate out the functions where continuous provision is vital for the economy and to distribute losses appropriately among shareholders and creditors would have this effect and so curtail the implicit guarantee.

5.28 The economic benefit of curtailing the state's implicit guarantee goes beyond its effect on risk-taking and the probability of crises. Removing unintended subsidies should be good for the balance of activity in the economy, freeing up resources to be employed more productively elsewhere. Where these subsidies increase unnecessary risk-taking, there is a double benefit in their removal. In addition, greater financial stability improves investment conditions for the economy as a whole.

5.29 Assessing how large an effect these reforms would deliver inevitably involves a degree of judgement. This is because no model exists which can both reliably account for the frequency and incidence of financial crises and encompass the effects of reform recommendations. Even if such a model did exist, sufficient empirical historical data about the relation between the recommendations and the frequency or impact of financial crises is not available to populate it. Indeed, it could reasonably be argued that attempts to quantify these effects are inherently limited, because the aim of the reforms is to provide some insurance against future risks which will certainly arise but whose precise scale and nature is fundamentally unknowable.

5.30 One of the key challenges is assessing the incremental benefit of the Commission's recommendations alongside those that have been implemented or are likely to be so in the near future. This involves making a judgement on the changes to the likely probability and impact of financial crises resulting from other reforms. In forming its recommendations, the Commission has taken full account of the various regulatory reforms being implemented or seriously considered by others, including: the Basel III changes to risk weights, capital and liquidity requirements; the Financial Stability Board's (FSB) and BCBS's proposal for global systemically important banks (G-SIB) equity surcharges as discussed in Chapter 4; recovery and resolution planning in the form of 'living wills'; emerging proposals for bail-in debt; changes to remuneration structures; governance reforms in the UK following the Walker Report on the governance of banks and other financial institutions; changes to accounting standards; and reforms to increase standardisation of derivatives products and the extent to which they are traded through central counterparties.[9]

5.31 The recommendations contained in this report are designed to be complementary to these other reforms, to give effect to some of them, and to reinforce others. In formulating them the Commission has also decided not to make recommendations in a number of areas, including on remuneration, liquidity, derivatives and governance, where progress by others appears sufficient (although these areas are addressed directly where they arise in the context of the Commission's recommendations, for example in relation to governance of ring-fenced banks). When analysing the economic benefits (and costs) of its recommendations, the Commission has therefore sought to consider their incremental effects, beyond those which can be expected to flow anyway from other reforms.

5.32 Despite the analytical challenges, a simple framework can be adopted to inform judgements about the balance of costs and benefits of the Commission's recommendations. The framework – set out in the 'Quantification' section below – uses the metric of GDP, which leaves out a number of factors (e.g. the undesirability of volatility and the social consequences of crises). The reforms should deliver not just a higher level of GDP, but more stable and balanced GDP, which will be welfare enhancing. If such factors were brought into account, the case for reform would in the Commission's view be stronger still.

9 Further details of these and other reforms were set out in the *Interim Report*, with more recent developments in key areas summarised in Annex 2 of this report.

What are the economic costs of reform?

5.33 This section sets out how costs to affected banks might arise ('private costs') and discusses the relationship between these costs and their impact on the economy as a whole ('social costs'). It draws in part on more detailed analysis contained in Annex 3.

Loss-absorbency

5.34 The loss-absorbency measures would reduce the probability and impact of future crises by making banks better able to absorb the losses they experience. This would be achieved by requiring banks to have more equity and less debt, and by making it easier for the authorities to impose losses on bank creditors if necessary. The measures would make it less likely that banks get into trouble, make it easier to sort them out (without taxpayer support) when they do get into trouble, and improve their risk-taking incentives in the first place.

5.35 The first question is whether such changes would have *any* cost to the economy, as distinct from the affected banks? A basic but incomplete answer – which is subject to important qualifications and adjustments below – is no. That is because greater loss-absorbency does not increase risk; it shifts who bears it. Cost is redistributed, not increased in aggregate.

5.36 Moreover, it is shifted to where it should be – with the providers of bank capital and debt, who are much better placed and/or better motivated than government or ordinary depositors to monitor the risks run by banks. Shifting risk so that it is borne by parties with a stronger incentive and greater capability to manage it effectively should curb excessive risk-taking. So excessive risk-taking should decrease relative to the situation with a degree of implicit government guarantee, and the cost of risk should if anything go down, not up, resulting in a net improvement. This is wholly consistent with the costs of funding of the affected banks going up: that is part of the process of the risk being shifted.

5.37 This is not, however, a complete answer because there are other factors to consider, including, but not limited to:[10]

- tax treatment of equity versus debt; and
- arbitrage possibilities.

5.38 First, as discussed above, the differential tax treatment of debt and equity creates strong private incentives for banks to use as much debt as possible. Regulating the

10 There is also some support for banks to be funded by debt instruments in addition to equity, because debt holders are particularly sensitive to downside losses, and have the ability to redeem debt claims. This provides a monitoring device to manage risk-taking. This value may be lost with very high levels of equity. However, in the context of the Commission's recommendations, a small shift in the ratio of debt funding is unlikely to diminish the effectiveness of monitoring, and at any rate, the recommendations to improve debt loss-absorbency should considerably sharpen monitoring incentives.

amount of equity that a bank must hold may therefore be reflected in a higher weighted average cost of funding. However, the higher private costs that come from differential tax treatment are not social costs. And as discussed above, insofar as cost and price increases reflect the correction of (unintended) tax/subsidy distortions, that should have a positive impact on the economy. Moreover, Government now has a policy instrument – the bank levy, now yielding £2.5bn a year – that directly influences UK bank costs. The higher tax yield from more equity could for example be offset by lowering the levy, should that appear desirable to Government.

5.39 However, these changes would make bank funding costs more visible and they would have to be borne, relative to the *status quo,* by some combination of bank shareholders, employees, creditors and/or borrowers. On the other hand, but much less visibly, the large contingent liability carried ultimately by the taxpayer would be reduced (and the Exchequer would get a long-run revenue gain from the tax associated with more equity, and lower sovereign debt service cost to the extent that exposure to systemic bank failure affects the terms on which government can borrow).

5.40 The question of how much the cost and price of credit provision might shift as a result of the Commission's loss-absorbency recommendations is considered below. Even leaving aside the benefits of crisis reduction, it is not obvious that the net effect on the economy of these changes would be negative at all. There is ample evidence of credit provision pre-crisis on unduly easy terms, for example in parts of the mortgage market. Anyhow, the possible impacts on the price of bank credit are very small in absolute terms, and much less than the 0.25% changes in official interest rates that commonly occurred before the crisis.

5.41 The second important qualification is arbitrage, which has two dimensions – geographical and institutional. If pressed too far, loss-absorbency reforms in the UK could push banking activities into other locations and/or sectors. The risk/return profile for investors in UK banks might appear unattractive compared to that of (possibly subsidised) foreign banks and/or less regulated non-banks, including so-called 'shadow banks' such as some large hedge funds. That would result in growth in those providers at the expense of the domestic banks, which might or might not be detrimental to financial stability. Such migration is dangerous when, as occurred on a large scale in the run-up to the recent crisis, the risks are not properly shifted out of the banking sector but rather connected back to it. But it can be beneficial when risks are genuinely shifted, insulating core banking services from them. The Commission has factored the possibility for arbitrage into its analysis in calibrating its recommendations on ring-fencing as well as loss-absorbency.

5.42 In sum, while the costs to banks of funding themselves would rise as a result of the loss-absorbency recommendations, the increases would be relatively limited and any costs to the economy as a whole would be smaller still.

Ring-fence

5.43 As well as its important contribution to UK financial stability, part of the motivation for structural reform is that it provides a mechanism for economising on costs to banks which might otherwise arise from loss-absorbency requirements. Specifically, ring-fencing allows higher equity requirements to be targeted directly on those banking activities which must be continuously provided for households and SMEs, while allowing UK wholesale/investment banking to operate (subject to provisos to protect the UK taxpayer) according to international requirements, and to be resolved in an orderly fashion thanks to simpler structures and more effectively loss-absorbing debt. Without such a mechanism, the same stability benefits could be secured only by requiring all banks to hold much more capital than is recommended in this report for large ring-fenced banks.[11]

5.44 Turning to the costs of the ring-fence, a major component of the private costs relate to the curtailment of the implicit government guarantee. A number of market participants take the view that the Commission's financial stability recommendations would together have the effect of substantially reducing the impact of the implicit guarantee on bank funding costs, particularly for those outside the ring-fence. Moody's state that "[t]he ring-fencing proposals would likely lead to a further reduction in our assumptions of systemic support included in the senior debt ratings of these [major UK] banks".[12] RBS analysts foresee a substantial effect from the ring-fence and loss-absorbency recommendations combined.[13] JP Morgan analysts state that "ring-fencing of retail operations will be a transformational change for the UK banks and will most likely lead to the undermining of sector ratings, particularly for the entities excluded from the retail ring-fence", and anticipate that "the ratings associated with the non-ring-fenced entity should tend towards the standalone ratings[14] of such institutions."[15] HSBC analysts reach a similar view.[16] The Commission's view is that the guarantee would be curtailed for ring-fenced banks as well as for non-ring-fenced banks, because it would equip the authorities much better to resolve ring-fenced banks by distributing losses among shareholders and creditors without the need for taxpayer support.[17]

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11 Even in this context the Commission has had to be mindful of the scope for arbitrage across the boundary of the ring-fence, which presents a constraint in terms of how large a gap between capital requirements on either side of the fence is sustainable.
12 Moody's, 2011, *UK Treasury Support for Ring-fencing is Credit Negative for Banks*. Available at: http://www.moodys.com/research/Moodys-UK-Treasury-support-for-ring-fencing-proposals-is-credit?lang=en&cy=global&docid=PR_220985.
13 RBS, 2011, *Banks: Avoiding Strangulation.*
14 That is, ratings excluding any government support.
15 JP Morgan Europe Credit Research, 2011, *Running Rings Around the Banks*.
16 HSBC Global Research, 2011, *The ICB Ring-fence: This is Going to Hurt*.
17 However, the standalone credit ratings of ring-fenced banks, and therefore their funding costs, would be less adversely affected than non-ring-fenced banks, and possibly improve, as ring-fenced banks would be simpler and less volatile entities. See Standard & Poor's, 2011, *Industry Risk for Investment Banking is Generally Higher than for other Financial Institutions*. Available at: http://www2.standardandpoors.com/spf/pdf/media/IndustryRiskForInvestmentBankingIsGenerallyHigherThanForOtherFinancialInstitutions.pdf.

5.45 The curtailment of the implicit guarantee would bring significant benefits for the economy through increased financial stability and less distorted credit pricing. Further, its removal would not incur an extra cost for the economy: rather, the risk would be shifted from taxpayers onto others as described in Paragraph 5.36.

5.46 A separate type of cost concerns loss of diversification benefits and other synergies from universal banking. Although it is debatable how large these diversification benefits are, this could potentially increase the cost to the economy as well as to the banks, especially if full separation of retail and wholesale/investment banking were required. The Commission's ring-fence proposal has been designed, however, to preserve most of the synergies from universal banking by a targeted, not blanket, measure of structural reform.

5.47 Under full separation of retail and wholesale/investment banking the following features of universal banking would be removed:

- the ability of banks to combine the earnings of retail and wholesale/investment banking – such diversification can smooth earnings streams if the two business lines do well at different times;
- the ability of banks to shift excess capital and other resources between retail and wholesale/investment banking according to where the most profitable lending opportunities are judged to lie;
- the option for customers to receive their banking services from one bank (and conversely the ability of the bank to cross-sell services from their retail and wholesale/investment banking divisions);
- the free sharing of information (subject to existing rules on conflicts of interest) and expertise between the management of retail banks and the management of wholesale/investment banks; and
- the sharing of operations, such as IT systems, between retail and wholesale/investment banks.

5.48 In what follows 'diversification benefits' refers to the first two of these. In principle, any such diversification losses could be offset by shareholders through their portfolios because they could replicate the same diversification by investing in the shares of different types of banks. However, this does not work perfectly (for example, the possibility that one of the components might support the other in an integrated business cannot be adequately replicated via ownership of a similarly diversified portfolio of separate companies, given the exceptional costs imposed by financial distress).[18]

18 Note that as banks become better capitalised, this diversification benefit will become less valuable because the risk of financial distress diminishes.

5.49 How significant might be the costs of removing diversification benefits by full separation? On the one hand, universal banks state that they could be large. In their public responses to the *Interim Report*, HSBC noted (but did not quantify) the existence of diversification benefits between corporate and household lending.[19] RBS suggested that non-ring-fenced banks could be downgraded on account of reduced diversity, and also ring-fenced banks, but to a lesser degree.[20] Standard Chartered stated that "[t]he universal banking model provides resilience by helping to diversify risks across different sectors, clients and geographies."[21] On the other hand, the picture from the academic literature does not clearly support this view and indeed casts some doubt on it. For instance, while Baele et al. find that some kinds of diversification increase the franchise value of European banks,[22] Laeven and Levine find that diversified banking conglomerates are worth less than the sum of their parts, perhaps because they are more difficult to manage.[23] Schmid and Walter also find a diversification discount in general for financial companies, but find a market capitalisation premium from the conjunction of commercial and investment banks. They also find that firms with total assets over $100bn trade at a premium and they conclude that this is due to a 'too big to fail' subsidy.[24] Van Lelyveld and Knot find no universal diversification discount or premium in their study of bank-insurance conglomerates in the EU.[25]

5.50 In summary, the belief that universal banks offer diversification benefits is held by a number of market participants, including some universal UK banks, but the available empirical evidence is mixed. This makes the cost of full separation uncertain.

5.51 A retail ring-fence of the kind proposed by the Commission, however, would preserve to a large extent such diversification benefits as exist. Capital above the safeguard level could be transferred within banking groups. Furthermore, the option to place many kinds of activity (non-retail deposits, wholesale funding, loans to non-financial companies) on either side of the ring-fence would also facilitate the retention of diversification benefits in that these activities could be placed where they were most valuable. This is one reason why ring-fencing would be less costly, both privately and socially, than proposals such as narrow banking, which would dramatically reduce the range of intermediation possibilities. At times when both the retail and

19 HSBC, 2011, *Response to the Interim Report of the Independent Commission on Banking*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/HSBC-Response-to-ICB-Interim-Report_Redacted-Version1.pdf.
20 RBS, 2011, *Response to the Interim Report of the Independent Commission on Banking*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/RBS_response_ICB_Interim_Report_public_final_v2.pdf.
21 Standard Chartered, 2011, *Response to the Interim Report of the Independent Commission on Banking*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Standard-Chartered.pdf.
22 Baele, L., De Jonghe, O. and Vander Vennet, R., 2006, Does the stock market value bank diversification?, *Journal of Banking and Finance*, 31(7), pp. 1999-2023.
23 Laeven, L. and Levine, R., 2007, Is there a diversification discount in financial conglomerates?, *Journal of Financial Economics,* 85(2), pp. 331-367.
24 Schmid, M. M. and Walter, I., 2009, Do financial conglomerates create or destroy economic value?, *Journal of Financial Intermediation*, 18(2), pp. 193–216.
25 Van Lelyveld, I. and Knot, K., 2009, Do financial conglomerates create or destroy value? Evidence for the EU, *Journal of Banking and Finance*, 33(12), pp. 2312–2321. For a fuller discussion see Annex 3.

wholesale/investment banks were healthy, managers of the banking group could take a view about where the most profitable opportunities lay within the full range of banking activities. In times of stress, if the ring-fenced bank were at risk of failure but the group as a whole had sufficient capital then the capital could be deployed to save the ailing bank. Up to a point the reverse could happen: excess capital from the retail bank could be transferred to ease stress in the rest of the bank.

5.52 One case where the ring-fence would constrain capital flows, however, is when the group did not have sufficient capital to maintain appropriate safeguard levels in the ring-fenced bank. That is, a bank could not run down the capital supporting UK retail activities below the required level in order to shift it, for instance, to global wholesale and investment banking. The rest of the bank may choose to issue more capital to make some provision for this, which may have some private costs, but for the reasons given above would not be social costs. Such a limit on banks' freedom to deplete capital is moreover likely to impinge at a point when the social benefit of the constraint is likely to be greatest, i.e. at times of financial distress when the safety and continuity of the retail banking operations could be jeopardised by transferring capital across the ring-fence.

5.53 Leaving aside the diversification benefits, the proposed ring-fence would also preserve the other synergies which full separation would remove. Customers would be able to receive their banking services together in one place. The ring-fence would not require separation of the operational provision of all services to customers – rather it would require separation of the financial transactions to which these give rise. Further, the ring-fence itself would place no restriction on the sharing of information and expertise between ring-fenced banks and the rest of the banking group.[26] Information is a particularly important commodity in banking – the ability to share private information about the creditworthiness of particular customers might, for example, lower the price of products for that customer. Finally, while restrictions would be placed on the operations of ring-fenced banks – in order to ensure resolvability – these need not require *ex ante* separation of all operations. For example, some sharing of operations all placed within a bankruptcy-remote legal entity would be permitted. In areas of banking involving large infrastructure investment, such as complex computer systems providing payments services, this would reduce costs.

5.54 In sum, the introduction of a degree of separation through a suitably designed ring-fence, together with higher loss-absorbing capacity measures, aims to secure the benefits of structural reform while minimising the social (and many private) costs. Government guarantees would be curtailed leading to significant private costs, but synergies which have benefits would be largely retained. In particular, the balance of costs and benefits would be more favourable than those of full separation.

26 'Chinese walls', designed to remove conflicts of interest between different banking activities, would of course continue to be observed.

Quantifying the costs and benefits

5.55 Establishing the private costs of the recommendations, the proportion of these that are social costs, and the benefits of reform all necessarily involve significant irreducible uncertainties as discussed above. There are considerable analytical challenges too, with one of the main ones being the difficulty of disentangling the incremental costs and benefits of the Commission's reforms from those which will result from other reforms already planned or under way. This requires an assumption to be made about what the baseline is to which the recommendations are additive, and particularly about whether to include in that baseline the agreed Basel III changes, the proposed G-SIB surcharges, and the emerging proposals for bail-in debt, all of which to varying degrees overlap with the Commission's recommendations. In general, the approach taken is to err on the side of inclusion rather than exclusion by including both benefits and costs where material uncertainty remains about the extent to which other reforms will be implemented. In application, this means that Basel III and the G-SIB surcharges are included in the baseline but bail-in debt is not.

5.56 In taking this approach, the Commission has therefore given careful consideration to the cumulative impact of the various reforms under way together with its own recommendations. International reform initiatives are important on a number of fronts but are not alone sufficient for UK financial stability, which is why the Commission is building on them, reinforcing them, and adding to them in making its recommendations. The Commission believes that the overall reform package, of which its own recommendations are an essential part, will deliver major benefits in the future at low and acceptable cost, and that had it been in place prior to the financial crisis they would have made a significant contribution in reducing the probability and impact of failures of banks of all kinds (see Box 2.1 in Chapter 2).

5.57 Given the challenges and uncertainties described above, the Commission does not regard attempts to quantify the costs and benefits of the reforms as the main pillars on which its recommendations rest, but rather as a way of providing a quantitative perspective on them. At best, such efforts can help to illustrate the very broad orders of magnitude of the various effects, and therefore serve as one reference point when forming judgements and may add some limited value to the analysis.

5.58 First, the private costs to the banks (this section draws on the analysis in Annex 3). These arise from four main sources:

- higher funding costs resulting from higher regulatory capital and loss-absorbency requirements and/or market requirements due to diminished asset diversification;
- higher cost of funding for the ring-fenced or non-ring-fenced bank resulting from market requirements to improve its capital and liquidity position due to restrictions on the ability to transfer funds;

- higher funding costs arising from the curtailment of the implicit government guarantee; and

- operational costs associated with the subsidiarisation of the ring-fenced bank.

5.59 A number of analysts have put estimates of these costs into the public domain (see Annex 3 for more detail). None of these estimates cost precisely the package of recommendations contained in this report, with variance between: assumptions on the impact of other reforms, methodological approach, and the extent of the Commission's proposed reforms. The reports also have varying coverage, with a focus on the big UK banks where the costs would very largely (but not exclusively) reside – but they do serve as one guide to the range of possible costs. Broadly, those analyst estimates relevant to the package of reforms proposed suggest that the annual pre-tax cost for the major UK banks could be from £2bn up to £10bn, with an average estimate of around £6bn, equivalent to 0.1% of the funded assets of the largest UK banks.

5.60 The Commission has also received more detailed confidential cost estimates from the banks for various scenarios including ring-fencing. These cannot be published. But broadly, while they support the analysts' views about the general drivers of cost, they indicate clearly that the top end of the above range is an over-estimate of the private costs. There are several reasons why some of the analysts' estimates may be too high, including:

- most of the analyses attribute little, if any, value to the diversification benefits retained by ring-fencing as proposed relative to full separation: in reality, under the Commission's proposals the ability of banks to transfer excess capital around the group in normal conditions should provide substantial advantages to creditors and capital providers compared to full separation;

- the freedom to place some assets on either side of the fence should also lower costs;

- price adjustments for bank debt are informed by spread differentials typically based on recent market observations, which may reduce when current stresses ease and as the financial position of banks improves in light of reforms which are already in train; and

- the higher private cost estimates do not take account of management actions which would almost certainly be taken to reduce costs.

5.61 However, some of the lower analyst estimates may under-estimate private costs. Some estimates do not cover all of the big UK banks affected by the reforms. The estimates also do not include all elements of the Commission's proposed recommendations, although none of the excluded elements are expected to have significant incremental private costs (principally, this is because once implicit

government guarantees have been assumed to be removed, changes to the order in which liabilities take losses – from depositor preference and bail-in – should have no significant effect on the average cost of funding).[27]

5.62 There would also be some one-off costs arising from implementation of the ring-fence, for example from establishing the legal arrangements of the ring-fence, dealing with tax and pensions issues, etc. Relative to the ongoing costs, these are likely to be small.

5.63 Considering all of the evidence received, a plausible range for the annual pre-tax cost to UK banks of the proposed reform package is £4bn-£7bn, with at least half of these costs arising from curtailing the implicit government guarantee.[28] Within this range the uncertainties are sufficiently high that it would not be sensible to attempt to gain greater precision. This range still does not take account of mitigating management actions which could lower it further. On the other hand, if the government guarantee is higher, the private costs could also be higher, but this would not feed into higher social costs.

5.64 How might these private costs to banks impact on the economy, leaving aside any economic benefits from greater financial stability and curtailed subsidies? Two general observations can be made.

- First, to the extent that private costs would result from the removal of an implicit government guarantee, they would not be social costs (indeed they would reflect a benefit).

- Second, where private costs result purely from the tax differential between debt and equity they too would not have a social cost. Because this factor is a significant element of the private costs, the social cost would again be considerably lower than the associated private costs.

5.65 The Commission's view is therefore that the social cost would be very much lower than the private cost. With private costs in the range £4bn-£7bn, a range of £1bn-£3bn would seem reasonable for social costs given the proportion of private costs that results from removal of government guarantee and tax effects. The social costs arise from the operational cost of the ring-fence, as well as the marginal loss of diversification in assets and liabilities that arises as a result of the ring-fence. There is also a risk that some short-term social costs would be incurred if banks rapidly de-leveraged by contracting lending to businesses and households in the economy in order to meet higher equity requirements on a tight timetable. This transitional risk has been addressed in both the design of the Commission's recommendations and the timetable proposed for implementation, discussed in Paragraphs 5.90 to 5.100. Therefore, transitional risk should in practice be low.

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27 See Annex 3 for more details.
28 The range of private costs is discussed in detail in Annex 3, Paragraphs A3.76-A3.103.

5.66 How might the costs to banks of reform, once implemented, impact on the economy? The private costs, to the extent that they are not mitigated, would be borne by some combination of banks' shareholders, employees, creditors and borrowers. There is widespread agreement among analysts that most of the private costs arise for the wholesale/investment and non-EEA parts of banks, not for the ring-fenced retail banks. Given the international nature of competition in wholesale/investment banking, the degree to which private cost increases could pass through to customers in the UK economy should be relatively small.

5.67 It is impossible precisely to estimate the likely GDP effect of the costs and benefits of the reform package, but some illustrative calculations can indicate broad magnitudes, and in particular can provide an upper bound on likely cost. One simple approach is to compare the social cost range of £1bn-£3bn (i.e. around 0.1%-0.2% of GDP) with the benchmark annual costs of crises of around £40bn (i.e. 3% of GDP).[29] On this basis, the recommendations would deliver net benefits if they reduced the probability or impact of crises by a range between one fortieth (2.5%) and one thirteenth (7.5%).

5.68 An alternative approach is to examine the relationship between higher funding costs, lending and GDP, using the kind of model that has been employed to calibrate capital standards. This approach generally assumes, for analytical simplicity, that increased costs are passed on one-for-one by banks to their customers in the form of higher lending spreads, and that higher spreads feed into GDP through lower investment.[30]

5.69 This approach is also more complex, involving a number of assumptions and judgements, which increase uncertainty about the final cost. It may also understate some costs, but it is nonetheless a useful reference point. There are three stages.

- First, private costs of between £4bn and £7bn are between 0.09% and 0.16% of the £4.4tn of funded assets on the largest UK banks' balance sheets.[31] The potential effect on UK borrowers, if these costs were passed on in higher prices of lending, could be in theory greater or smaller than this average effect, but if the main effect is on wholesale/investment banking, a less-than-average effect would relate to them. Where costs are passed on to non-UK customers, this would of course limit the effect on UK lending rates.

- Second, if nevertheless say 0.1% were passed on to UK borrowers in this way in the form of higher prices for bank lending (i.e. the price of bank credit went up by

29 The calculations in this chapter and Annex 3 use £40bn. This is a rounded figure from 2.8% as the benchmark annual average cost of crises (63% x 4.5%), which when applied to UK 2010 GDP yields £41bn.

30 This simplification is convenient for analytical purposes because evidence (albeit imperfect) on the relationship between higher lending costs and GDP happens to exist. In reality costs will be spread more evenly between shareholders, creditors and employees. It is likely that this assumption will yield a higher estimate of costs to the economy as a whole than methods that distribute costs between the parties. Banks can also reduce costs by de-leveraging: the cost of this *is* allowed for in the estimates provided, but the short-term transitional risks around de-leveraging present a case against very rapid implementation. This is discussed in Paragraphs 5.90-5.94.

31 Excludes Standard Chartered.

0.1%),[32] how might this affect GDP? This can be estimated by using a number of empirical studies which examine the relationship between lending spreads and GDP. These give a range of factors for converting lending spread increases into GDP decreases, with GDP level decreases ranging from 0.045% to 0.083% for a 0.1% increase in lending spreads (for more details of these studies see Annex 3). This is the impact on the *level* of GDP at some point in the future, not on the annual growth rate.

- Third, leaving aside the financial stability gains to GDP, this gross effect on GDP should be adjusted downwards because some of it results from the removal of the implicit government guarantee, which should not have a social cost, and from tax effects as the Government could use the revenue to defray the costs (or for other purposes). Since there is strong reason to believe that most of the private costs arising from the reform package relate to the removal of the implicit guarantee and tax effects, the gross effect on GDP could be adjusted downwards by at least half. However, this step is complicated by the fact that the studies referred to above might themselves be affected by changes in the strength of government guarantees and tax changes.

5.70 There is no single right set of assumptions to make about these various parameters, and different assumptions yield different estimates. One set of assumptions is as follows:

- a private cost of £6bn, from within the range of £4bn to £7bn;
- that this cost was passed through entirely by the banks in the form of higher lending spreads for borrowers;
- that this effect was concentrated on £3tn out of the banks' funded assets of £4.4tn, including all UK borrowers;
- that the resulting increase in lending spreads for UK borrowers translated into decreases in UK GDP at a rate of 0.075% (from the range of 0.045% to 0.083%) for each 0.1% of increase in lending spreads; and
- a downwards adjustment of 50% for the removal of government guarantee, but no further downwards adjustment for tax effects.

5.71 This approach would yield a gross cost to the long-run level of GDP, ignoring the benefits of crisis reduction, in the region of 0.075% ((£6bn/£3tn) x 0.75 x 0.5), or around £1bn, compared with the benefits of reducing the annualised cost of financial crises of up to £40bn (or 3% of GDP). On this basis, the recommendations would have to reduce the probability or impact of future crises by only one fortieth (2.5%) in order to deliver net social benefits.

32 That is, the cost of lending is 0.1 percentage points higher.

5.72 Taken together, these approaches yield a range of costs from around £1bn to £3bn of annual GDP (or around 0.1% to 0.2%). That means that the recommendations would have to reduce the probability and impact of crises by between one fortieth (2.5%) and one thirteenth (7.5%) to deliver net GDP benefits. The Commission believes that £3bn is likely to prove a considerable over-estimate of GDP cost, but it is notable that even if the actual costs were double this estimate, for instance, the recommendations would only have to reduce the probability or impact of future crises by around one seventh (15%) in order to be worth pursuing.

5.73 On the benefits side, the estimates of the annual cost of crises are of course also subject to a number of uncertainties. For the reasons discussed above, the impact or probability of crises in the future may be higher or lower than in the past, and there are good reasons to believe that the costs may be higher without sufficient reform. However, using a central estimate of the social costs from the range above (£2bn, or 0.14% of GDP), if the costs of financial crises were only half the benchmark figure – so £20bn (equivalent to just 1.5% of GDP annually rather than 3%) – the reforms would deliver net benefits if they reduced the probability or impact of financial crises by any more than one tenth (10%).

5.74 Cost-benefit analyses of this kind suffer from many important limitations and should therefore only be used as one way of looking at the effects of the reform proposals. They should be regarded as a tool to explore the possible orders of magnitude of the effects, and not as attempts to achieve certainty or precision. Nonetheless, the analysis indicates clearly that the benefits of the reforms should exceed the costs by a very large margin. If account were taken of the additional benefit of reducing distortions to credit allocation (by curtailing the implicit guarantee), and the positive effect of financial stability on business investment, the margin of benefit would be even higher.

5.75 A theme throughout this chapter has been the divergence between the private costs of reform to banks and their cost to the economy as a whole. Many private costs are not social costs at all, notably those relating to the curtailing of the implicit government guarantee, which is beneficial, not costly, to the wider economy. The analysis above attributed at least half the private cost of the reforms – so £3bn-£4bn annually as an order of magnitude – to curtailment of the implicit guarantee.

5.76 When compared with estimates considerably in excess of £10bn for the current scale of the implicit guarantee, this appears to be a modest attribution. It gives no reason to believe that the illustrative calculations above were based on an exaggerated gap between private and social costs. If anything, it calls into question as low an estimate as £3bn-£4bn for the curtailment of the guarantee. Part of the answer to that question is that the Commission's proposed reforms are not the only relevant reforms in train. Reforms such as Basel III and the G-SIB surcharge may already reduce the value of the implicit subsidy by up to a half. Also relevant is that the data on spreads, etc. upon which estimates of the current scale of the implicit guarantee are based may shift over time – the spreads should ease once market conditions normalise, and as and when

that happens, estimates of the private costs of reform will likewise reduce. These issues are discussed in greater detail in Paragraphs A3.52 to A3.63 and A3.84 to A3.85 of Annex 3.

Competitiveness

5.77 The Commission's terms of reference require it to pay attention to the potential impact of its recommendations on the competitiveness of the UK financial services sectors and the wider economy. This consideration has been fully factored into the recommendations – indeed the package has been designed to address the dilemma facing the UK of how to maintain a globally competitive international financial services sector while securing greater domestic financial stability.

5.78 The most extensive analysis of this question in the public domain is the consideration of competitiveness in the *Interim Report*. The Commission has revisited that analysis, alongside responses from banks and others, in the formulation of its final recommendations. The provisional conclusions of the *Interim Report* were that the impact of the recommendations on the competitiveness of the UK would be broadly neutral, and that increased financial stability would be positive for the UK's role and reputation as a financial centre as well as for the wider economy. The Commission believes that the final package of recommendations has strengthened this conclusion.

5.79 As noted in the *Interim Report*, the banks that would bear the highest private costs are in practice likely to be UK-authorised banks with significant wholesale and retail operations. Some of these banks have suggested in their responses to the *Interim Report* that the impact of the reforms would be to make it hard for them to compete with foreign competitors with the result that they might lose market share. They argue further that this would have an impact on the reputation of the UK as a financial centre, and on the UK economy.

5.80 It is true that these reforms, in particular the ring-fence, might require some banks to re-think how they run their wholesale/investment banking operations. That is a natural consequence of the (desirable) curtailment of the implicit government guarantee. But the Commission believes that the overall impact would be contained for four reasons.

5.81 First, should some affected UK banks lose business to other banks, this does not constitute a coherent reason to maintain that subsidy in the UK, even if some foreign banks continue to enjoy an implicit state guarantee. The UK does not subsidise other industries in this way and there seems no reason to do so for wholesale/investment banks, particularly given the damaging incentives that these guarantees create. Moreover, reform should be positive for business and the wider economy, both because any unintentional subsidies are likely to distort the relative profitability of other sectors, but also because other sectors, particularly those who rely most heavily on bank-intermediated credit, suffer as a result of the sudden withdrawal of credit

that accompanies banking crises. Financial stability is a prerequisite for the competitiveness of the UK economy.

5.82 Second, looking at City competitiveness more narrowly, as discussed in the *Interim Report*, even if these banks' wholesale/investment banking divisions were adversely affected, they constitute a relatively small portion of the UK wholesale and international financial services sector as a whole. A deliberately cautious (i.e. erring on the high side) analysis in the *Interim Report* found that the affected banks constitute around 14%-16% of the 'City'.[33] The historical record does not suggest there is any strong link between the success of UK banks in wholesale/investment banking and the success of the City. In fact, the proportion of the City accounted for by the affected banks today appears to be a recent phenomenon. The Commission did not receive any further evidence in response to the *Interim Report* to challenge this analysis.

5.83 Third, the package of reforms would not require the wholesale/investment banking divisions of UK banks to go beyond internationally required standards, for example on capital (subject to them having credible resolution plans including adequate loss-absorbing debt) – the private costs to the affected banks, outside the removal of an implicit subsidy, would be relatively small. Moreover, the reforms have been designed in order largely to preserve such diversification and other benefits as may arise from universal banking, which should allow UK firms to compete with other universal banks. The emergence during the twentieth century of the world's leading investment banks out of the US despite the Glass-Steagall restrictions in place at the time also cautions against making an assumption that activity restrictions would hinder the long-term ability of UK investment banks to compete. Further, the presence in the market of successful standalone wholesale/investment banks shows that the unrestricted combination of retail and wholesale/investment banking is by no means the only successful business model in these markets.

5.84 Finally, stronger banks and fewer costly bail-outs of the domestic banking system should be positive for the UK's reputation as a financial centre and as a place to invest more generally. As noted in the *Interim Report*, international businesses cite stability of tax and regulation as a central determinant of business decisions.[34] This phenomenon was witnessed in the most recent financial crisis, when robust financial centres attracted an influx of activity from other, less well rooted financial centres.[35] While the UK was a beneficiary in that instance, this benefit could very quickly turn into a deficit in a future financial crisis unless reform secures financial stability.

33 The UK's internationally active wholesale financial services sector, broadly defined. As a shorthand the 'City' is used to describe the sector, but this includes some non-retail activities across the UK. See Paragraph 4.144 of the *Interim Report*.
34 Cook, G.A.S., Pandit, N.R., Beaverstock, J.V., Taylor, P.J. and Pain, K., 2007, The role of location in knowledge creation and diffusion: evidence of centripetal and centrifugal forces in the City of London financial services agglomeration, *Environment and Planning (A)*, 39(6), pp. 1325-1345. It should also be noted that the predictability of regulation is often cited as an important factor as the absolute level, so reforms that improve regulatory certainty should have a benefit, even if they are fractionally more costly.
35 See Paragraph 4.156 of the *Interim Report*.

5.85 The consequences for the public finances of domestic bail-outs have further implications for the competitiveness of the sector and the economy as a whole. Governments are often forced to raise taxes to repair the fiscal position, while regulations on publicly sensitive areas such as remuneration can be tightened heavily. These costs fall upon not just the banks that had to be saved, but on the whole economy. This reduces the stability of taxation and regulation that international businesses say is so central to their location decisions. Targeted reforms that focus on the parts of the sector to which the UK Government is particularly exposed should therefore enhance both the City's international reputation and the UK's ability to attract investment.

5.86 The Commission's conclusion is therefore that any economic impact resulting from the effects of its proposals specifically on UK competitiveness, including that of the City, should be broadly neutral – or positive, especially over the longer term.

Government shareholdings

5.87 Historical evidence suggests that the costs of making investments to bail out banks are generally very large, but much smaller than the wider costs of financial crises (including the burden on the public finances). While the Exchequer cost of the bail-outs will not be known for some time, the recent experience of bank bail-outs in the UK appears to be consistent with this. The guiding imperative of reforms should therefore be to reduce the impact and probability of crises. The vulnerability of current share prices merely underlines the need to make UK banks more robust, and an important objective of the reforms is to reduce the probability that the Government has to make such investments again in the future.

5.88 Insofar as much of any reduction in the value of the government shareholdings represents the reduction in the value of an implicit government guarantee, this mitigates the extent to which value to the Exchequer has been reduced. The loss of value from the shareholding would be made up by the lower cost of the contingent fiscal liability. Extending further guarantees would, conversely, increase the value of the Government's shareholding, but offer bad value for the taxpayer, who would hold a larger contingent liability, since most of the benefit would go to private shareholders and creditors. Thus, the value of any implicit government guarantee is shared between all of the funders of affected banks, not just the Government. This represents a transfer of wealth from taxpayers to the shareholders and creditors of those banks.

5.89 There may be some financial impact on the Government finances from a reduction in the value of the affected banks, due to the fact that not all costs represent a subsidy. Nonetheless, any impact on the valuation of the banks in which the Government has a shareholding would be more than offset by the long-term fiscal benefits. At any rate the ultimate costs to the economy of any impact on the Government shareholdings would not be additive to the cost estimates set out above, which assume that all the costs flow through to borrowers.

The pace of economic recovery

5.90 The Commission's terms of reference ask it to have regard to lending to UK consumers and businesses and the pace of economic recovery. The Commission has factored economic conditions into both the shape of its final recommendations and the implementation timetable, discussed in Paragraphs 5.102–5.104.

5.91 The UK's economy and its banking system are still suffering the effects of the financial crisis. Growth remains subdued, with weak domestic and external demand, while the UK's banking system remains vulnerable to shocks, especially from the Eurozone. This is not peculiar to the UK – European and US banks also face a period of uncertainty and are experiencing stress in equity and funding markets. This has been reflected in the most recent results of nearly all of the major banks, with depressed returns, increased funding costs, and job losses.

5.92 The economic conjuncture certainly does not reduce the need for financial reform. On the contrary, it reinforces the need to make the UK's banking system more robust. However, the Commission has been attentive to the risks of short-term de-leveraging by banks, especially in order to meet higher equity requirements, and the potential impact on the economy.

5.93 The Commission has taken into account the current equity capitalisation of the UK banks and the levels of potentially loss-absorbing capacity that they already hold in forming its recommendations and setting the timetable for implementation set out below. This should provide sufficient time for banks to build up extra capacity without having rapidly to shrink assets. If implemented on this timetable, and given the degree to which transitional and arbitrage risks have been factored into the recommendations, the risks to the pace of recovery around the reform package should be low.

5.94 This point is reinforced by the nature of the proposed ring-fence, which is intended, among other things, to provide a sound basis for the supply of credit to households and (non-financial) businesses in the economy, based in good part on a large pool of stable retail deposits. The rate of growth in the supply of bank credit to financial companies was a major cause of increases in bank leverage in the years preceding the crisis, far outstripping the rate of growth in bank credit for households and non-financial companies (see Figure 3.4 in Chapter 3). At the end of 2010 EEA retail and corporate assets accounted for around a quarter of the assets of the largest UK banks (see Figure 3.2 in Chapter 3). More moderate leverage is therefore fully consistent with the healthy supply of credit to the economy, and in due course would make it even healthier.

Implementation

5.95 The Commission is satisfied that its structural reform proposals are compatible with current European Union law, although a number of issues including the ability of the UK authorities to apply capital and liquidity standards to ring-fenced banks will need to be clarified in relation to the ongoing consultation on CRD IV (see Box 5.1). The draft proposal on CRD IV from the European Commission envisages that it will be maximum harmonised, but allowing some flexibility for member states in certain areas. For the reasons set out in Box 4.6 in Chapter 4, the final CRD IV text should be clear that member states may apply higher minimum standards to their banks if they wish.

Box 5.1: CRD IV

On 20 July 2011, the European Commission published a draft legislative proposal known as the 'Capital Requirements Directive IV' (CRD IV). The legislation is designed to implement the Basel III rules on capital and liquidity standards. It also addresses other issues, including corporate governance, reliance on credit ratings, and collaboration and information sharing among national supervisors. The legislation is currently in draft form. It will be subject to further negotiation and must be approved by both the Council of the European Union and the European Parliament before it comes into force. Accompanying technical standards, which provide detail to the legislation, will also need to be drafted.

The draft proposals are far-reaching and include a proposal for a Regulation which will set a single set of harmonised prudential rules which will apply directly to all banks in the EU. This Regulation will be 'maximum harmonised' (see Box 4.6 in Chapter 4). In other words, it will not be possible for member states to demand stricter requirements except in limited cases. Of particular potential significance to the Commission's proposals are the draft CRD IV proposals on capital, leverage and liquidity, which will need to be closely monitored.

Capital

Under the draft CRD IV Regulation, member states would not be permitted to go beyond the requirements set out in the Regulation. Some flexibility is introduced which may enable national authorities to apply additional, discretionary 'Pillar 2' capital requirements to groups of firms which are exposed to similar risks, and to apply additional capital requirements and buffers.

Leverage

The draft Regulation does not contain any firm proposals for imposing leverage ratios, but it does suggest that data and experience must be gathered before an effective leverage ratio is introduced as a binding requirement in each jurisdiction, potentially in 2018.

Liquidity

The draft Regulation also proposes a new 'liquidity coverage' requirement to be applied to firms on an individual basis. If certain conditions are fulfilled it also contains a requirement that national authorities waive the application of the liquidity coverage requirement to individual firms, and instead apply the requirements in aggregate to firms within a banking group.

Ring-fence

5.96 The Commission's structural reform measures would best be implemented through primary legislation, providing authorities with the appropriate powers to implement and enforce the ring-fencing of retail banks in accordance with the principles set out in Chapter 3.

5.97 Banks would each face different circumstances when establishing their ring-fenced bank. A bank might wish to transfer either or both of its retail and non-retail business to new legal entities. The recommendations do not prescribe the method by which a ring-fenced bank is created.

5.98 There are many legal and practical issues that banks would have to address when separating their businesses. These include:

- obtaining third party consents to transfer contracts;
- separating out contracts which relate to the ring-fenced bank and other group entities;
- transferring deposits;
- renegotiating contracts to preclude third parties from recourse against the ring-fenced bank for defaults by other group companies;
- renegotiating negative pledge clauses which prevent the original bank company from disposing of certain assets or falling below certain size of business thresholds;
- dealing with foreign assets and liabilities and rights and obligations which are subject to foreign law; and
- transferring personnel and dealing with related pensions issues.

5.99 The Commission has taken legal advice on these and other issues relating to implementation of the ring-fence. While the process would involve substantial legal and administrative work, there are no insurmountable problems. Part VII of the Financial Services and Markets Act 2000 provides an existing mechanism for the transfer of banking businesses. If required, this process could be enhanced by new legislation.

5.100 If the ring-fence is implemented, there will be a continuing need to monitor and evaluate whether the rules and design of the ring-fence require adjustment to ensure that it is achieving its purpose and objectives, including whether banks are adhering to the spirit as well as to the letter of such rules, as well as the build-up of risks from outside the ring-fenced banks. Implementing and monitoring the ring-fence would

require enhanced technical capabilities and more supervisory resources for the regulator.

Loss-absorbency

5.101 The Commission's loss-absorbency measures would best be implemented through primary legislation, providing authorities with the appropriate powers to effect the recommendations.

Timetable

5.102 The Commission believes it would be desirable for the Government to provide clarity about its view of the Commission's recommendations as soon as possible. If it accepts the recommendations, the authorities should then move rapidly to put in place the necessary legislation and rules.

5.103 On loss-absorbency, the Commission considers that the Basel III timetable of completion by no later than the start of 2019 is appropriate and would strike a good balance between transition costs and effectiveness, having regard also to the current weakness of the economic recovery. In particular this timetable would enable banks to build up their equity while continuing to lend into the real economy.

5.104 For the ring-fence, the Commission recommends that structural reform of the UK's banks should be completed by the same date, with efforts made to complete it sooner. This timetable would allow sufficient time for banks to implement a ring-fence following the passage of legislation and development of related regulatory rules and guidance, while also minimising any transitional costs and risks to the economy.

PART II: COMPETITION
Chapter 6: Overview

6.1 Part II of this *Final Report* is devoted to competition issues in UK banking. Chapter 7 below (supported by Annex 4) contains an assessment of competition in UK retail banking markets, and Chapter 8 sets out the Commission's competition recommendations.

6.2 This overview chapter has two purposes. First, it summarises the approach to competition issues taken by the Commission and highlights the main arguments put forward by respondents to the *Interim Report*. Second, it discusses relationships between financial stability and competition, and explains the pro-competitive nature of the financial stability recommendations in Part I of this report.

The Commission's approach to competition issues

6.3 In banking markets as elsewhere, what matters is not competition in the abstract but competition to provide what customers want – *effective* competition. In markets that work well, suppliers compete vigorously with each other, and with the real threat of entry by other firms, to provide a choice of products to well-informed customers. Moreover, this happens without damaging side effects on others. Customers, though individually small, enjoy the power of informed choice.

6.4 Where markets are not working well, customers lack that power and suppliers' incentives can be distorted. Competition may then be weak and/or a mixed blessing. For example, competition might be directed not at serving customers well but at luring them into superficially appealing bad deals – as with the sale of much payment protection insurance (PPI) in recent years. And competition might have damaging side effects – as with ineffective food safety or pollution regulation, or with financial system risk created by lax and under-capitalised lending. The interconnected nature of financial institutions heightens the risk of such side effects arising.

6.5 The underlying problem in such cases, however, is not competition but the frameworks – including consumer protection and financial regulation – in which competition takes place. To blame competition would be to misdiagnose the problem. A more comprehensive analysis is needed. In short, a distinction is needed between 'good competition' to serve customers well, and 'bad competition' that exploits customer unawareness or, for example, creates a race to the bottom on lending standards.

6.6 The Commission's approach therefore involves assessment of:

- structural conditions for competition in UK retail banking;[1]
- conditions for the exercise of well-informed choice by consumers; and
- financial stability and competition.

Problems of competition and choice in retail banking

6.7 There have been long-standing problems on the first two counts above, especially in markets for personal current accounts (PCAs) and banking services for small and medium-sized enterprises (SMEs), which are particularly important for the economy. PCAs and business current accounts are also gateways to other products. Most of the competition problems highlighted in 2000 by the Cruickshank report into competition in UK banking remain.[2] Over the past decade the competition authorities (the Office of Fair Trading (OFT) and the Competition Commission (CC)) have been involved with banking markets on a number of occasions – for example blocking the proposed Lloyds TSB/Abbey National merger in 2001, the SME banking report of 2002, and the unauthorised overdraft case which the OFT lost before the Supreme Court in 2009.[3]

6.8 Though challenger banks to the main four incumbents made some inroads before the crisis hit, the market is now considerably more concentrated than ten years ago. Challengers have left the market, often by being absorbed by others, most notably through the Lloyds TSB/HBOS acquisition, which was not referred to the CC despite the fact that the OFT had found that the test for reference to the CC on competition grounds was met in respect of PCAs, banking services to SMEs and mortgages.

6.9 Market concentration of the supply side is coupled with weaknesses on the demand side. In particular, current account switching costs are perceived as being high and product comparisons are opaque. Switching rates are remarkably low, and this is not explained by high levels of customer satisfaction with existing suppliers. Indeed there has been strong public dissatisfaction with aspects of bank pricing, such as unarranged overdraft charges, and widespread mis-selling in the case of PPI.

6.10 Against this background, the Commission in its *Interim Report* provisionally concluded that competition in UK retail banking is not working well and advanced three ways

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1 The *Interim Report* presented the Commission's evidence on wholesale and investment banking. No further evidence has been received to change this view, and therefore the Commission's final recommendations have focused on personal and small business banking.

2 Cruickshank, D., 2000, *Competition in UK Banking*. Available at: http://webarchive.nationalarchives.gov.uk/20100809005617/webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/fin_bank_reviewfinal.htm.

3 CC, 2001, *Lloyds TSB Group Plc and Abbey National Plc: A Report on the Proposed Merger*. Available at: http://www.competition-commission.org.uk/rep_pub/reports/2001/458lloyds.htm#full. CC, 2002, The Supply of Banking Services by Clearing Banks to Small and Medium-Sized Enterprises. Available at: http://www.competition-commission.org.uk/rep_pub/reports/2002/462banks.htm#full. *Office of Fair Trading v Abbey National plc & Others* (2009) UKSC 6. Available at: http://www.supremecourt.gov.uk/docs/uksc_2009_0070_judgmentV3.pdf.

– beyond financial stability measures and the continued application of competition and consumer law – of improving competition:

- improving prospects for a new, strong challenger by substantial enhancement of the divestiture being undertaken by Lloyds Banking Group (LBG) as a condition for its receipt of state aid ('Project Verde');
- improving switching and consumer choice by the early introduction of a new system for switching personal and small business current accounts, together with greater transparency; and
- securing pro-competitive financial regulation by giving the new Financial Conduct Authority (FCA) a clear primary duty to promote effective competition.

Responses to the *Interim Report*

6.11 These problems were described in the *Interim Report*, along with provisional views on solutions. Responses to the *Interim Report* fell into three broad groups.

6.12 Some respondents agreed with the assessment of the market, but argued that additional problems exist and that the Commission should go further in its solutions. Key points made by this group included:

- problems with switching are greater than set out in the *Interim Report*, and not improving over time – account number portability should be considered as well as a redirection service;
- tariff structures for current accounts are overly complex, and should be regulated to make them simpler;
- it is important not only to have new entrants, but to encourage new entrants with alternative business models, such as credit unions;
- prudential regulation is a barrier to entry, and the Prudential Regulation Authority (PRA) should have a competition duty as well as the FCA; and
- banking markets are overly concentrated, and a number of sizeable divestitures are needed to address this.

6.13 Others largely agreed with the assessment of the market but disagreed with some of the solutions. In particular, a number of respondents saw the demand side as the root of the problems, and considered that solutions should therefore focus on switching

and transparency but not address structure directly. Points made by this group of respondents included:

- switching is indeed a problem, which can be addressed through improvements to the current system and a redirection service;
- transparency is important, and is being addressed by OFT initiatives;
- market structure is not part of the problem. There are a large number of providers – the problem is lack of confidence in switching between them; and
- financial regulators should have regard to competition, but should not allow this to distract them from consumer protection and prudential regulation.

6.14 A third, smaller group disagreed with much or all of the assessment and with the proposed solutions. These respondents argued that banking markets are already competitive, particularly when compared with other countries and sectors, and that therefore only minor solutions, if any, are required. Points made by this group included:

- banking markets are not concentrated – other markets are more highly concentrated;
- UK banks offer greater choice and lower prices than seen in other countries;
- structural solutions are the wrong answer and are disproportionate;
- the reason that customers do not switch is that they are content with their current provider, and there is little to be gained by switching. Therefore, changing the switching system will have little effect; and
- it would be disproportionate for the sector regulator to have a primary competition duty in a sector that is not a natural monopoly and has never been under state control.

6.15 These arguments, and the evidence provided to support them, are examined in detail in Chapters 7 and 8, and in Annex 4.

Summary of competition recommendations

6.16 The Commission's competition recommendations are set out in detail in Chapter 8, and are summarised here.

6.17 In the light of further evidence, the Commission confirms its view that the prospects for competition in UK retail banking would be much improved by the creation of a strong and effective new challenger by way of the LBG divestiture (the divestiture

by Royal Bank of Scotland (RBS) is already underway). Since the currently proposed divestiture has important limitations, its substantial enhancement would be desirable, to address issues of its size and its funding position. The Commission therefore recommends that the Government seek agreement with LBG to ensure that the divestiture leads to the emergence of a strong challenger bank.

6.18 The consultation on the *Interim Report* has indicated that a greatly improved switching system can be introduced without undue cost. The Commission therefore recommends the early introduction of a redirection service for personal and small business current accounts which, among other things, provides seamless redirection for more than a year, catches all credits to and debits from the old account, and is free of risk and cost to customers. This should boost confidence in the ease of switching and, together with greater transparency, enhance the competitive pressure exerted on banks through customer choice. The Commission has considered recommending account number portability. It appears that redirection may deliver many of the benefits of account number portability at lower cost. However, this should be re-evaluated in future.

6.19 Improving the switching process alone will not necessarily lead to more effective switching: transparency must also be improved so that customers can identify the products that best suit their needs, forcing banks to offer the prices and services that customers seek. Therefore, the Commission recommends that interest foregone[4] is included on customers' annual statements, and that the FCA takes further action to require transparency in future, such as making account usage information available to consumers electronically, or requiring that product ranges include a standardised option comparable across the industry.

6.20 One of the reasons for long-standing problems of competition and consumer choice in banking and financial services more generally has been that competition has not been central to financial regulation. The creation of the FCA presents an opportunity to change this. Statements by the Government indicate that the policy goal of a pro-competitive FCA is accepted. The Commission believes, however, that this could be secured more effectively than in current proposals, and recommends that the statement of objectives for the FCA is strengthened accordingly. The issues of switching and transparency mentioned above are examples of where the FCA, with strong pro-competitive powers and duties, could make markets work much better for consumers. It could also do so by tackling barriers to the entry and growth of smaller banks.

6.21 The *Interim Report* also considered whether there was a case for the relevant authorities to refer any banking markets to the CC for independent investigation and possible use of its powers to implement remedies under competition law. Such a reference is not recommended before important current policy questions are

4 Interest foregone is calculated by subtracting the amount of interest earned currently on a PCA from the amount of interest that could be earned had the consumer put his or her money in a PCA which earns higher interest, or put some of that money in savings.

resolved, but could well be called for depending how events turn out in the next few years, especially whether:

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

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

Financial stability and competition

6.22 Some respondents to the *Interim Report* called for further analysis of relationships between financial stability and competition. This was discussed in general terms in the Commission's *Issues Paper* of September 2010, and some of the points from that discussion are summarised in Box 6.1.

6.23 The Commission sees no good reason to deny customers the benefits of competition on financial stability grounds. Instances where competition has arguably been bad for stability have involved unduly lax financial regulation, including implicit government guarantees leading to large banks being perceived as 'too big to fail' and encouraging excessive risk taking. The right policy response therefore is not to tolerate weak competition but to implement proper regulation for financial stability.

Box 6.1: Interactions between financial stability and competition

Some arguments that competition can be bad for financial stability

One argument is that by reducing profitability, competition encourages risk-taking, to the detriment of stability, because banks have less to lose if risks go bad. But the solution to the problem of excessive incentives to take risk is better regulation of capital and liquidity, not toleration of weaker competition.

A second argument is that banks have less incentive to monitor the credit risk of their borrowers if customers can more easily switch between banks. On the other hand, their incentives to invest in relationships with customers may be poor if there is little prospect of them shifting their business to a competitor.

Competition can reduce the incentive of banks to help other troubled banks during a period of stress, though other factors such as counterparty exposures may lean in the opposite direction.

Some arguments that market power can be bad for financial stability

Banks with market power are more likely to be (regarded as being) 'too big to fail', and so have a proportionately greater implicit government guarantee.

If market power leads to higher borrowing rates, then borrowers might themselves take on more risk.

If market power leads to higher mark-ups and less incentive to be efficient, the result might be migration of some business from bank to non-bank channels. The effects on overall financial stability might be negative (but need not be so).

Effects of financial (in)stability on competition

Lax financial regulation can lead to misdirected competition, in particular unduly risky borrowing and lending, the consequences of which hit others if the risks go bad. Therefore, lax financial regulation is bad for both stability and competition.

Financial instability may cause banks to fail, requiring them to be rescued by other banks leading to increased concentration and reduced competition as a result.

Failure by regulation to solve the problem of the implicit government guarantee distorts competition in favour of banks thought to possess it.

Conclusions

The general conclusion to draw from numerous analyses of the topic is that there are various and mixed effects of competition on financial stability, and *vice versa*.[1] The financial stability of banks depends primarily on the regulatory framework in which they operate and how well they are run.

[1] For example, see recent surveys such as Beck, T., 2008, Bank competition and financial stability: friends or foes?, *World Bank Policy Research Working Paper No.4656*; OECD, 2011, *Bank Competition and Financial Stability;* and Vives, X., 2011, Competition policy in banking, forthcoming in *Oxford Review of Economic Policy*.

6.24 This section focuses on two beneficial effects that the Commission's financial stability recommendations should have on competition:

- removal of competitive distortions arising from the 'too big to fail' problem; and
- removal of incentives to misdirect competition towards high-risk lending.

Competition and the 'too big to fail' problem

6.25 A focus of the Commission's financial stability recommendations is to improve the ability of governments to resolve banks without supporting creditors, and to do so in a way which is clear to creditors *ex ante*. This is necessary to curb incentives for excessive risk-taking. But removal of implicit government support is also important for competition. If one bank is seen as more likely to receive government support than another this will give it an unwarranted competitive advantage. As creditors are assumed to be less likely to take losses, the bank will be able to fund itself more cheaply and so will have a lower cost base than its rival for a reason nothing to do with superior underlying efficiency.

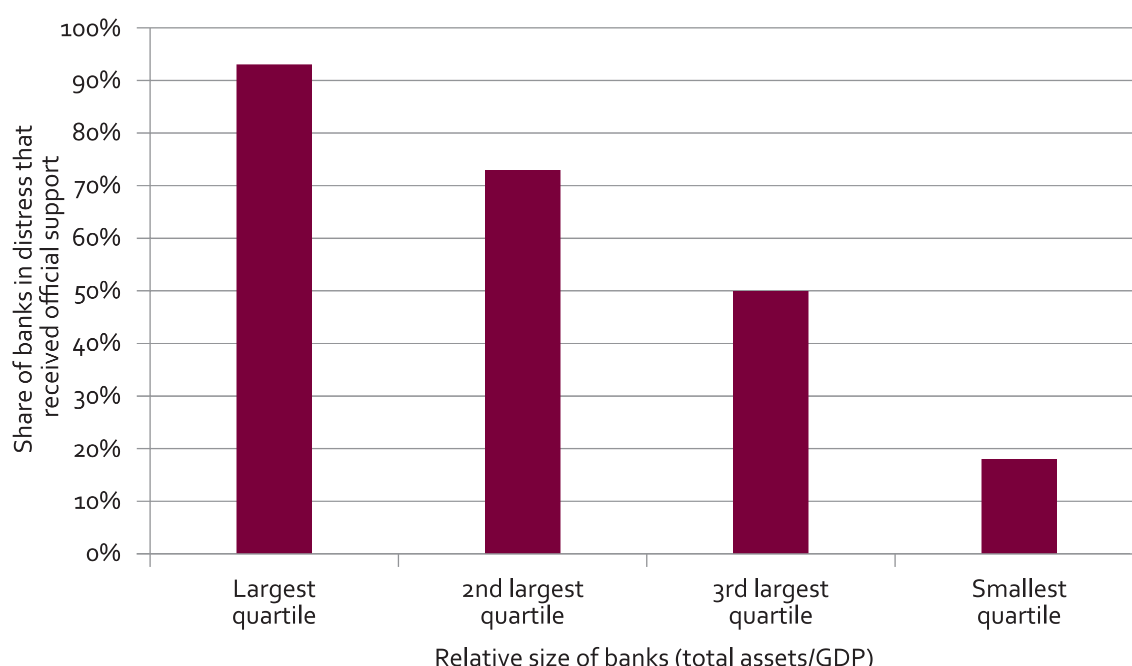
6.26 There has been much debate about the absolute size and nature of the reduction in funding costs which results from creditors anticipating government support for banks.[5] In particular, the label 'too big to fail' reflects the intuition that the size of a bank is a crucial factor for determining the likelihood of government support, and thus the quantum of subsidy from which a bank benefits. If this is correct, large banks would enjoy an unwarranted competitive advantage over smaller banks.

6.27 There is a significant body of evidence which suggests that large banks do indeed benefit as a result of creditors anticipating government bail-outs. Many studies are based on the US, where in 1984 the testimony of a key regulator before Congress was widely taken to imply that the largest eleven banks could not be allowed to fail. Studies of that event have found it had a positive effect on the banks considered 'too big to fail', and a negative effect on other banks.[6] Similarly, studies of the value of banks over a period of time find that very large banks enjoy a premium related to perceptions of government support.[7]

5 See Annex 3 of this report and Annex 3 of the *Interim Report* for further consideration of the absolute size of implicit government guarantees.
6 O'Hara, M. and Shaw, W., 1990, Deposit insurance and wealth effects: the value of being 'Too Big to Fail', *Journal of Finance,* 45(5), pp.1597-1600, find a positive effect in relation to equity values. Morgan, D. and Stiroh, K., 2005, Too big to fail after all these years, *Federal Reserve Bank of New York, Staff Report No.220* find a positive effect on bond ratings.
7 Schmid, M.M. and Walter, I., 2009, Do financial conglomerates create or destroy economic value? *Journal of Financial Intermediation,* 18(2), pp.193-216 find that overall financial conglomerates trade at a discount, but that firms with total assets over $100bn trade at a premium and they conclude that this is due to a 'too big to fail' subsidy. Gandhi, P. and Lustig, H., 2010, Size anomalies in U.S bank stock returns: a fiscal explanation, *NBER Working Paper No. 16553* find that the presence of a government guarantee reduces the cost of equity for the large US banks.

6.28 The widespread government support for large financial institutions during the recent crisis, and the difficulties revealed when one, Lehman Brothers, was allowed to fail, has made this effect worse. Indeed, the difference in the funding cost of small and large US banks has widened following the crisis.[8] And, as Figure 6.1 shows, the support actually provided by governments around the world during the crisis suggests that creditors were in retrospect right to assume greater support for large banks.

Figure 6.1: Likelihood of official support, given distress, by relative size of banks (total assets/GDP)[9]



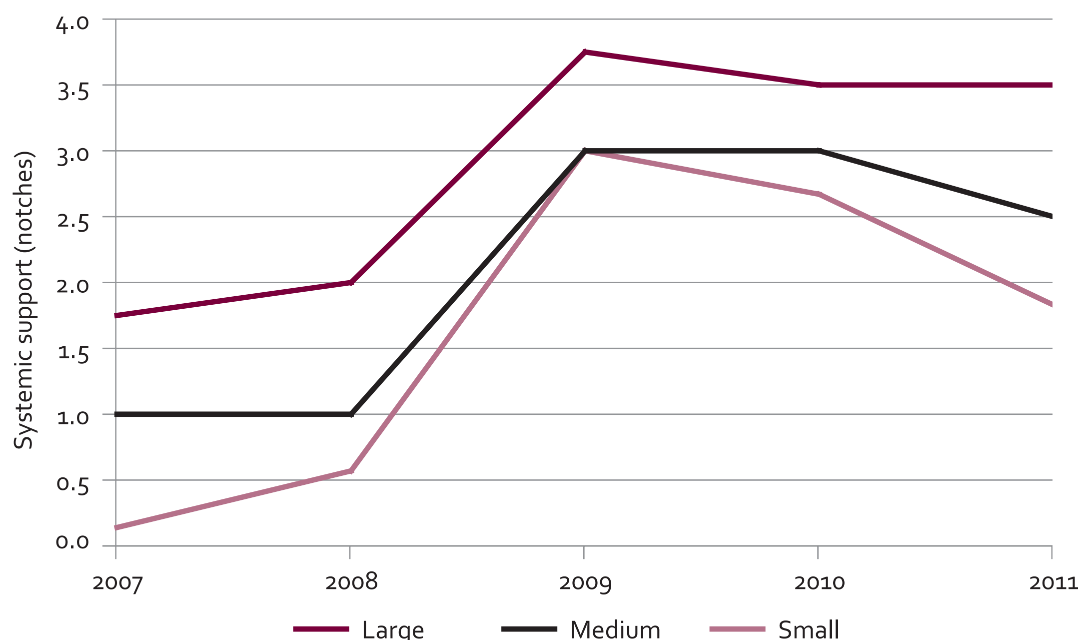
Source: IMF[10]

6.29 Another way to measure the 'too big to fail' subsidy is to look at the benefit given by rating agencies for expected government support. Some agencies ascribe to banks both 'standalone' ratings – based purely on the financial strength of the bank itself – and 'support' ratings – which incorporate expectations about bail-outs. As shown in Figure 6.2 large banks have a higher assumed level of government support in their ratings than medium and small banks. The differential treatment of banks of different

8 For example see Figure 1 in Ötker-Robe, I., Narain, A., Ilyina, A. and Surti, J., 2011, Too-important-to-fail conundrum: impossible to ignore and difficult to resolve, *IMF Staff Discussion Note*. Available at: http://www.imf.org/external/pubs/ft/sdn/2011/sdn1112.pdf.
9 Bars show the share of institutions that received official support as a percentage of the total number of institutions that were in distress in each quartile. "Distress" is defined as a situation when a bank has at least one year of negative return on assets, or if it was a recipient of government support (capital injections and asset restructuring) during 2007-2009.
10 Ötker-Robe, I., Narain, A., Ilyina, A. and Surti, J., 2011, Too-important-to-fail conundrum: impossible to ignore and difficult to resolve, *IMF Staff Discussion Note*. Available at: http://www.imf.org/external/pubs/ft/sdn/2011/sdn1112.pdf.

sizes during the crisis has perhaps increased the competitive distortion arising from 'too big to fail' subsidies.[11]

Figure 6.2: Number of notches benefit to credit ratings attributable to expectations of government support received by banks according to size[12]



Source: Moody's, Commission analysis.

6.30 The Commission has, however, received some analysis which finds that ratings do not depend on bank size.[13] Conclusive evidence in this area is difficult given the number of factors affecting bank funding costs and the small number of banks in the UK for which analysis can be conducted. Further, ratings are far from conclusive in determining the cost of bank funding.

6.31 However, unless the effect of implicit government guarantees is minimal or the benefit uniform across all banks, a competitive distortion will be introduced. So while it is important to consider who benefits most from the implicit subsidy, the difficulties of identifying precisely which factors lead a bank to obtain such a benefit do not negate the need for its removal. Whether it is a bank's size or its connections with the

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11 For further evidence of this see Haldane, A., 2010, *The $100 Billion Question*. Available at: http://www.bankofengland.co.uk/publications/speeches/2010/speech433.pdf.

12 Analysis conducted for a sample of 15 UK banks. Large banks are those with non-equity liabilities of over £300bn during the period as they appear in Moodys' ratings: Barclays Bank plc, HSBC Bank plc, Lloyds TSB plc, and RBS plc. Medium-sized banks are those with non-equity liabilities of between £100bn and £300bn: Nationwide Building Society, Santander UK plc, Clydesdale Bank plc and Co-operative Bank plc. Small banks are a set of building societies with non-equity liabilities of under £100bn: Chelsea, Coventry, Leeds, Principality, Skipton, West Bromwich and Yorkshire.

13 Barclays, 2011, *Perspectives on Valuing a Perceived Public Guarantee of the Banking System*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Barclays-Perspective-on-Implicit-Subsidy.pdf.

rest of the financial system which determines the benefit for its funding cost, any subsidy is a competitive distortion nonetheless.

6.32 In principle, not only should implicit subsidies be eliminated, but systemically important banks should operate with *greater* safeguards than others, because their failure would cause proportionately greater economic harm. In practice, higher regulatory requirements have tended to be applied to smaller and/or newer banks rather than large established ones. This issue, and its implications for barriers to the entry and growth of smaller rivals, is taken up in Chapter 7.

6.33 The Commission's proposed financial stability reforms – on ring-fencing as well as loss-absorbency – should therefore be pro-competitive insofar as they curtail the 'too big to fail' problem. Moreover, as with the Basel III proposals for higher equity requirements for global systemically important banks, the proportionately greater capital requirements that the Commission recommends for large UK ring-fenced banks (as set out in Part I of this report) lean against the competitive distortion in favour of such banks, and so would not create an undue distortion against them. These measures should help smaller banks overcome some of the obstacles to competing against larger banks.

Competition and the excessive risk problem

6.34 A theme emphasised throughout this report has been that making banks better able to absorb losses, and easier to resolve if they still get into trouble, will help curb incentives for excessive risk taking in the first place. This was manifestly not the case in the run-up to the crisis. There was excessive credit creation as loans were made to unsound borrowers on lax terms, such as very high loan-to-value ratios for residential and commercial mortgages, which inflated the prices of assets that collateralised the lending. Incautious lenders gained business at the expense of more cautious lenders, and hence exerted pressure on the latter to follow suit. When the crunch came, the incentives for risk-taking went into reverse with calamitous effects.

6.35 This was a failure of regulation, as a result of which competition was ill-directed towards excessive risk. Consider an analogy with pollution. If pollution control is too lax, polluters will gain business from cleaner firms as they are able to produce at a lower cost, unless the cleaner firms also reduce their costs by lowering their standards and polluting more (a 'race to the bottom'). The solution is not less competition but proper pollution control.

6.36 The Commission's recommendations on financial stability should therefore help competition not only by addressing the 'too big to fail' problem but also by channelling competitive forces in better directions than in the under-regulated pre-crisis regime. In short, they should help promote more effective competition, and will set a regulatory framework within which competition does not conflict with stability.

6.37 Some respondents to the *Interim Report* argued, moreover, that separation of retail from wholesale/investment banking (whether through full separation or ring-fencing) would improve the quality of everyday banking services, particularly to SMEs.[14] Other evidence has also suggested that banks where management is focused on retail activities, and with a more distinct retail banking culture than under current arrangements in universal banks, will be better placed to understand and meet retail customers' needs, with the result that retail competition is more customer-oriented.

14 Page 6, Federation of Small Businesses, 2011, *FSB Response to the Independent Commission on Banking Interim Report*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Federation-of-Small-Businesses.pdf. Page 3, The Work Foundation, 2011, *The Discouraged Economy: A Submission from The Work Foundation to the Independent Commission on Banking*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Hutton-Will-and-Nightingale-Paul.pdf.

Chapter 7: Assessment of the market

Introduction

7.1 This chapter sets out the Commission´s assessment of the state of competition in UK banking. It focuses on those markets within which competition is working least effectively, namely the personal current account (PCA) and SME banking markets.[1] The Commission's recommendations on competition are set out in Chapter 8.

7.2 This assessment builds on the *Interim Report* and on the many studies and investigations into competition in retail banking services conducted by others in recent years, in the UK and elsewhere. These have identified a number of factors that affect competition in retail banking, including concentration, barriers to entry, regulation, switching costs, customers' ability to compare products, and other informational problems. In many markets, including the UK, problems have been found in a number of these areas that inhibit effective competition in retail banking, and a range of measures have been introduced by the competition authorities to attempt to address these.[2]

7.3 There were some positive signs of competition increasing in the UK over the past decade, notably through the activities of 'challenger' banks – those that are large enough to be a threat to the incumbents, but with a strong incentive to compete to increase their market share. These challengers played an important role in stimulating competition in a number of retail banking markets. The financial crisis has reversed some of the gains of the past decade by leading to a significant increase in concentration in retail banking markets, and by sharply reducing the number of challengers.

7.4 The data upon which the Commission has based its analysis are taken from the past ten years or so, to understand how banking markets work over the long term. However, it is important to note that market conditions now are very different from the average of the past decade. In particular, in the years running up to the crisis banks saw incentives to increase their lending and take on more risk. Since 2008, that dynamic has reversed: as spreads on savings and loans reflect, UK banks now have strong incentives to attract deposits and to be much more cautious in their lending practices. There are not yet sufficient data to draw conclusions on the longer term. In any case, this change in market dynamics affects the markets for savings and credit

1 In this chapter and Chapter 8, 'bank' is used to refer to any provider of PCAs and/or business current accounts (BCAs). This includes both banks and building societies.
2 See for example, Office of Fair Trading (OFT), 2008, *Personal Current Accounts in the UK.* Available at: http://www.oft.gov.uk/shared_oft/reports/financial_products/OFT1005.pdf.

products more than the markets that the Commission identifies as its focus – PCAs and business current accounts (BCAs). But it means that there are greater concerns about price and availability of lending now than in the past.[3]

7.5 This chapter summarises the evidence presented in the *Interim Report*, providing an overview of the current state of competition in UK banking markets. It highlights important points submitted as evidence by respondents to the *Interim Report*, considers these points and adds additional evidence and analysis on these and other areas. The chapter is arranged as follows:

- first, it looks at the supply side of the market: levels of concentration over the last decade and barriers to entry;
- second, it turns to the demand side: how willing and well equipped customers are to choose and switch providers, and to compare products and prices;
- third, the role of 'challenger' banks is discussed; and
- fourth, a short summary is provided.

7.6 This chapter does not include further investigation of competition in wholesale and investment banking markets in the UK. In the *Interim Report*, the Commission provisionally concluded that there is limited scope for action by the UK authorities, due to the global nature of some of these markets and the absence of strong representations from customers, but invited further evidence. Very little evidence was received on this area from respondents to the *Interim Report*, and accordingly the Commission has not investigated further.

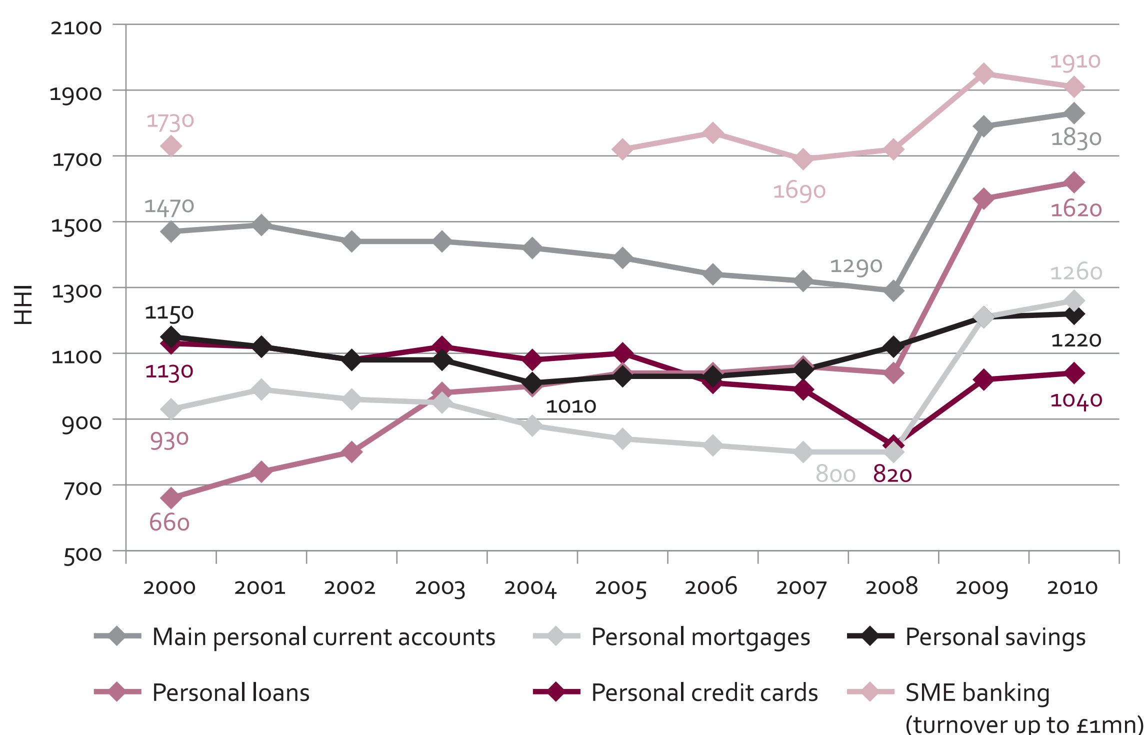
Concentration in UK banking markets

7.7 The financial crisis resulted in a significant increase in the concentration of UK banking markets, as a number of banks left the market or were absorbed into larger groups.[4] The reductions in concentration across the majority of markets in the years preceding the crisis were reversed. For example, the total market share of main PCAs of the four biggest banks – Barclays, HSBC, Lloyds TSB (or Lloyds Banking Group (LBG) since 2009), and Royal Bank of Scotland (RBS) – fell from 74% in 2000 to 64% in 2008, but rose again to 77% in 2010, largely as a result of the Lloyds TSB/HBOS merger.[i] [5] Figure

3 The August 2011 Inflation Report gives a useful overview of the recent evolution of credit spreads. See Pages 16-17 of Bank of England, *Inflation Report August 2011*. Available at: http://www.bankofengland.co.uk/publications/inflationreport/ir11aug.pdf.
4 For the purposes of this analysis, the Commission has considered separately the markets for PCAs, savings accounts, mortgages, credit cards and personal loans. In general, the Commission has assumed markets to be UK-wide. The great majority of retail banking products are available to customers across the UK without any difference in characteristics or prices and a number of large banks have national branch networks that make the same products available across the country (Commission analysis of data provided by Defaqto). The Commission has considered separate markets to enable a complete economic analysis, rather than conducting a full relevant market definition exercise for the purposes of competition law.
5 Roman numerals refer to endnotes at the end of this chapter.

7.1 shows Herfindahl-Hirschman indices (HHI),[6] which measure market concentration, for major retail banking products. For many of these products, concentration fell gradually between 2000 and 2008. But between 2008 and 2010, concentration rose sharply, to its highest points in a decade or more. For all six of these markets, concentration is now above the HHI benchmark of 1000 that indicates a concentrated market.[7] (The LBG and RBS state aid divestitures, which will reduce concentration to some extent, are considered in the following chapter.)

Figure 7.1: Concentration levels in retail banking measured using the Herfindahl-Hirschman Index[8]



Source: Commission analysis of SME banking data from the Competition Commission (2000), TNS (2005-2009) and Charterhouse (2010), and personal banking data from GfK FRS.[ii]

6 The Herfindahl-Hirschman Index is a measure of market concentration that takes account of the differences in the sizes of market participants, as well as their number. The HHI is calculated by adding together the squared values of the percentage market shares of all firms in the market.
7 The OFT's merger assessment guidelines say that any market with a post-merger HHI exceeding 1000 may be regarded as concentrated and any market with a post-merger HHI exceeding 2000 as highly concentrated. However, the OFT does not use these mechanistically, and the significance of these thresholds will be less if the product is differentiated. Pages 38-41, Competition Commission and OFT, 2010, *Merger Assessment Guidelines*. Available at: http://www.oft.gov.uk/shared_oft/mergers/642749/OFT1254.pdf.
8 Main PCAs are those that survey respondents holding more than one current account indicated was their 'main' account. SME banking data were taken from the Competition Commission, TNS and Charterhouse. Market shares (by number of customers) for SMEs with a turnover of <£1mn were used as these were available for the longest time period. Where market shares are also available for larger businesses, these were similar to the shares for this sub-section. The TNS RI Small Business Banking Survey data uses respondents' subjective opinion of a definition based on 'main bank'. In the view of at least one bank this has a potentially misleading effect on any subsequent assessment, analysis and calculations of the 'SME market' based on the data. 2009 and 2010 data do not include the RBS and LBG divestitures, which have not yet been completed.

7.8 Competition led to a steady decrease in concentration of the PCA market before the crisis. However, this decrease was only gradual, and in general even those brands with consistently the highest level of customer service, or better interest rates, have grown only slowly.[iii] In aggregate, challengers achieved some organic growth (that is, growth not through mergers), though smaller banks did not. However, as a result of the crisis there was a jump in concentration and the PCA market is now particularly concentrated, as Figure 7.1 shows. Total revenue in the PCA market was approximately £10bn in 2009, and PCAs accounted for around one-third of total personal banking revenue on average for the four biggest banks in 2009.[9]

7.9 The Competition Commission (CC) has previously defined four separate product markets for SME banking services.[10] The concentration level shown in Figure 7.1 above is for SMEs' main banking relationships (SMEs with turnover of up to £1mn).[11] This is a good proxy for concentration of the business current account (BCA) market, as 96% of SMEs with a BCA obtain it from their main bank and there is little multi-banking among SMEs.[12] This is also a good proxy for competition in other products such as corporate credit cards, deposit accounts, business loans and commercial mortgages, as for all these products at least 80% of SMEs that hold them have one from their main bank.[iv] Total revenue from BCAs was around £2bn in 2009, and for the SME banking market as a whole it was around £8bn.[13]

7.10 The market for BCAs[14] is concentrated (even when compared to other retail banking markets), and has been for at least the last ten years. In 2010, the four biggest banks had a market share of 85% between them.[v] There has been little organic growth, which in part explains why concentration levels have not changed significantly between 2000 and 2008. Challenger banks have also struggled to increase their BCA market share over the last decade – in 2001, the CC identified only four potential challengers to the four largest banks,[15] and out of these only two were able to grow to a significant size.

9 Commission analysis of data provided by banks.
10 CC, 2002, *The Supply of Banking Services by Clearing Banks to Small and Medium-Sized Enterprises*. Available at: http://www.competition-commission.org.uk/rep_pub/reports/2002/462banks.htm.
11 Note that this is different from the Companies Act definition of SME used elsewhere in this report. Market share data seen by the Commission was generally only available for SMEs with a turnover of up to £1mn. Therefore, in this chapter, 'SME' generally refers to businesses with a turnover of up to £1mn. Wherever this is not the case, it is specified in the text.
12 The CC defined a market for liquidity management services which includes BCAs together with short-term business deposit accounts and overdraft facilities in conjunction with BCAs. In this report the BCA market is a proxy for a market for liquidity management services. A slightly different market definition would not change the conclusions in this report. By multi-banking, the Commission means holding BCAs or similar products with more than one bank. It is common for SMEs to obtain some kinds of financial products, such as insurance, from providers that are not their main bank. Commission analysis of data from the Charterhouse Research UK Business Banking Survey 2010, based on more than 16,000 interviews with businesses conducted between January and December 2010. Data from SMEs with a turnover of up to £1mn have been used in this analysis.
13 Commission analysis of data provided by banks. Calculations include SMEs with a turnover of up to £15mn.
14 Using 'SME main banking relationship' as a proxy for BCAs.
15 Pages 44-45, CC, 2001, *Lloyds TSB Group Plc and Abbey National Plc: A Report on the Proposed Merger*. Available at: http://www.competition-commission.org.uk/rep_pub/reports/2001/fulltext/458c2.pdf.

7.11 Other retail banking markets show varying degrees of concentration.

- A number of new firms (including foreign banks) entered the mortgage market over the past decade, though many have since exited, and it may be more difficult to enter in the coming years due to more difficult funding conditions. The market is currently concentrated, and significantly more concentrated than at any time since at least the year 2000.[vi]

- The savings market is less concentrated and more contestable than the PCA market.[vii]

- The credit card market – the supply of credit card services to personal consumers rather than to retailers – is not particularly concentrated. There has been significant entry and exit, and changes in market share over time.[viii]

- The personal loan market is of more concern. It has become considerably more concentrated, with the five biggest banking groups expanding their market share from under 50% in 2000 to over 75% in 2010. Despite this, some small players have been able to increase their market share.[ix] However, market conditions for lending have changed significantly since 2008, with credit spreads remaining high relative to pre-crisis levels for unsecured personal loans.[16] Given that personal loans may be a partial substitute for overdrafts attached to PCAs, the increase in concentration in the personal loan market heightens the risk of insufficient competition in the PCA market.

7.12 The savings, credit cards and personal loans markets therefore appear to be more contestable than the PCA and SME banking markets. The mortgage market was contestable before 2008, as new firms could enter the market with a specialist model of borrowing from wholesale markets to lend as mortgages, using networks of independent financial advisers to reach customers. Given that wholesale funding is now much less readily available than it was before 2008, it is unclear whether the mortgage market remains contestable.[17] These credit markets have had other suppliers beyond banks, but in the past few years more business has been concentrated in the hands of major banks.

7.13 The four biggest banking groups have had significant market shares in all of the five personal banking markets mentioned above, as well as SME banking, throughout the last decade.[x] Following Lloyds TSB's merger with HBOS, in 2010 LBG had a significantly greater market share in all of these five personal banking markets than any other bank.[xi] Once complete, however, the LBG and RBS state aid divestitures will lead to reductions in market concentration from current levels.

16 Bank of England, *Inflation Report August 2011*. Available at: http://www.bankofengland.co.uk/publications/inflationreport/ir11aug.pdf.

17 Higher funding costs are one of the reasons why mortgage spreads above the official base rate have remained high. See Bank of England, *Inflation Report August 2011*. Available at: http://www.bankofengland.co.uk/publications/inflationreport/ir11aug.pdf.

7.14 Regional concentration is generally higher than concentration measured at national level, and some regional markets in particular are significantly more concentrated than the national average. For example, in Scotland, which the CC and the Office of Fair Trading (OFT) identified as a separate market,[18] concentration levels for SME banking are high (HHI of 3160 for businesses with a turnover of up to £25mn in 2009),[xii] and significantly above the OFT and CC's threshold of 'high concentration' (HHI of 2000).[19] This issue was noted in both the 2002 CC investigation, and the 2008 OFT study into the Lloyds TSB/HBOS merger. Though it will be somewhat alleviated by the RBS and LBG divestitures, the HHI will still be well above 2000. Separately, the market in Northern Ireland is complicated by the financial stability problems of the Irish-owned banks.

7.15 As some respondents to the *Interim Report* highlighted, the UK appears to be similar to many other developed countries, such as the Netherlands, Sweden, Australia and Canada, in having a concentrated retail banking market. However, they have smaller populations, which is relevant if there are scale economies. In general, it is difficult to compare across countries as their histories and competitive dynamics differ (for example, in some countries regional banks are the norm), and there are few comparators with similarly sized markets that also have national bank networks.[20] In any case, the fact that there are other examples of concentrated markets does not indicate an absence of problems with competition in the UK: governments or regulators in other countries (for example, Australia and the Netherlands) have recently investigated aspects of retail banking competition in their own markets. Other countries are also acting to address market concentration: in the US, the Dodd-Frank reforms prohibit a financial company from merging with or acquiring another firm, if the result is a company with over 10% of the 'aggregate consolidated liabilities' of all firms in the domestic market.[21]

7.16 Respondents also stated that, since prices for banking products in the UK are not substantially higher than in other countries, UK markets must be competitive. However, the Commission did not receive evidence that contradicted its finding in Paragraph 2.72 of the *Interim Report* that it is difficult to draw conclusions from international comparisons. In particular, costs under a free-if-in-credit model will vary significantly over time depending on the interest rate environment.

18 The CC's provisional conclusions found that there were separate geographical markets (in England and Wales; Northern Ireland; and Scotland) for the markets of liquidity management services and general purpose business loans, Page 24, CC, *The Supply of Banking Services by Clearing Banks to Small and Medium-Sized Enterprises*. Available at: http://www.competition-commission.org.uk/rep_pub/reports/2002/462banks.htm. The OFT agreed with this recently, Page 51, OFT, 2008, *Anticipated Acquisition by Lloyds TSB plc of HBOS plc*. Available at: http://www.oft.gov.uk/shared_oft/press_release_attachments/LLloydstsb.pdf.

19 OFT and CC, 2010, *Merger Assessment Guidelines*. Available at: http://www.competition-commission.org.uk/our_role/ms_and_fm/pdf/100916_merger_assessment_guidelines.pdf.

20 France and Germany would be more appropriate comparators to the UK than the countries listed above, since in a scale industry, smaller markets would be expected to have fewer banks, holding all else equal. But in France and Germany, regional bank networks mean that concentration at national level may not be representative of regional concentration.

21 See analysis of Section 622 of the Dodd-Frank Act in Financial Stability and Oversight Council, 2011, *Study and Recommendations Regarding Concentration Limits on Large Financial Companies*. Available at: http://www.treasury.gov/initiatives/Documents/Study%20on%20Concentration%20Limits%20on%20Large%20Firms%2001-17-11.pdf.

7.17 Respondents to the *Interim Report* in general did not dispute the facts on concentration and market shares, but some disagreed with the conclusions drawn from them. Some respondents argued that concentration in banking markets is not high, and compared it to other markets with higher levels of concentration. For example, in its submission one bank showed that after the state aid divestitures, the PCA market will be less concentrated than the markets for short-haul packaged holidays, bricks, retail of pre-owned video game software,[22] online family history, breakdown services, supermarkets, licensed betting offices, and glass packaging.[23] The Commission acknowledges that there are other sectors more concentrated than retail banking markets. However, the sectors identified differ significantly from retail banking, and particularly from PCAs, in that none of them exhibit the same combination of concentrated supply alongside high switching costs, customers' inability to compare prices, and high barriers to entry. Hence these comparisons are of limited value in assessing the state of competition in UK banking markets.

7.18 Concentration is, of course, not deterministic of competition – competition is also affected by many other factors. The *Interim Report* set out evidence that, holding all else equal, higher concentration in retail banking leads to worse consumer outcomes.[24] Some respondents to the *Interim Report* disputed this analysis,[25] while others agreed that increased concentration led to worsening terms for consumers of banking services[26] – for a full review of these and other points, see Annex 4. This chapter goes on to consider other features of the market that affect competition.

Barriers to entry

7.19 The OFT reported recently on barriers to entry in retail banking, and found that new entrants face significant challenges in attracting customers and expanding their market shares.[27] The greatest barriers came from the difficulty in attracting personal and SME customers, due to customers' preference for banks with an extensive branch network, strong brand loyalty and low switching rates. New entrants into SME banking struggle to gain customers for these reasons, as well as the almost universal

22 However, the CC did not identify retail of pre-owned video game software as a relevant market – it considered that mint and pre-owned software are in the same market. Page 4, CC, 2007, *Game Group plc and Games Station Limited*. Available at: http://www.competition-commission.org.uk/inquiries/ref2007/game/pdf/summary_of_provisional_findings.pdf.
23 LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.
24 For example, one review of a number of other studies found that: "Market concentration ... results in significant spreads in both deposit and loan markets." Page 540, Degryse, H. and Ongena, S., 2008, Competition and Regulation in the Banking Sector: A Review of the Empirical Evidence on the Sources of Bank Rents, in Thakor, A.V. and Boot, A. eds., *Handbook of Financial Intermediation and Banking*, Amsterdam: Elsevier.
25 For example, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf. Barclays, 2011, *Interim Report: Consultation on Reform Options.* Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Barclays.pdf.
26 For example, Which?, 2011, *Which? Response to the ICB Interim Report*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Which.pdf.
27 OFT, 2010, *Review of Barriers to Entry, Expansion and Exit in Retail Banking*. Available at: http://www.oft.gov.uk/shared_oft/personal-current-accounts/oft1282.

offer of free banking for start-ups. According to an OFT survey, for 27% of SMEs, one of the main reasons for choosing a bank was that its branch location was closest to their business. Around 35% of SMEs said that already holding a PCA with that bank was one of the main reasons for choosing it as their business bank, showing that banks without a presence in personal banking face an additional barrier in attracting SME customers.[28] In addition, evidence was submitted to the Commission that prudential capital and liquidity requirements inhibit entry into banking.

7.20 These barriers can have the effect of deterring firms from entering the market in the first place if they do not believe they will be able to attract sufficient numbers of customers to recover start-up costs, grow market share and maintain a successful presence in the market. Table 7.1 provides a summary of the OFT's conclusions on the barriers to entry in retail banking.

28 OFT, 2010, *Review of Barriers to Entry, Expansion and Exit in Retail Banking*. Available at: http://www.oft.gov.uk/shared_oft/personal-current-accounts/oft1282.

Table 7.1: OFT's conclusions on barriers to entry

Issue	Potential barrier investigated	OFT conclusion
Regulatory requirements	FSA authorisation requirements	Not identified as a barrier/no evidence received.
	FSA authorisation process	Noted as a barrier in the past by some firms due to length and uncertainty of process; initiatives have now been put in place to improve this (although it is too early to say how effective they are).
	OFT consumer credit licence	Not identified as a barrier/no evidence received.
	FSA capital and liquidity requirements	Potentially high barrier for new entrants and smaller firms due to disproportionately high capital requirements relative to incumbents. New capital and liquidity requirements could exacerbate or reduce these barriers.
Access to essential inputs	Implementation of IT systems	While a high sunk cost at start-up, the costs of IT systems only become a barrier if firms believe they will be unable to attract enough customers to recover these costs in the future.
	Access to payments systems (e.g. CHAPS and Bacs)	Barriers may exist for certain unconventional business models, but no evidence received to suggest there are significant or widespread barriers to access.
	Customer information access	Not a significant barrier for personal banking (many information providers); however, banks can find it more difficult to source financial information on small enterprises in order to price SME banking products accurately.
	Access to funds to finance expansion	Post-crisis, limited access to interbank funding and few alternative funding sources can pose a barrier to expansion for certain firms, especially monoline credit providers.
Ability to attract customers and reach scale	Levels of switching in PCA and BCA markets	Low levels of switching make it difficult to attract customers.
	Brand loyalty	A significant barrier to expansion, as consumers are often wary of switching to unfamiliar brands, perhaps in particular in Scotland and Northern Ireland.
	Branch network	A significant barrier to expansion, especially for PCAs/BCAs (both gateway products). Alternative distribution channels remain complements not substitutes.

Source: OFT[29]

29 OFT, 2010, *Review of Barriers to Entry, Expansion and Exit in Retail Banking*. Available at: http://www.oft.gov.uk/shared_oft/personal-current-accounts/oft1282.

7.21 Based on evidence of entry over the past decade, the credit card and personal loan markets were the most contestable (i.e. it was easy for firms to enter and exit). These were the markets with the greatest number of providers, and also a high number of entrants over the past decade compared to the size of the market. There were also some new entrants into the markets for mortgages and savings accounts, though entry into these markets has dropped off since the crisis. Many of the entrants into the credit card, loan and mortgage markets have provided only a small number of products (rather than the full range of personal banking products), and typically, these providers have individually captured only a small share of the market.[xiii]

7.22 In contrast, Table 7.2 shows that there have been very few entrants into the PCA market: just five over the past decade, which between them managed to acquire less than 2% of the market from 2001 to 2010.[xiv] Figure 7.2 shows the share of new business that went to new entrants over the past decade – that is, of the new accounts opened each year (whether by switchers, as additional accounts, first bank accounts, etc.), how many were opened with a bank (or non-bank provider) that was new to the market since 2000. Given the small number of new entrants and the low market share they have attracted, the sample size for these figures is small and hence they are not precise. However, they clearly show that over a ten year period, new entrants failed to make a significant impression in any retail banking market apart from credit cards.[30]

Table 7.2: Number of new entrants since 2000[31]

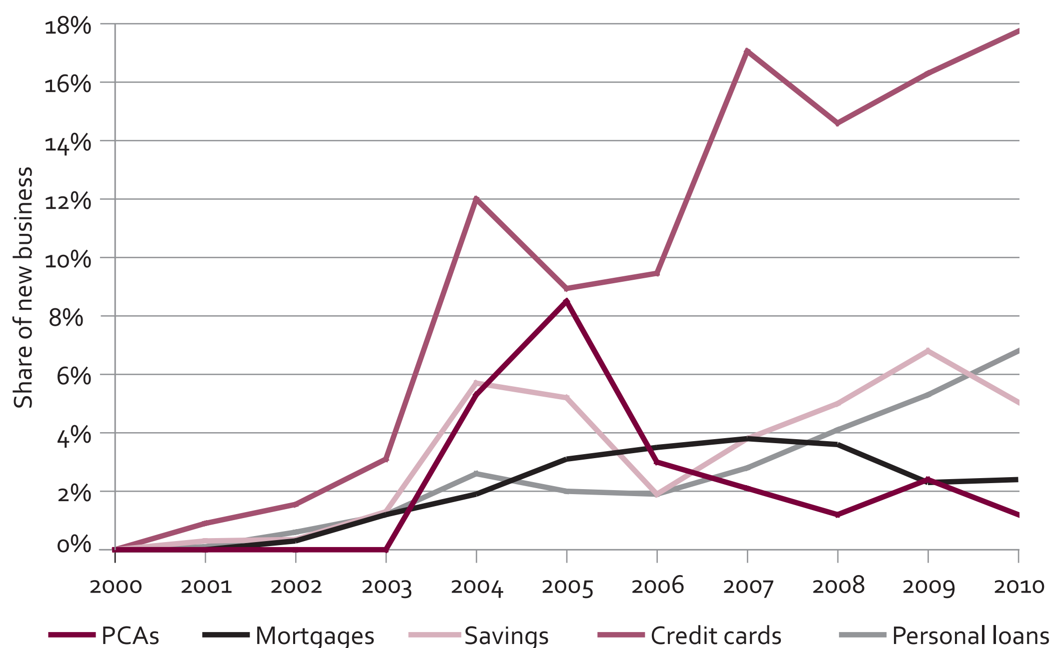
	PCAs	Mortgages	Savings accounts	Personal loans	Credit cards
Total number of new entrants	5	16	19	23	34

Source: GfK FRS and Commission calculations.[xv]

30 The 2004-2005 increase in PCA market share taken by new entrants is due to the Post Office entering the market. Unlike other new entrants, it already had an extensive network of branches and a large number of benefit claimants and pensioners who were beginning to receive payments electronically – including into accounts offered by the Post Office (see Annex 4).

31 New entrants are defined as those with no market share in 2000 that subsequently gained any market share or share of new business.

Figure 7.2: Share of new business each year for new entrants since 2000



Source: Commission analysis of data provided by GfK FRS.[xvi]

7.23 One of the potential barriers to entry identified by the OFT was customers' preference for banks with branch networks. Some respondents to the *Interim Report* argued that the internet had reduced or removed this barrier, as it made it possible to enter the market without an extensive branch network.[32] Other respondents emphasised the need for a branch network to enter the PCA and SME markets,[33] and one recent entrant has based its brand differentiation on improving branch-based service. Customer survey data consistently shows that branch-related attributes are top of customers' reasons for choice of PCA provider, and that this is not decreasing over time, despite the change in how customers interact with their bank once they have opened an account.[xvii] In addition, share of new business is very highly correlated with banks' shares of the national branch network,[xviii] providing additional quantitative evidence that the branch network remains important for consumers in choosing their bank. The proportion of customers banking with internet-only brands has remained low and stable between 2003 and 2010, despite their generally better prices and higher customer satisfaction ratings.[xix] Thus, lack of a branch network is still a significant barrier to entry despite developments in technology, as most customers

32 For example, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.
33 For example, see Virgin Money, 2011, *Virgin Money Response to ICB Interim Report*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Virgin-Money-response-to-ICB-Interim-Report-040711-FINAL-redacted.pdf.

view internet banking as a complement to branch-based banking, rather than a substitute.[34]

7.24 One bank also submitted evidence that intermediaries, such as independent financial advisers, provide a distribution network for banks to reach customers without the need for branch networks. It is clear that this has been a characteristic of the mortgage market. However, for PCAs and BCAs evidence shows that intermediaries are not a major factor in competition.

7.25 The *Interim Report* highlighted that small banks might be disproportionately affected by prudential regulation (Paragraphs 5.19-5.21), creating a regulatory barrier to entry. There are three potential ways in which small banks or new entrants might face higher capital requirements than large incumbents: they might be penalised for less experienced management or lack of a track record (especially new entrants); they might be required to hold extra capital to compensate for concentration in a particular market or geographical region (especially small banks); or the risk weights on their assets might be higher due to using a standardised rather than advanced approach to risk-weighting.

7.26 Small and new banks typically use the standardised approach to risk-weighting, which can produce higher risk weightings than the advanced methods used by large banks. New banks do not have the back history of data nor the experience of managing their assets required for the transition to the advanced approaches.[35] And small banks tend not to have the scale to justify the investment in the transition to the advanced approaches.

7.27 On certain types of asset, there can be a substantial difference in risk-weighting between the two approaches. One of the most extreme differences is for prime mortgages (i.e. mortgages with less than 80% loan-to-value (LTV) ratio made to good quality borrowers), where the standardised risk weighting is 35%, while weightings calculated with advanced models tend to be around 10% (and may be lower). This means that a small bank using a standardised approach could need to hold more than three times as much capital against a good-quality mortgage book as a large diversified bank using an advanced internal ratings-based (IRB) approach.[36]

34 It is worth noting that in 2001, internet and telephone banking were already being pointed to as offering the potential for new entrants to put competitive pressure on incumbents: see for example Paragraph 5.8 of the CC's report into the proposed Lloyds TSB/Abbey National merger (Competition Commission, 2001, *Lloyds TSB Group plc and Abbey National plc: A Report on the Proposed Merger*. Available at: http://www.competition-commission.org.uk/rep_pub/reports/2001/fulltext/458c5.pdf). Yet the evidence from the past decade clearly shows that internet-only banks have not succeeded in becoming mainstream players.
35 The FSA Handbook requires that a firm applying for permission to use one of the more advanced internal ratings-based (IRB) approaches to risk-weighting must demonstrate that it "has been using for the IRB exposure classes in question rating systems that were broadly in line with the minimum IRB standards for internal risk measurement and management purposes for at least three years prior to the date of its IRB permission."
See Paragraph 4.2.11, FSA, *Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU)*. Available at: https://fsahandbook.info/FSA/html/handbook/BIPRU/4/2.
36 The difference will depend on what other assets are held by banks, as there are floors to prevent too little capital being held overall through low risk weighting. But a diversified bank that holds assets with a variety of different risk profiles is unlikely to be constrained by these floors.

7.28 Table 7.3 shows the risk weightings for retail assets held by three banks and two building societies. It illustrates the differences that can arise between standardised and IRB risk weightings.

7.29 Table 7.3 shows that IRB risk weightings can be significantly lower than standardised weightings, and also that IRB risk weightings vary significantly from bank to bank (and building society to building society), depending on the riskiness of their assets. It also shows that at least one small building society – Norwich and Peterborough – has succeeded in using the IRB approach, so it is not impossible for small firms, though evidence suggests that it is less common for them. It is important to note that capital requirements for small, undiversified lenders will usually be constrained by an overall floor, whereas this is unlikely to be the case for diversified universal banks. In the table below, the three large banks would hold capital as determined by their IRB risk weighting, while the two building societies would be constrained by the floor and therefore required to hold more capital overall than Table 7.3 suggests.

Table 7.3: Risk weightings under the IRB approach for retail assets of select banks and building societies[37]

	Asset class (as reported)	Minimum standardised risk weightings for these asset classes[38]	Risk weighting under IRB (Commission calculations)
RBS	All retail[39]	<80% LTV mortgages: 35% 80%-100% LTV mortgages: 35%-43% Other retail lending (unsecured): 75%	36%
LBG	Residential mortgages	<80% LTV mortgages: 35% 80%-100% LTV mortgages: 35%-43%	16%
Barclays	Retail secured by real estate collateral	<80% LTV mortgages: 35% 80%-100% LTV mortgages: 35%-43%	16%
Nationwide	Retail mortgages (prime secured against residential property)	35%	5%
Norwich and Peterborough	Residential mortgage (prime)	35%	11%

Source: Commission analysis of Pillar 3 disclosures.

7.30 The Commission did not receive clear evidence that the additional capital that small or new banks might be required to hold to address, for example, concentration risk and proven management capability, is unreasonable, though it was suggested that the process could be made more transparent.[40] Nor did the Commission receive compelling evidence that liquidity regulations structurally disadvantage small or new banks, although there do appear to have been some implementation problems with the Financial Services Authority's (FSA) application, and ongoing review, of such regulations.

37 Commission calculations based on RBS, 2010, *Pillar 3 Disclosure 2010*. LBG, 2010, *Basel 2 Pillar 3 Disclosures*. Barclays, 2010, *Basel II Pillar 3 Disclosures*. Nationwide, 2011, *Pillar 3 Risk Disclosures*. Norwich and Peterborough, 2010, *Risk Profile Disclosure*. The banks show aggregate figures for a variety of retail assets, including mortgages of various qualities. Therefore, the IRB risk weighting should be compared to the standardised risk weightings for this range of assets. The building societies show figures specifically for prime mortgages – these IRB risk weightings can be compared to a standardised risk weighting of 35%.
38 Actual risk weightings are likely to be higher, as mortgage books may include mortgages where borrowers are behind on their payments, or where house prices have fallen resulting in LTVs exceeding 100%. For example, 13% of LBG's mortgage portfolio has an indexed LTV ratio of greater than 100%, and 0.9% of the portfolio has an LTV greater than 100% and is more than 3 months in arrears. (See LBG, 2010, *Basel 2 Pillar 3 Disclosures*.) For these mortgages, the standardised risk weighting would be substantially higher than the 35%-43% range in Table 7.3.
39 Includes SME lending, mortgages, credit cards, overdrafts and loans.
40 For an overview of the FSA's approach to Pillar 2 scalars, see: FSA, 2007, *Our Pillar 2 Assessment Framework*. Available at: http://www.fsa.gov.uk/pubs/other/Pillar2_framework.pdf.

7.31 Some new entrants experienced difficulties with the FSA process for determining capital and liquidity requirements. Some found that it was difficult to present an investment case to investors when the FSA judgement of capital and liquidity requirements could be very different to their own internal modelling. Additionally, the process for reviewing capital and liquidity requirements was in their view inconsistent and, combined with the opacity of the FSA's methodology, could make it difficult for banks to understand how to improve their risk management or manage their capital and/or liquidity requirements. However, other new banks gave evidence that the process was appropriate and fair.

7.32 This evidence is consistent with the OFT's review of barriers to entry.[41] In some cases, the application of prudential standards may have anti-competitive effects. The standardised risk weights can be burdensome for certain (relatively less risky) business models, or can incentivise banks using the standardised approach to take on the maximum risk allowable under each category of risk weighting. The result may be that small banks are less systemic and easier to resolve than large banks, and yet are required to hold proportionally more capital. The Commission's recommendations on loss-absorbency, by requiring large ring-fenced banks to hold higher levels of capital, will help to level the playing field between large and small banks.

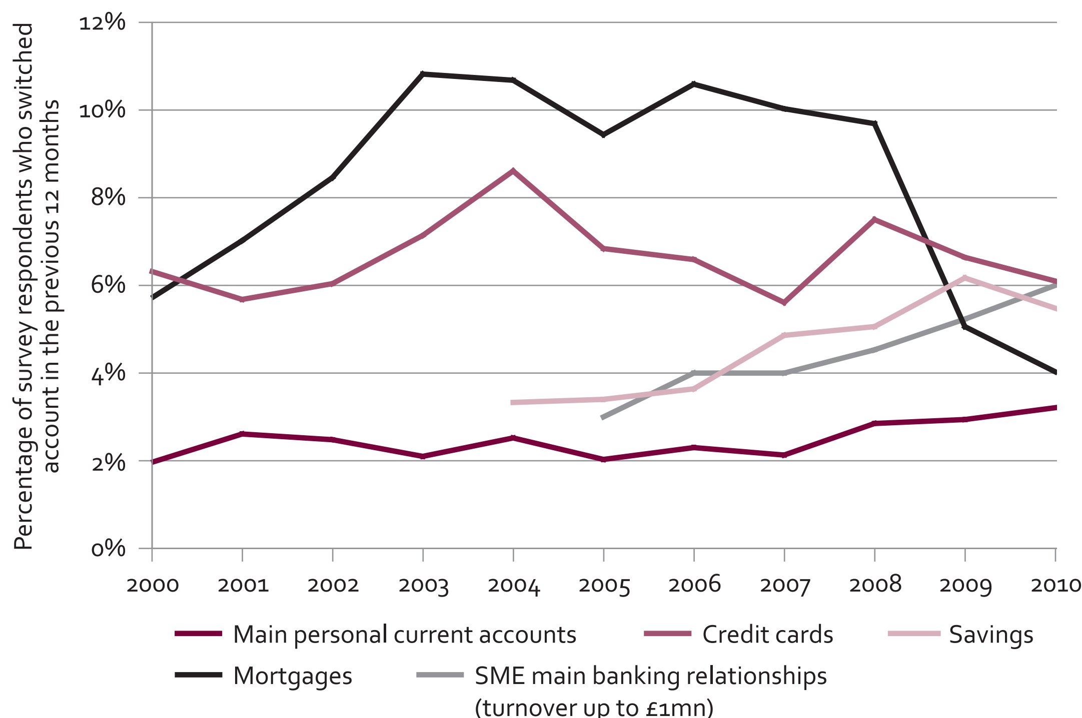
Switching and choosing providers

7.33 Competition between banks is blunted by the actual and perceived difficulties for customers in identifying the right account for their needs and switching to it, and by poor conditions for consumer choice more generally. Without consumers being willing to switch between competitors, banks have weak incentives to provide better offers. The OFT study of PCAs in 2008 found that a significant proportion of consumers believe that it is complex and risky to switch accounts, with the result that switching rates are very low. Few consumers actively monitor the relative competitiveness of their accounts. It also found that many consumers are not familiar with the key fees associated with their PCA, and that they have difficulty understanding and calculating these fees.[42]

41 OFT, 2010, *Review of Barriers to Entry, Expansion and Exit in Retail Banking*. Available at: http://www.oft.gov.uk/shared_oft/personal-current-accounts/oft1282.

42 OFT, 2008, *Personal Current Accounts in the UK*. Available at: http://www.oft.gov.uk/shared_oft/reports/financial_products/OFT1005.pdf.

Figure 7.3: Annual switching rates



Source: Commission analysis of data provided by GfK FRS, Charterhouse and TNS.[xx]

7.34 Figure 7.3 shows that annual switching rates are low for banking products.[43] Mortgages have the highest switching rates, peaking at just over 10% in the middle of the last decade. PCAs and SME banking appear to have low switching rates over time.[xxi] A switching rate of 3.8% (as in 2010 for PCAs) implies that customers move their current accounts only every 26 years, on average.[44] In addition, other research has found that three-quarters of consumers have never considered switching their current account.[45] This is similar for business customers: the OFT found that 51% of SME respondents have never switched their main banking relationship,[46] while the

43 Here, switching in personal banking markets is defined as those customers who reported that they had switched their account in the past 12 months or that they had opened an additional account with a different brand. This includes switchers between brands of the same banking group. Therefore, it is likely to overstate the total amount of switching (in the sense of opening a new account with a different banking group and closing an old account). In SME banking, switching refers to survey respondents who reported that they had changed their main bank within the past 12 months. This does not include the case where a SME has started an additional relationship with a different bank, and hence may underestimate the amount of shopping around, although evidence shows that multi-banking for SMEs with a turnover of less than £1mn is rare (Charterhouse Research UK Business Banking Survey 2010, based on more than 16,000 interviews with businesses conducted between January and December 2010 covering businesses with turnover up to £1bn).
44 Assuming that switchers are randomly distributed amongst the population of those with a PCA.
45 Consumer Focus found that 75% of customers have never considered switching their current account provider. Consumer Focus, 2010, *Stick or Twist*. Available at: http://www.consumerfocus.org.uk/files/2010/10/Stick-or-twist-for-web1.pdf.
46 See Annex C, OFT, 2010, *Review of Barriers to Entry, Expansion and Exit in Retail Banking*. Available at: http://www.oft.gov.uk/shared_oft/personal-current-accounts/oft1282.

Federation of Small Businesses found that 85% of businesses surveyed have not switched their main banking provider in three years.[47]

7.35 One bank contested the definition of switching used by the Commission, arguing that the switching rate was higher than indicated above. It suggested that a broader measure should be used, including customers who transfer internally within a bank or open a new account with the same brand, and customers who already have multiple accounts moving their money between providers. Table 7.4 presents the Commission's figures for switching PCAs plus other figures on PCA account opening for 2010. The Commission's definition of switching (customers who say they have switched accounts, plus those who have opened an additional account with a new brand) is already a broad measure of switching – it will overestimate the number of customers who have opened a new current account with a different banking group and transferred their direct debits and salary mandate over to it. It is a broad measure of the extent to which existing customers are exerting competitive pressure on brands: moving their custom either to take advantage of a better offer elsewhere, or in reaction to poor service from their old bank. This is in line with the methodology used in other markets, and with other previously reported switching rates for PCAs (see Paragraph A4.51). A wider definition, for example including internal transfers or people moving money back and forth between accounts, would be a less accurate indicator of competitive pressure – there is unlikely to be strong competition for internal transfers, and although some people have multiple accounts, many of these will be either dormant or for a particular purpose, such as sole and joint accounts.[48]

47 Federation of Small Businesses, 2010, *The FSB-ICM 'Voice of Small Business' Annual Survey*. Available at: http://www.fsb.org.uk/policy/assets/fsb%20icm%20annual%20survey%20uk.pdf.

48 In addition, it is unlikely that customers manually switch their salary mandates and direct debits back and forth between PCAs in response to changing interest rates, given that banks tend not to offer assistance with this kind of partial switch. In any case, they would still only be switching between a small number of banks, rather than comparing all offers across the market.

Table 7.4: All new business in the PCA market (2010)[49]

Reason for opening a new PCA	Percentage of survey respondents who gave each reason for opening a new PCA in the previous 12 months
Switched accounts	2.1%
Opened an additional account with a different brand	1.8%
Subtotal: switcher definition used in this report	**3.8%**
Transferred internally between accounts	1.4%
Opened an additional account with the same brand	1.0%
Re-entered PCA market	0.3%
Opened first ever account	1.2%
Total new accounts opened	**7.7%**

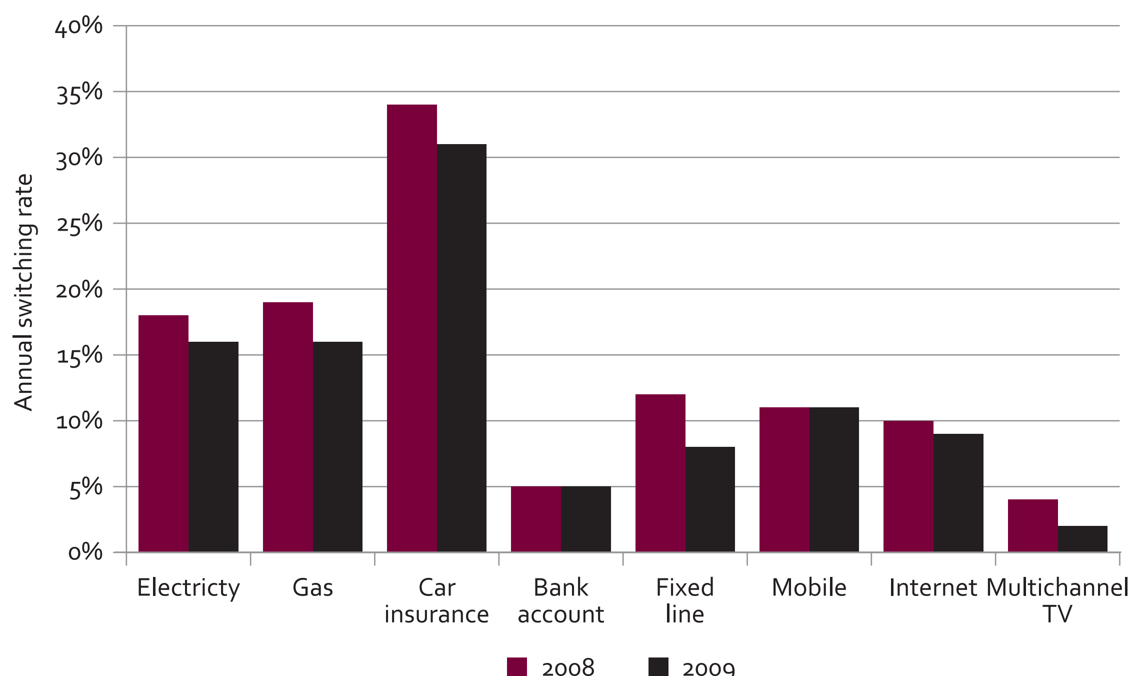
Source: GfK FRS[xxii]

7.36 The low switching rates in the PCA and BCA markets are an important barrier to competition not only for those products but also for others, because they define a customer's main banking relationship and enable cross-selling of other products. Cross-selling off PCAs is more effective than cross-selling off other retail products: small banks in particular may be reliant on cross-sales to maintain a presence across multiple markets.[50] Banks that offer BCAs have a substantial advantage over those that do not, as they are able to gather transactional history on the customer before issuing a loan or overdraft. As the vast majority of SME customers have their main banking relationship with one of the largest five banks (90% in 2010), this gives these banks an advantage in supplying many business banking services.[xxiii]

7.37 Switching rates for PCAs are low relative to other markets – see Figure 7.4. For example, Ofgem recently reported that during 2010, 15% of consumers reported switching their gas supplier and 17% reported switching their electricity supplier.[51] Consumer Focus also conducted a survey in 2010 comparing switching rates across industries, and found that only 7% of respondents had switched current accounts in the past two years, compared to 31% who had switched energy provider, 26% who had switched telephone provider, and 22% who had switched insurance provider.[52]

49 Numbers do not add as a result of rounding.
50 This is not to suggest that customers automatically buy all of their products from the same bank, without shopping around. However, there is evidence that personal customers' main current accounts, and businesses' main bank relationships, act as gateways, as cross-selling off these products is more effective than off other products, and banks that hold a customer's main relationship stand a greater chance of being selected for further product sales than do other banks.
51 Ofgem, 2011, *The Retail Market Review – Findings and Initial Proposals*. Available at: http://www.ofgem.gov.uk/Markets/RetMkts/rmr/Documents1/RMR_FINAL.pdf.
52 Consumer Focus, 2010, *Stick or Twist*. Available at: http://www.consumerfocus.org.uk/files/2010/10/Stick-or-twist-for-web1.pdf.

Figure 7.4: Switching rates in banking, communications and utilities in 2008 and 2009

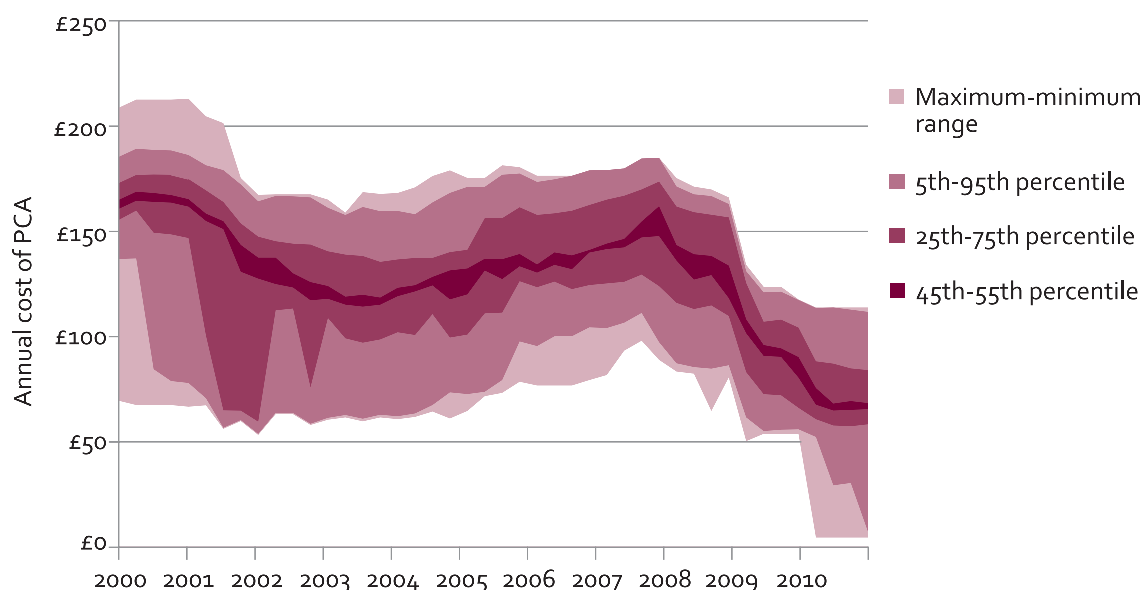


Source: Ofcom[53]

7.38 Low levels of *actual* switching on their own would not be a concern if consumers were *willing and able* to switch quickly when differences between firms' products or prices occurred. However, there appears to have been persistent price dispersion over the past decade for PCAs and BCAs.[54] Figure 7.5 shows the dispersion in total annual cost of a current account to consumers who keep a moderate balance in their account and do not make extensive use of unarranged borrowing ('Type B' consumers).[55] The difference between the 25th and 75th percentile for these customers has been around £40 per year on average over the past decade, showing that there are significant savings to be made by moving between accounts. While price dispersion can occur in competitive markets, its conjunction with low switching indicates that in these markets customers have tended not to switch to better deals that have existed.

53 Figure 143, Ofcom, 2009, *The Consumer Experience 2009*. Available at: http://stakeholders.ofcom.org.uk/binaries/research/consumer-experience/research09.pdf.
54 Price dispersion measures the variation in prices being offered to customers. If banks are able to offer very different rates for similar products (high price dispersion), this suggests that customers are not switching to take advantage of better prices elsewhere.
55 Unarranged overdraft charges are charges paid by PCA customers for using, or attempting to use, an unarranged overdraft. They are also sometimes called unauthorised or unplanned overdraft charges.

Figure 7.5: Dispersion of total annual cost of a standard PCA for 'Type B' consumers[56]



Source: Commission analysis of data provided by Defaqto.[xxiv]

7.39 Low switching rates for PCAs are not unique to the UK, and rates in the UK are close to the average for the European Union (EU). However, for other products (mortgages, savings and personal loans), UK switching rates are relatively high by EU standards.[57]

7.40 Some respondents suggested that the reason for low switching rates is that customers are highly satisfied with their banking services.[58] Survey data show that on average, between 65% and 69% of customers have been very or extremely satisfied with their PCA over the past decade.[xxv] However, other research found that "although customers are satisfied, there is a proliferation of 'passive satisfaction'". It suggested that customers were equating satisfaction with an absence of negatives, rather than positive reasons.[59] Dissatisfied customers are more likely to switch accounts than satisfied customers, but only 25% of very dissatisfied customers, and 40% of extremely dissatisfied customers, are likely to switch.[60] High satisfaction clearly cannot explain the low switching rates. This is reinforced by evidence received from other

56 See Annex 4 for details of consumer profiles.
57 Gallup Organisation, 2009, Consumers' views on switching service providers: analytical report, *Flash Eurobarometer Series No.243*. Available at: http://ec.europa.eu/public_opinion/flash/fl_243_en.pdf.
58 For example, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.
59 Page 24, Quadrangle, 2011, *PCA Consumer Research Findings*. Available at: http://www.quadrangle.com/PCA_switching_consumer_research.pdf.
60 LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.

respondents, showing that potential switchers are put off by worries about the switching process and lack of trust in banks.[61]

7.41 There is significant evidence to show that consumers are put off by the current switching process. To switch current accounts, it is necessary for all direct debit originators to update their records with the customer's new account details, and for the customer to notify their employer and anyone else who makes payments into their account of their new account details. On average, this process takes around 18 days,[62] and requires action by the customer, both the new and the old banks, direct debit originators, and employers and other people or organisations that make payments to the customer.

7.42 The OFT has taken steps to improve this process: in 2009, following its review of the PCA market, it worked with Bacs[63] to increase consumer awareness of the switching process, improve practice by direct debit originators, and update Bacs rules. In 2010, 85% of switchers reported that they were satisfied with the switching process.[64] However, even a small risk of a problem may be enough to deter potential switchers, and the *perception* of ease of switching is as important as the actual level of problems experienced: 41% of customers are not very or not at all confident in moving their account, and 55% think that it would be "a lot of hassle".[65] These fears are grounded in reality: although Bacs evidence shows that only around 8.5% of direct debits are sent to the old account after a customer has switched,[66] for an account with multiple direct debits this equates to a substantial chance that at least one of them will go wrong. This is supported by evidence from customers who have switched: Consumer Focus found that 44% of customers who had switched had had problems with the switching process, with 27% having problems transferring direct debits.[67]

7.43 For business customers switching accounts, there is an additional barrier: switching secured borrowing between banks. This was identified by the CC in its inquiry into SME banking in 2002, which found inherent difficulties in the process, including the need for the new bank to satisfy itself as to the existence, title, nature and value of the

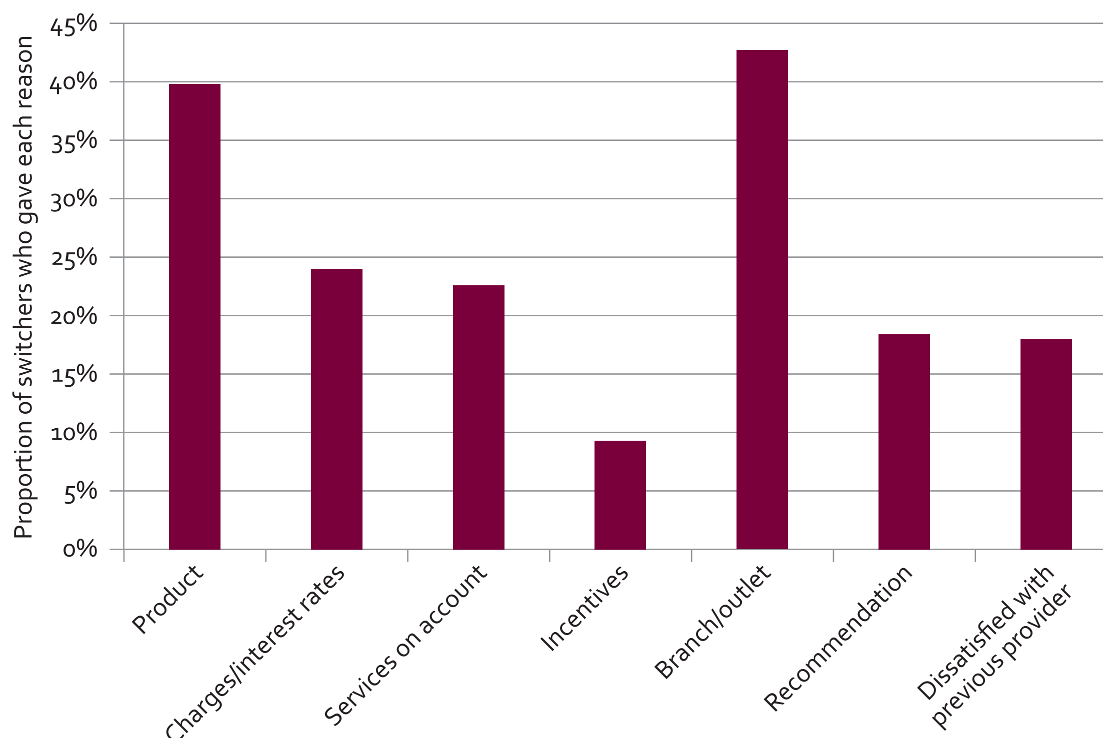
61 Which?, 2011, *Which? Response to the ICB Interim Report*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Which.pdf. Consumer Focus, 2011, *Consumer Focus Response to the Independent Banking Commission Consultation on Reform.* Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Consumer-Focus.pdf.
62 Bacs, 2011, *Account Switching Timeline*. Available at: http://www.thesmartwaytopay.co.uk/SiteCollectionDocuments/Account_switching_timeline.pdf.
63 Bacs (originally known as Bankers' Automated Clearing Services) is an industry body responsible for the schemes behind the clearing and settlement of automated payments in the UK.
64 OFT, 2010, *Review of Barriers to Entry, Expansion and Exit in Retail Banking*. Available at: http://www.oft.gov.uk/shared_oft/personal-current-accounts/oft1282.
65 "Quantitatively, the data tells us that, basically, the market isn't working." Page 13, Quadrangle, 2011, *PCA Consumer Research Findings*. Available at: http://www.quadrangle.com/PCA_switching_consumer_research.pdf.
66 Paragraph 1.7, OFT, 2011, *Personal Current Accounts in the UK: Progress Update*. Available at: http://www.oft.gov.uk/shared_oft/reports/financial_products/PCA_update_March_2011.pdf.
67 Consumer Focus, 2010, *Stick or Twist*. Available at: http://www.consumerfocus.org.uk/files/2010/10/Stick-or-twist-for-web1.pdf. This does not mean that the OFT's initiatives have had no success, since it is not clear that all of the switchers surveyed had switched after the OFT's changes had taken effect. However, it presents a recent survey of switching experience.

security.[68] The CC called for the banks to conduct a study into the possibility of transferring security. That study found that transferring security was not feasible, but since then there have been improvements in information sharing on security processes, which could be a basis for improving the switching process for SMEs with secured borrowing.[69]

7.44 Whether consumers are switching or opening a new account, how do they choose their provider? Figure 7.6 below shows the reason given by people who switched accounts for their choice of a new PCA provider. They were most likely to cite branch and product characteristics as the main factors in their choice of new PCA.[xxvi] These results are similar to the reasons given by all those who chose a new PCA provider in 2010 – not just those who switched. As discussed in the earlier section on barriers to entry, branch characteristics (location, opening hours, etc.) have been consistently the most common reason for choosing a PCA provider for the last decade,[xxvii] and are also important in SMEs' choices of banking provider.[70] For other personal banking products such as mortgages, credit cards, savings and personal loans, charges and interest rates are the most important factor in consumers' choice of provider. Qualitative factors are still important, however, including the staff, recommendations, and existing relationships with the provider.[xxviii]

68 See Page 140, CC, 2002, *The Supply of Banking Services by Clearing Banks to Small and Medium-Sized Enterprises*. Available at: http://www.competition-commission.org.uk/rep_pub/reports/2002/fulltext/462c4.pdf.
69 See, for example, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.
70 OFT, 2010, *Review of Barriers to Entry, Expansion and Exit in Retail Banking*. Available at: http://www.oft.gov.uk/shared_oft/personal-current-accounts/oft1282.

Figure 7.6: Reasons for choosing their personal current account provider given by those who switched provider in the last 12 months (2010)



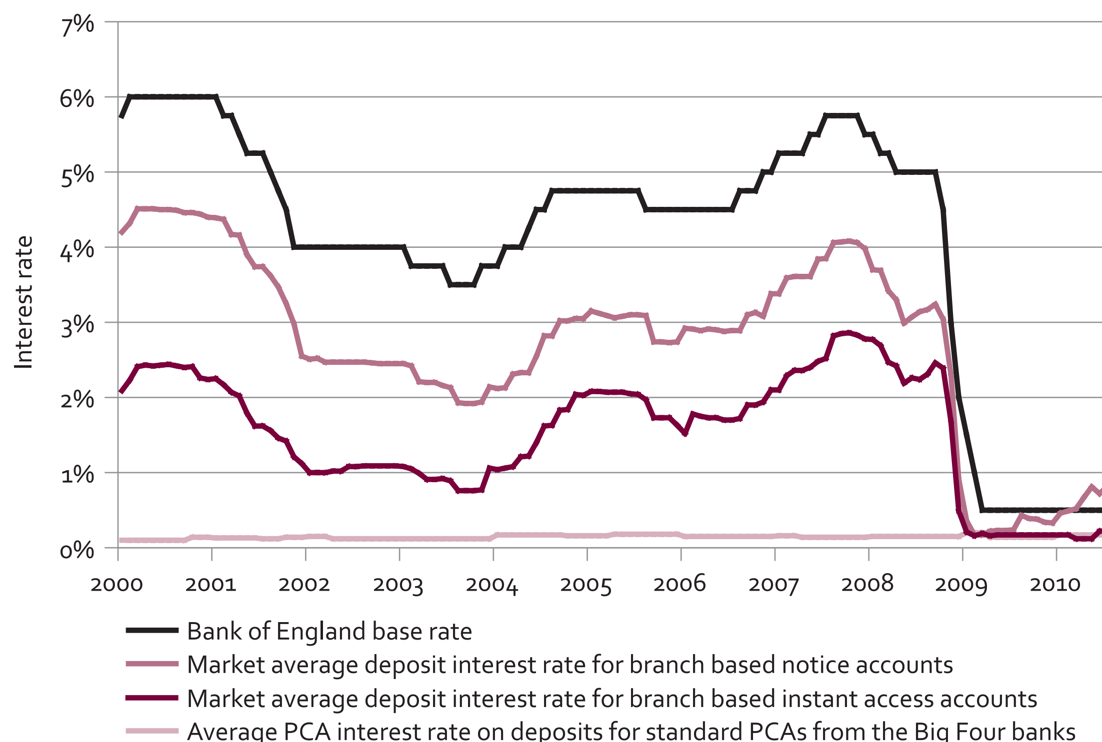
Source: Commission analysis of GfK FRS.[xix]

Pricing and transparency

7.45 Figure 7.7 shows that the PCA deposit rate for the four biggest banks did not change in response to changes in the underlying base rate even when that varied between 4% and 6%. This is an indication of a lack of competition on price, as in a competitive market, price would be expected to move when costs move. PCAs, particularly free-if-in-credit PCAs, have a more complex pricing structure than savings accounts, and interest paid on deposits makes up a greater proportion of the cost of savings accounts than of PCAs. However, Figure 7.7 shows barely any change in the PCA deposit rate at all. This suggests that banks are earning considerably more from PCAs when official interest rates are high than when they are low, as now. It should however be noted that banks have not been able to fund themselves at rates close to the official rate since mid-2007. Even though the official rate has been at 0.5% since March 2009, banks' marginal funding costs have been in the region of 2% (for new household secured lending) and have recently been estimated at 2.5%.[71] The current spread between marginal funding costs and PCA deposit rates is therefore considerably greater than indicated by base rate. Lending spreads over base rate have also widened at least as much as funding spreads over base rate.

71 Marginal funding costs are estimated as 3-month Libor plus a weighted average of lenders' CDS premia. See Page 16, Bank of England, *Inflation Report, August 2011*. Available at: http://www.bankofengland.co.uk/publications/inflationreport/ir11aug.pdf.

Figure 7.7: Average interest rate for deposit products



Source: Bank of England and Commission analysis of data provided by banks, GfK FRS and Defaqto.[xxx]

7.46 Part of the reason for low importance of price factors in customers' choice of PCA may be the prevalence of the free-if-in-credit pricing model, in which customers do not incur fees or charges for account use as long as they keep a positive balance in their PCA. Banks derive revenues from PCA customers in various ways, including:

- net interest margins – the difference between the interest on loans enabled by deposits and the interest paid on current account deposits;
- monthly fees and transaction fees, if any;
- charges for arranged and unarranged overdraft facilities; and
- revenues from products and services sold to PCA customers alongside PCA provision – savings accounts, personal loans, mortgages, credit cards, insurance, etc.

7.47 The cost that customers incur (and their profitability to the bank) varies according to their pattern of account usage and related purchasing. Introductory rates, which are

prevalent on both savings and loan products, are another source of variation in cost. This inhibits transparency in pricing, as customers need to understand both the full range of prices associated with their account (during and after introductory periods), and the nature of their own account usage.

7.48 One consequence is considerable price discrimination in markets for banking services, in that some services supplied to some customers appear to make little money while others have high mark-ups. There have been recent efforts by the competition authorities to address seemingly highly-priced services. In 2007, following action that had reduced late fees on credit cards, the OFT began an investigation into the fairness of unarranged overdraft fees on PCAs. The banks challenged the OFT's powers under the Unfair Terms in Consumer Contracts Regulations to do this. The fairness test in those Regulations may not be applied to the price or remuneration for the services provided, so long as the contract terms at issue are in plain intelligible language. The OFT's case was upheld, for the most part, in the lower courts, but in November 2009 it lost in the Supreme Court, where the terms for unarranged overdraft charges were declared to "constitute part of the price or remuneration for the banking services provided".[72]

7.49 Separately, the market for payment protection insurance (PPI) services has also been found to be a source of excess profits, as well as a common area of mis-selling (see Box 7.1).[73] Banks found that they could earn large fees by selling PPI alongside a loan or mortgage, and in many cases through misleading sales techniques. This may have distorted the market for loans, as banks had an incentive to make loans in order to earn fees from PPI, even where the loan itself might not have been profitable. This is an example of misdirected competition: instead of increasing their earnings by selling products that met consumer needs on better terms than their competitors, banks profited by selling inappropriate PPI contracts to many customers that were overpriced and unsuitable for customers' needs.

72 Page 22, Office of Fair Trading v Abbey National plc & Others (2009) UKSC 6: http://www.supremecourt.gov.uk/docs/uksc_2009_0070_judgmentV3.pdf.
73 R (on the application of the British Bankers' Association (BBA)) v Financial Services Authority (FSA) [2011] EWHC 999 (Admin). Available at: http://www.bailii.org/ew/cases/EWHC/Admin/2011/999.html.

Box 7.1: Payment Protection Insurance

PPI is a contract which insures the payments of a policyholder's obligations (e.g. a mortgage or a loan) in the event of redundancy, or an accident or injury resulting in involuntary unemployment or the incapacity to work. While PPI can be purchased from insurance providers as a standalone policy, it has in fact more often been bought alongside credit products sold by banks (i.e. at the point of sale).

In its 2005 review into the selling of PPI, the Citizens Advice Bureau (CAB) concluded that customers were often sold policies that were inappropriate for them, without a complete explanation of the cost and the terms of the policy, and called for the FSA to regulate the sale process more closely.[1] This led to a super-complaint from the CAB, encouraging the OFT to investigate the competitive aspects of the market.[2]

In its review into the selling practices of PPI policies, the FSA found that PPI policies were often mis-sold, with many providers not explaining the coverage of the policy, nor that it was only an optional, rather than a compulsory component of their credit product. Furthermore, distributors often failed to disclose the monthly cost of the policy, as well as its full cost over the term of the loan, resulting in the policy being purchased by customers who could not necessarily afford it.

Even after this issue was brought to light by the FSA, its investigation in 2007 still found significant issues in the selling process of PPI. For example, a mystery shopping exercise revealed that only 28% of the 'customers' were asked in some way about their health, despite the accident and sickness element of PPI cover typically not covering claims resulting from an existing medical condition.[3]

In 2008, the Financial Ombudsman Service (FOS), which deals with individual complaint handling, wrote to the FSA, drawing attention to the high number of PPI complaints.

Table 7.5: PPI complaints referred to the Financial Ombudsman Service (FOS)

Year ending 31st March	Number of complaints referred to FOS	Proportion of complaints upheld by FOS
2006	1,315	–
2007	1,832	–
2008	10,652	47%
2009	31,066	89%
2010	49,196	89%
2011	104,597	66%
Apr-Jun 2011	56,025	55%

Source: FOS annual reviews and complaint statistics.

Box 7.1: Payment Protection Insurance (continued)

In response, the FSA consulted on a set of rules for complaint handling procedures, which included redress procedures for historic policy purchases. In 2010, the British Bankers' Association (BBA) launched a judicial review on behalf of a number of high street banks, challenging the FSA's new rules and the OFT's handling of the complaints. On 20 April 2011, the legal challenge was rejected by the High Court, and the BBA and the banks decided a month later not to appeal.[4] The FSA has now set out a timetable for banks to review PPI complaints and reimburse customers where appropriate.[5] Already, a number of lenders have made provisions for PPI redress, with the largest five banks making provisions of almost £6bn in total.

[1] Citizens Advice Bureau, 2005, *CAB Evidence on Problems with Payment Protection Insurance*. Available at: http://www.citizensadvice.org.uk/index/policy/policy_publications/er_credit_debt/protection_racket.htm.

[2] The OFT investigation led to a referral to the CC, which found that due to banks having a 'point-of-sale' advantage over other insurance providers, there was little competition in the market, resulting in higher prices for customers. It noted that banks were able to charge over 40% commission for various PPI policies. The 12 largest distributors made £1.4bn worth of profits from unclaimed PPI premiums, resulting in a 490% return on equity. CC, 2009, *Market Investigation into Payment Protection Insurance.* Available at: http://www.competition-commission.org.uk/rep_pub/reports/2009/fulltext/542.pdf.

[3] FSA, 2007, *The Sale of Payment Protection Insurance: Thematic Update*. Available at: http://www.fsa.gov.uk/pubs/other/ppi_thematic_update.pdf. To date, the FSA has taken action against 24 firms for PPI mis-selling, with fines totalling £12.6mn.

[4] R (on the application of the British Bankers' Association (BBA)) v Financial Services Authority (FSA) [2011] EWHC 999 (Admin). Available at: http://www.bailii.org/ew/cases/EWHC/Admin/2011/999.html.

[5] FSA, 2011, *FSA Grants Temporary Extension for Some PPI Complaints*, 13 June. Available at: http://www.fsa.gov.uk/pages/Library/Communication/PR/2011/049.shtml.

7.50 A second important consequence of the pricing model described above is that it is not transparent, and hence customers find it difficult to compare PCAs to find which is the most cost-effective for their pattern of usage. Some respondents to the *Interim Report* submitted evidence that complexity in pricing structures makes it difficult for consumers to receive good value. One went as far as to suggest that firms design complex tariffs and pricing structures to decrease the ability of consumers to compare prices.[74]

7.51 The OFT has found that many customers are not familiar with the key fees associated with their PCA, and that they have difficulty understanding and calculating these fees. It concluded that there are low levels of transparency in the PCA market on unarranged overdraft charges, foregone interest and other fees.[75] In order to have a transparent market, consumers need to be able to:

- work out what services they are currently receiving, and at what cost;

74 Which?, 2011, *Which? Response to the ICB Interim Report*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Which.pdf. Consumer Focus, 2011, *Consumer Focus Response to the Independent Banking Commission Consultation on Reform*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Consumer-Focus.pdf.
75 OFT, 2008, *Personal Current Accounts in the UK*. Available at: http://www.oft.gov.uk/shared_oft/reports/financial_products/OFT1005.pdf.

- search the market for other services and estimate their cost and service levels; and
- make a decision about the best product for them based on the information collected.

7.52 Price comparison tools help customers to go through this process in many other sectors. But they are not widely used in choosing PCAs and BCAs, with only 2.4% of PCA customers citing comparison sites as being important in their choice of account in 2010.[xxxi] This is reinforced by confidential data provided to the Commission by banks showing the percentage of PCA and BCA account openings that come through comparison sites. Price comparison sites do not appear to be effective in comparing current accounts, and given how little they are used in PCA switching there is little incentive currently for the sites to invest in improving this service.

7.53 Transparency is important because without it consumers do not know whether they can get a better deal elsewhere, and hence they are unlikely to switch to better products even if the switching cost is low. Therefore, banks will be under little competitive pressure, and new banks will find it hard to enter the market. For some time regulators have been working to increase transparency in financial services as well as other sectors. For example, Ofgem recently attempted to increase transparency of energy prices by proposing new regulations to limit energy suppliers to one 'evergreen' product per payment method based on a single 'per unit' price.[76]

7.54 It is incumbent on banks to ensure that customers are aware of their banking costs, have ready access to the information required to compare alternative offers, and have confidence in the switching process should they decide to move bank. In some respects, PCAs are naturally more complex than other financial services, or utilities. However, greater transparency would help consumers to understand their PCAs better, and provide the conditions for third parties (such as price comparison websites) to be effective in helping customer to choose suitable accounts.

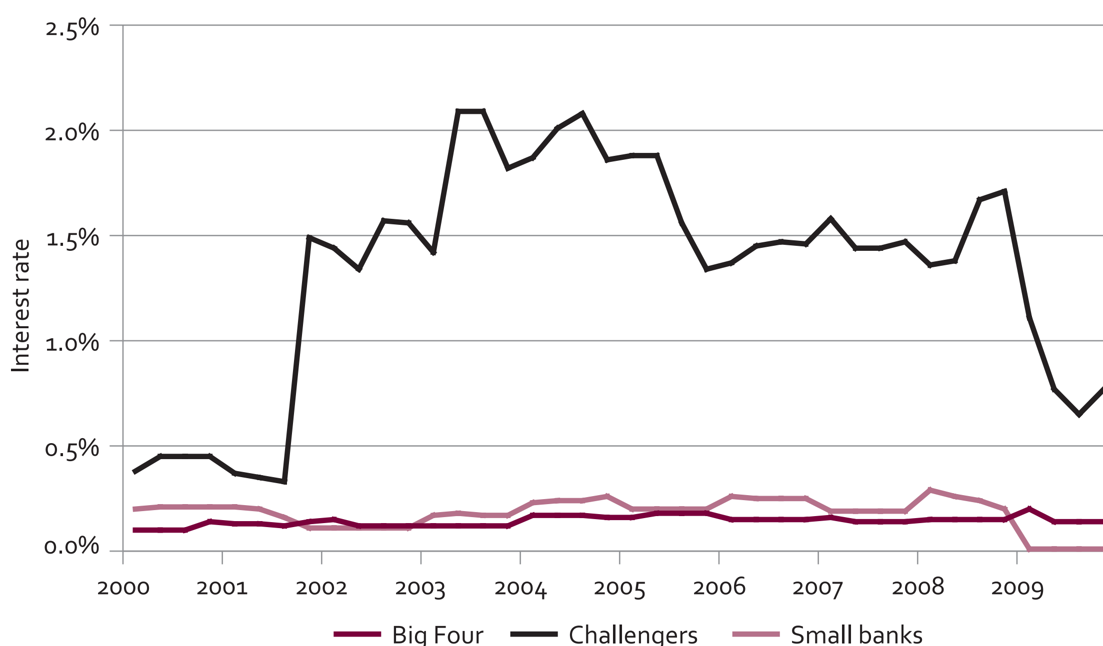
Importance of challengers

7.55 Challenger banks are those that have a strong incentive to compete for new market share combined with the ability to be a significant competitive constraint on the major incumbents. In 2008, the OFT took the view that HBOS, Santander and Nationwide were the main challengers to the incumbent banks in the PCA market. The OFT concluded that the Lloyds TSB/HBOS merger would remove a major driver of competition in the market.[77]

76 Ofgem, 2011, *The Retail Market Review – Findings and Initial Proposals*. Available at: http://www.Ofgem.gov.uk/Markets/RetMkts/rmr/Documents1/RMR_FINAL.pdf. Standard evergreen products are those that have no termination date.
77 OFT, 2008, *Anticipated Acquisition by Lloyds TSB plc of HBOS plc*. Available at: http://www.oft.gov.uk/shared_oft/press_release_attachments/LLloydstsb.pdf.

7.56 At various points over the past decade, there have been up to four challenger banks competing in the PCA and/or SME banking markets: HBOS, Nationwide, Abbey National and subsequently Santander, and Alliance & Leicester (from 2003 until its takeover by Santander). Figures 7.8 and 7.9 below show that challengers offered higher interest rates on standard[78] PCA balances and lower overdraft rates than the four biggest banks (the 'Big Four'). This did not appear to come at the expense of customer service. On average across the two groups, there was little difference in customer satisfaction between incumbents and challengers.[xxxii] This therefore indicates that challengers were competing harder for PCAs than incumbents, as is to be expected in markets with switching costs (see Paragraphs 2.49-2.50 of the *Interim Report*). Figure 7.8 also shows a clear difference in pricing between challengers and small banks.

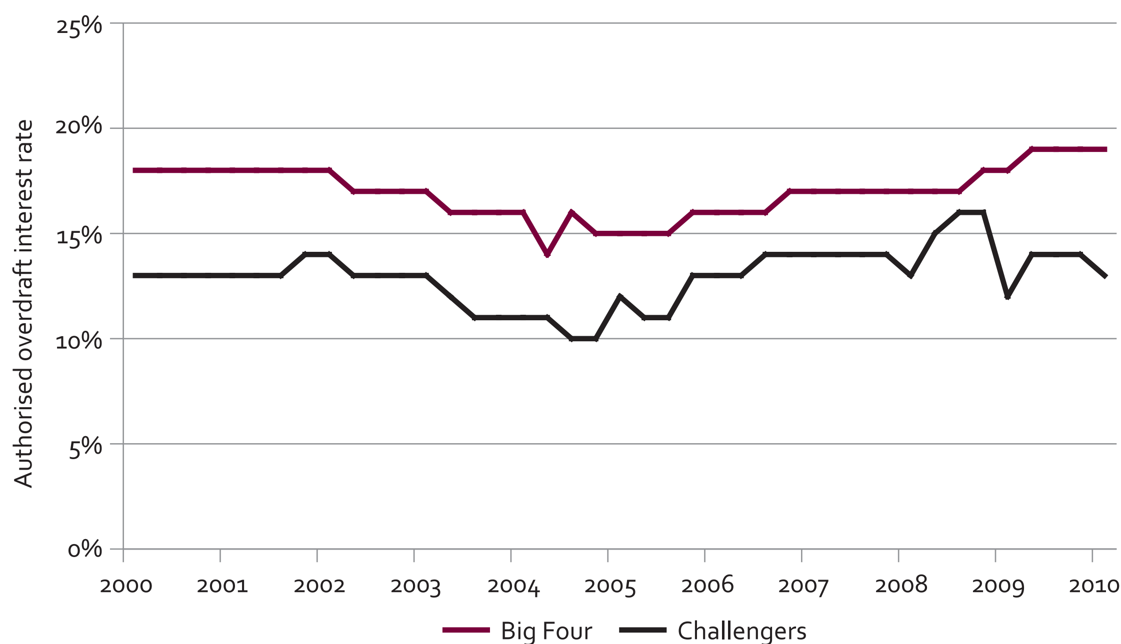
Figure 7.8: Estimated average interest rates on deposits for standard PCAs



Source: Commission analysis of individual bank data, GfK FRS and Defaqto.[xxxiii]

78 The Commission's analysis considered only standard PCAs, and not packaged accounts. Packaged accounts make up approximately 17% of the market, and include a wide variety of financial products in addition to a standard PCA. Given the difficulty in comparison, it is not obvious that challengers are either more or less costly for packaged accounts than incumbents, but it is clear that transparency and switching issues would be at least as strong for these products.

Figure 7.9: Average interest rates for authorised overdrafts on personal current accounts



Source: Commission analysis of data provided by Defaqto.[xxxiv]

7.57 In response to this observation in the *Interim Report*, one bank[79] submitted evidence to show that while challengers offered better rates on the visible charging structure of deposit and authorised overdraft interest, they imposed higher charges for unarranged borrowing, resulting in a higher total cost. Further analysis has shown that this was not significantly the case until 2005, but was true for three years after. However, this does not show that incumbents were competing strongly on total cost. For one thing, the large incumbents did not advertise their lower unarranged overdraft charges to attract new business. On the contrary, another respondent submitted evidence that unarranged overdraft charges were identified as an area where banks could generate greater profits specifically because they are less visible to consumers.[80]

7.58 Because unarranged overdraft fees are less visible to customers, the main changes in these charges appear to have been driven by regulation. In 2007, the OFT began an investigation into the fairness of unarranged overdraft fees on PCAs. Following the OFT's intervention, unarranged overdraft fees have fallen in recent years. In addition, large and small banks alike have introduced new products and charging structures in response to widespread concern about excessive unarranged borrowing charges.

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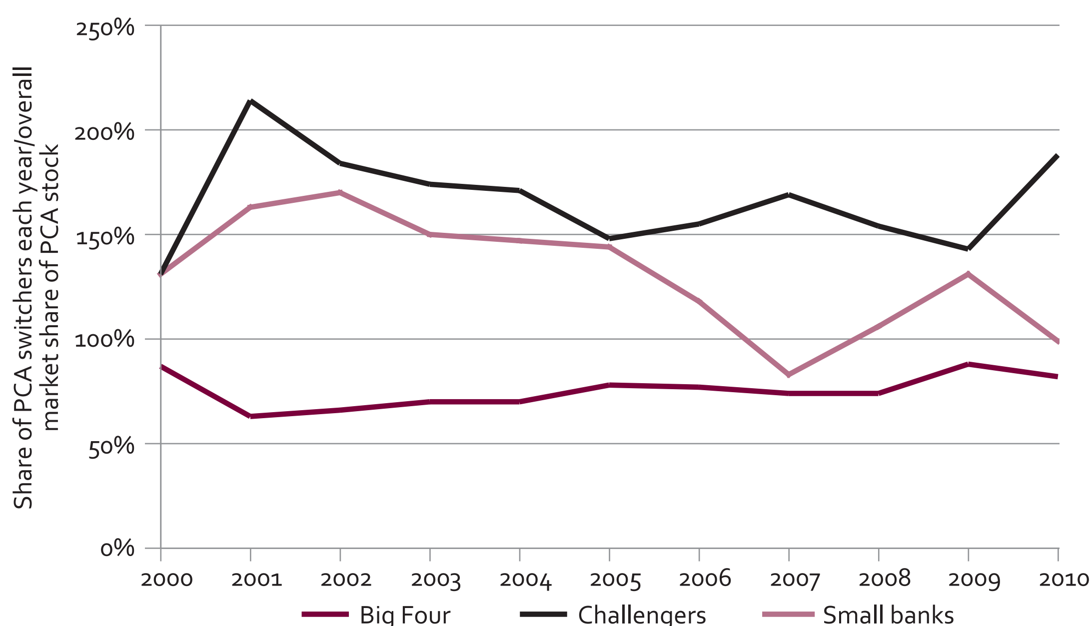
79 LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.
80 Which?, 2011, *Which? Response to the ICB Interim Report*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Which.pdf.

7.59 Further analysis of the total overall cost of a PCA for different customer types, including unarranged borrowing as well as deposit and overdraft interest rates, shows that on average over the past decade incumbents offered better rates than challengers for around 5% of the population who make extensive use of unarranged borrowing. However, for the rest of the population, on average challengers offered better rates, with a challenger bank offering the lowest average total cost around three-quarters of the time. (See Annex 4 for further details.)

7.60 The Commission's conclusion is that challengers do compete harder for PCAs, but that the competition problems associated with this product – including high and opaque charging structures for overdrafts – are not limited to incumbents.

7.61 This assessment is supported by challengers' success in attracting business. Figure 7.10 below shows that challengers attracted a greater proportion of switchers relative to their overall market share than the four biggest banks. As a group, challengers increased their market share from 2000 to 2008 in PCAs – see Figure 7.11. The same is true of personal loans, credit cards, and SME banking.[xxxv]

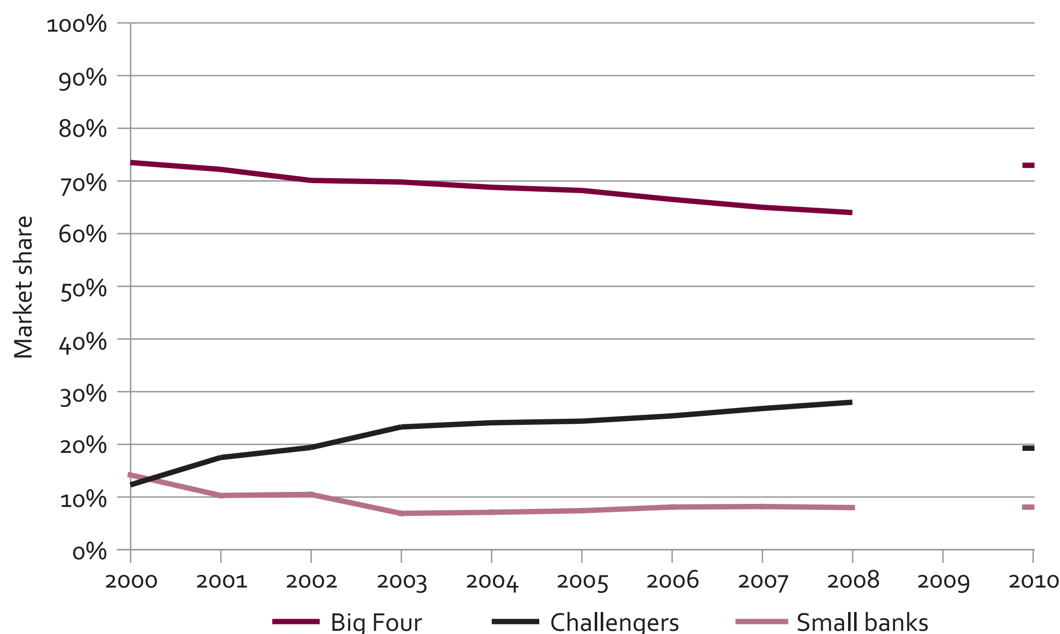
Figure 7.10: Ratio of switcher share to market share for personal current accounts[81]



Source: Commission analysis of data provided by GfK FRS.[xxxvi]

81 Each bank's share of switchers attracted each year is divided by their overall market share in that year. Banks whose ratio is greater than 100% are attracting more switchers than their overall market share, whereas banks with a ratio of less than 100% are attracting proportionally few switchers.

Figure 7.11: Market share of main personal current accounts



Source: Commission analysis of data provided by GfK FRS for 2000 to 2008 (post-2008 data from GfK FRS is excluded for confidentiality reasons) and OFT, 2010, Review of barriers to entry, expansion and exit in retail banking for 2010.[xxxvii]

7.62 Challenger banks can be contrasted not only with the four biggest banks, but also with smaller banks, which, on aggregate, failed to increase their PCA market share over the past decade (see Figure 7.11).[xxxviii] There is a clear distinction between a large fringe of small players that did not succeed in growing significantly, and a small number of medium-sized challengers who gained market share and drove competition. Share of new PCAs opened each year is strongly correlated with market share of PCAs, showing that as banks gain market share, they are better able to attract new customers.[xxxix]

7.63 Faced by the threat of challengers increasing their market share, the four biggest banks were put under pressure to offer better products and prices. By competing strongly for new customers, challengers also had an incentive to innovate, become more efficient and test out new business strategies. The *Interim Report* offered some evidence of challenger innovations being adopted by the rest of the market. Further analysis showed that both incumbents and challengers have innovated over the past decade, despite the latter's significantly smaller market share.[82]

7.64 Some respondents to the *Interim Report* put forward the argument that challengers, while potentially beneficial for competition, were a threat to financial stability. As set out in Chapter 6, a failure of regulation in the lead-up to the crisis had misdirected competition towards taking excessive risk. The failure was of regulation, not competition. The need for stronger disciplines on excessive risk taking by banks of all

82 Commission analysis of bank responses to Commission questionnaire.

kinds in no way diminishes the importance for competition of challenger banks in the future.

7.65 There have been up to four challengers competing in the PCA market over the decade preceding the crisis, but in 2010 only two of these remained in the market: Santander and Nationwide. After its recent acquisitions, Santander is also approaching the size in some markets (e.g. in PCA market share) of banks that have historically been considered 'incumbents' by the competition authorities, so it remains to be seen to what extent it will continue to act as a challenger.

Box 7.2: Respondents' views on factors affecting the ability of smaller banks to exert competitive pressure on larger incumbents

The *Interim Report* asked "What factors make smaller banks more likely to exert competitive pressure on larger incumbents?"

A number of responses focused on reducing the cost base of smaller banks: some claimed that small and new banks have in-built advantages stemming from their lack of legacy costs, relative to traditional banks which are more encumbered by dated IT systems or costly infrastructure. Other respondents felt that small and new players are less able to benefit from economies of scale, at least initially; or they may suffer from proportionately higher capital and liquidity costs, imposed by regulators or the market, especially if they are raising money from venture capital that requires higher returns than other sources of finance. To challenge, new banks would need to keep costs low, and to raise finance on no worse terms than incumbent banks.

Some respondents said that new entrants with strong parent companies would be most effective: for example, a foreign bank might be able to expand quickly through acquisition of assets and infrastructure; or a parent with an established reputation outside the financial services industry would have the profile to appeal to a wider set of consumers.

Differentiation between markets was important for some respondents, who claimed that it is easier for new banks to establish themselves in certain markets, such as savings and mortgages, where internet and intermediary channels have a greater presence. Having established themselves there, new banks could subsequently expand to become full service retail banks, including PCAs for which more costly infrastructure might be needed. Another model would be for small banks to distinguish themselves through better quality of service, particularly if they are locally based. They can therefore build up close relationships with customers through local branch networks and relationship products (particularly PCAs and BCAs), though entry into these markets is costly and takes time.

Summary

7.66 There have been long-standing problems with competition in UK retail banking markets, resulting in competition being both insufficient and misdirected. These problems stem from a concentrated market structure and significant barriers to entry, in conjunction with poor conditions for consumer choice, which reduce the threat of losing market share if a bank offers poor prices or service. These difficulties are particularly prevalent in the PCA and BCA markets, which represent a wider risk for

effective competition because these products can also act as gateways to other financial services. Over the past decade, a number of competition investigations have shed light on the poor consumer outcomes that result from concentrated banking markets with poor transparency and high switching costs.

7.67 Prior to the financial crisis, one of the dominant forces in retail banking competition was the presence of challenger banks, which succeeded in increasing their market share by offering competitive products and services. However, in 2011, these markets – and particularly the PCA and SME banking markets – are considerably more concentrated than any point over the previous decade, and the number of challengers has fallen sharply.

7.68 Market concentration on the supply side is particularly problematic due to weaknesses on the demand side, especially for current accounts: pricing structures are complex and opaque, and consumers are not confident in switching between accounts. Switching rates are low, despite the considerable dispersion in prices available across the current account market, and this is not explained by high levels of customer satisfaction. Lack of transparency also leads to competition being misdirected, with products such as PPI being mis-sold, and customers incurring high and unexpected charges in some areas, such as unarranged overdrafts.

7.69 This evidence supports the case for measures to address market concentration, switching and transparency. In addition, there is evidence that many of these problems persist over time and require ongoing attention, from the sector regulator as well as from the competition authorities.

Endnotes

i. Based on Commission analysis of the GfK NOP Financial Research Survey (FRS), 5 months ending September 2000-2010 (i.e. May-September for each year from 2000 to 2010), main current accounts (21,396-24,789). Calculated at the ownership level; for example, LBG is calculated as one brand group. (In this and all subsequent endnotes, the figures in brackets refer to the minimum and maximum sample size over the period specified.)

ii. SME banking analysis is based on Commission analysis of data for the year 2000 from Table 4.21 of the Competition Commission review of the proposed Lloyds TSB/Abbey National merger (Competition Commission, 2001, *Lloyds TSB Group Plc and Abbey National Plc: A report on the proposed merger,* available at: http://www.competition-commission.org.uk/rep_pub/reports/2001/458lloyds.htm#full), for the years 2005-2009 from the TNS RI Small Business Banking Survey in Great Britain (firms with a turnover <£1mn, sample size 9064-9188), and for the year 2010 from the Charterhouse Research UK Business Banking Survey 2010, based on more than 16,000 interviews with businesses conducted between January and December 2010 covering businesses with turnover up to £1bn. Personal banking analysis is based on Commission analysis of the GfK NOP Financial Research Survey (FRS), 5 months ending September 2000 – 2010 (i.e. May-September for each year from 2000 to 2010), main current accounts (21,396-24,789), mortgages (7,586-8,518), savings (26,315-33,759), GfK loans (this excludes sub-prime and other specialist lending) (2,555–3,545) and credit cards (15,701-20,081). Calculated at the ownership level; for example, LBG is calculated as one brand group.

iii. Based on Commission analysis of data provided by Defaqto and the GfK NOP Financial Research Survey (FRS), 5 months ending September 2000 – 2010, current account top 2 box satisfaction (that is, customers who rated their satisfaction as 'extremely satisfied' or 'very satisfied' out of seven possible options) (21,283-24,137), main current accounts (21,396-24,789), new main current accounts (1,061-1,487).

iv. Based on Commission analysis of data from the Charterhouse Research UK Business Banking Survey 2010, based on more than 16,000 interviews with businesses conducted between January and December 2010 covering

businesses with turnover up to £1bn. Data from SMEs with a turnover of up to £1mn has been used in this calculation.

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

vi. Based on Commission analysis of the GfK NOP Financial Research Survey (FRS), 5 months ending September 2000 – 2010, mortgages (7,586-8,518).

vii. Based on Commission analysis of the GfK NOP Financial Research Survey (FRS), 5 months ending September 2000 – 2010, savings (26,315-33,759).

viii. Based on Commission analysis of the GfK NOP Financial Research Survey (FRS), 5 months ending September 2000 – 2010, credit cards (15,701-20,081).

ix. Based on Commission analysis of the GfK NOP Financial Research Survey (FRS), 5 months ending September 2000 – 2010, GfK loans (2,555–3,545).

x. Based on Commission analysis of the GfK NOP Financial Research Survey (FRS), 5 months ending September 2000 – 2010, main current accounts (21,396-24,789), mortgages (7,586-8,518), savings (26,315-33,759), GfK loans (2,555–3,545) and credit cards (15,701-20,081); the TNS RI Small Business Banking Survey in Great Britain covering businesses with turnover of up to £1mn for the years 2005-2009 (9064-9188); and the Charterhouse Research UK Business Banking Survey 2010, based on more than 16,000 interviews with businesses conducted between January and December 2010 covering businesses with turnover up to £1bn.

xi. Based on Commission analysis of the GfK NOP Financial Research Survey (FRS), 5 months ending September 2000 – 2010, main current accounts (21,396-24,789), mortgages (7,586-8,518), savings (26,315-33,759), GfK loans (2,555–3,545) and credit cards (15,701-20,081).

xii. Based on Commission analysis of data from the TNS RI Small Business Banking Survey in Great Britain for firms of a turnover up to £25mn, 2005-2009.

xiii. Based on Commission analysis of the GfK NOP Financial Research Survey (FRS), 5 months ending September 2000 – 2010, mortgages (7,586-8,518), savings (26,315–33,759), GfK loans (2,555-3,545) and credit cards (15,701-20,081).

xiv. Based on Commission analysis of the GfK NOP Financial Research Survey (FRS), 5 months ending September 2000 – 2010, main current accounts (21,396-24,789).

xv. Based on Commission analysis of the GfK NOP Financial Research Survey (FRS), 5 months ending September 2000 – 2010, main current accounts (21,396-24,789), mortgages (7,586-8,518), savings (26,315-33,759), GfK loans (2,555–3,545) and credit cards (15,701-20,081).

xvi. In each year, a new entrant is defined in this figure as one that did not have any market share, or share of new business, in 2000, and had at least 0.05% of new business in the given year. If a new entrant is merged with another firm, the brands of the new entrant remain defined as new entrants. Source: GfK NOP Financial Research Survey (FRS), 5 months ending September 2000-2010, new main current accounts (1061-1487), new mortgages (943-1833), new savings accounts/cash ISA/national savings (1799-4519), all new credit cards (1761-2623), all new loans (GfK definition) (501-1160).

xvii. Based on Commission analysis of the GfK NOP Financial Research Survey (FRS), 5 months ending September 2000 – 2010, reason for choice, all new current account (1,410–2,662).

xviii. Based on Commission analysis of the GfK NOP Financial Research Survey (FRS), 5 months ending September 2000-2010, main current accounts (21,396-24,789), new main current accounts (1,061-1,487). Calculation includes Alliance & Leicester, Abbey, Barclays, Bank of Scotland, Clydesdale Bank, Co-operative Bank, Halifax, HSBC, Lloyds TSB, NatWest, Royal Bank of Scotland, Yorkshire Bank. Data on branch networks from British Bankers' Association.

xix. Based on Commission analysis of the GfK NOP Financial Research Survey (FRS), 5 months ending September 2000 – 2010, current account top 2 box satisfaction over time (21,396-24,789).

xx. Based on Commission analysis of the GfK NOP Financial Research Survey (FRS) 5 months ending September 2000 – 2010, current accounts (25,923-34,655), mortgages (7,586-8,518), savings (26,315-33,759) and credit cards (15,701-20,081) and the TNS RI Small Business Banking Survey in Great Britain covering businesses with turnover of up to £1mn for the years 2005-2009 (9,064-9,188); and the Charterhouse Research UK Business Banking Survey 2010, based on more than 16,000 interviews with businesses conducted between January and December 2010 covering businesses with turnover up to £1bn.

xxi. Based on Commission analysis of the GfK NOP Financial Research Survey (FRS), 2000-2010, 5 months ending September 2010, current accounts (25,923-34,655), mortgages (7,586-8,518), savings (26,315-33,759) and credit

cards (15,701-20,081) and the TNS RI Small Business Banking Survey in Great Britain covering businesses with turnover of up to £1m for the years 2005-2009 (9,064-9,188), and businesses with a turnover of up to £15mn for the years 2007-2009 (10,694-12,832); and the Charterhouse Research UK Business Banking Survey 2010, based on more than 16,000 interviews with businesses conducted between January and December 2010 covering businesses with turnover up to £1bn.

xxii. Based on Commission analysis of the GfK NOP Financial Research Survey (FRS), 5 months ending September 2000-2010, current accounts (25,923-34,655).

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

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

xxv. Based on Commission analysis of the GfK NOP Financial Research Survey (FRS), 5 months ending September 2000-2010, Overall satisfaction with service (21,283-24,137).

xxvi. Based on Commission analysis of the GfK NOP Financial Research Survey (FRS), based on new current accounts opened in the past 12 months by switchers, 5 months ending 2010, current account switchers (653). The Consumer Focus survey found that the main reason to switch was the pull factor of aiming to get a better deal, followed by the push factors of low service and dissatisfaction with price or value (branches were not one of the five potential answers). Consumer Focus, 2010, *Stick or twist*. Available at: http://www.consumerfocus.org.uk/files/2010/10/Stick-or-twist-for-web1.pdf.

xxvii. Based on Commission analysis of the GfK NOP Financial Research Survey (FRS), 5 months ending September 2000 – 2010, reason for choice, all new current accounts (1,410–2,662).

xxviii. Based on Commission analysis of the GfK NOP Financial Research Survey (FRS), 5 months ending September 2000 – 2010, reason for choice, mortgages (943-1,833), savings (1,799-4,519), GfK loans (501-1,160), and credit cards (1,761-2,623).

xxix. Based on Commission analysis of the GfK NOP Financial Research Survey (FRS), based on new current accounts opened in the past 12 months by switchers, 5 months ending 2010, current account switchers (653).

xxx. Standard PCAs in this figure are those that have no monthly charge, no restrictions on where they are offered, are not youth or student accounts and are not private bank accounts. The deposit interest rate used is the rate paid on balances of £1000. The interest rates for branch based instant access accounts and branch based notice accounts are estimates of the market average rates. Source: the Bank of England base rate, branch based instant access accounts and branch based notice accounts are from the Bank of England; and the PCA interest rate of deposits for the four biggest banks is based upon Commission analysis of data provided by banks, GfK NOP Financial Research Survey (FRS) and Defaqto. GfK NOP Financial Research Survey (FRS) data used for brand weighting only. All assumptions and analysis conducted by the Commission.

xxxi. Based on Commission analysis of the GfK NOP Financial Research Survey (FRS), 5 months ending September 2010, reason of choice (2,662).

xxxii. Based on Commission analysis of price data provided by Defaqto and customer satisfaction data from the GfK NOP Financial Research Survey (FRS), 5 months ending September 2000 – 2010, current account top 2 box satisfaction (21,283-24,137). There was variation in customer satisfaction levels within both groups, with some challengers performing better than others, and some incumbents performing better than others. However, between 2000 and 2008 the difference in the averages of the two groups was small (post-2008 is not comparable on a like-for-like basis).

xxxiii. Standard PCAs in this figure are those that have no monthly charge, no restrictions on where they are offered, are not youth or student accounts and are not private bank accounts. The deposit interest rate used is the rate paid on balances of £1000. Source: Commission analysis of data provided by banks, GfK NOP Financial Research Survey (FRS) and Defaqto. GfK NOP Financial Research Survey (FRS) data used for brand weighting only. All assumptions and analysis conducted by the Commission.

xxxiv. Based on Commission analysis of data provided by Defaqto. The average overdraft rate for each group was calculated by taking the mean authorised overdraft rate of all the rates offered by each group on standard PCAs.

xxxv. Based on Commission analysis of the GfK NOP Financial Research Survey (FRS) 5 months ending September 2000 – 2010, main current accounts (21,396-24,789), GfK loans (2,555–3,545) and credit cards (15,701-20,081), and the TNS RI Small Business Banking Survey in Great Britain covering businesses with turnover of up to £1mn for the years 2005-2009 (9,064-9,188).

xxxvi. Based on Commission analysis of the GfK NOP Financial Research Survey (FRS), 5 months ending September 2000 – 2010, main current accounts (21,396-24,789).

xxxvii. Based on Commission analysis of the GfK NOP Financial Research Survey (FRS), 5 months ending September 2000 – 2010, main current accounts (21,396-24,789), and Page 35 of OFT, 2010, *Review of barriers to entry, expansion and exit in retail banking*. Available at: http://www.oft.gov.uk/shared_oft/personal-current-accounts/oft1282.

xxxviii. Based on Commission analysis of the GfK NOP Financial Research Survey (FRS), 5 months ending September 2000 – 2010, main current accounts (21,396-24,789).

xxxix. The correlation of stock market share and new market share for PCAs from 2000 to 2010 is 0.94. Source: GfK NOP Financial Research Survey (FRS), 5 months ending September 2000-2010, main current accounts (21,396-24,789), new main current accounts (1,061-1,487). Calculation includes Alliance & Leicester, Abbey National, Barclays, Bank of Scotland, Clydesdale Bank, Co-operative Bank, Halifax, HSBC, Lloyds TSB, NatWest, Royal Bank of Scotland and Yorkshire Bank.

Chapter 8: Competition recommendations

8.1 Chapter 7 identified competition problems on both the supply side – the structure of markets – and the demand side – the conditions for customers to choose and switch accounts. These problems are particularly present in the personal and business current account (PCA and BCA) markets, and have persisted over time, being identified in numerous competition studies over the past decade.[1]

8.2 This chapter sets out the Commission's recommendations to address these problems. These fall into three main areas: market structure, including creating the conditions for a strong new challenger bank to emerge and reducing barriers to entry; consumer choice, including recommendations to improve switching and transparency; and pro-competitive regulation. For each area, this chapter:

- reprises the provisional findings in the *Interim Report*;
- summarises respondents' views and further developments since the publication of the *Interim Report*; and
- sets out the Commission's final recommendations.

Finally, this chapter discusses the case for further investigation by the competition authorities, in light of the Commission's recommendations and consequent events.

Market structure

8.3 This section presents the Commission's recommendations on market structure. Chapter 7 set out problems with the current structure of the retail banking market: concentration, a lack of challengers, and barriers to entry. The Commission's view is that the best way to address these problems is to secure the emergence of a strong, new challenger bank. In addition, progress should be made on reducing barriers to entry for other new players in the future.

A strong new challenger

8.4 Chapter 7 described the role that challenger banks have played in retail banking markets over the last decade. These banks – small enough to have a strong incentive to compete, but big enough to exert real pressure on incumbents – competed hard in key markets, including PCAs, and succeeded in winning some market share from

1 As in Chapter 7, in this chapter 'bank' is used to refer to any provider of PCAs and/or BCAs. This includes both banks and building societies.

incumbents. Smaller banks, in contrast, have generally not had a big impact on competition.

8.5 The reduction in the number of these challengers in retail banking as a result of the financial crisis can therefore be expected to reduce levels of competition and lead to worse outcomes for consumers. Can anything be done to offset – wholly or in part – the effects of this change?

8.6 An important part of the answer is to make it easier for customers to switch banks and understand the differences between them, and this is discussed in the next section. Another part (also discussed below) is to reduce barriers to entry. But the effect of such measures is long-term, and likely to be modest rather than transformational given the limits to what can be achieved through improved switching and the modest impact that small banks, including new entrants, have on the market. Therefore in order to deliver a significant effect in the near-to-medium term it is highly desirable to secure the emergence of one or more strong new challengers.

8.7 The *Interim Report* discussed a number of ways in which it might be possible to deliver this outcome.

- The Government could legislate to require a number of additional divestitures, separate from those already agreed with the European Commission (EC) as a condition of the state aid provided to Royal Bank of Scotland (RBS) and Lloyds Banking Group (LBG) during the financial crisis. Some respondents favoured this approach, for a variety of reasons including a general view that it would be beneficial to reduce the market power and influence of the large banks. However, the Commission has seen no evidence to challenge the provisional view presented in the *Interim Report*, that such an approach would be much more disruptive and less cost-effective than other options which should deliver comparable benefits.

- The Government could reverse the Lloyds TSB/HBOS merger, which was approved on public interest grounds despite the Office of Fair Trading (OFT) raising competition concerns. In the *Interim Report*, the Commission considered that the costs of unpicking the merger would be very high, relative to the benefits of recreating an ailing HBOS. No evidence has been received to challenge this view.

- The ongoing state aid divestitures by LBG and/or RBS could be enhanced. The *Interim Report* provisionally proposed that the most effective means of securing the entry of a new challenger would be a substantial enhancement of the LBG divestiture. There have been further developments in this area since the *Interim Report*, and additional evidence has been provided by respondents, both of which are discussed in more detail below. As to the RBS divestiture, the

Commission's provisional view at the time of the *Interim Report* was that this route was likely to prove less cost-effective than enhancing the LBG divestiture for a variety of reasons, including that its sale to Santander has already been agreed and that implementation of this deal is well underway.[2] Enhancing the divestiture to Santander does not appear likely to advance competition, so in effect a new, separate divestiture would be required. No significant new evidence has come to light on this since the *Interim Report*.

- Other Government-owned assets could be used to promote competition. The view advanced in the *Interim Report* was that assets such as Northern Rock plc and UK Asset Resolution Ltd would be too small to make a substantial difference at the level of national markets, but that the Government should have regard to competition in its disposal of these assets. Some further evidence has been received that these banks could have some impact in the mortgage market. But given their very small scale in the markets where competition is weakest (PCA and BCA), the Commission's final view remains the one stated in the *Interim Report*.

8.8 The *Interim Report* also considered other structural measures to promote competition, such as capping market share or balance sheet size, or automatically blocking mergers that take banks over a certain threshold, but suggested that these approaches appeared unlikely to be effective. These measures did not receive much support from respondents, nor has significant new evidence been provided on them. The Commission's view therefore remains that these measures would not be beneficial for competition in UK retail banking.

The LBG divestiture

8.9 The *Interim Report* advanced the view that the best way to improve the structure of UK retail banking markets would be substantially to enhance the LBG divestiture ('Project Verde' – see Box 8.1). The Commission's view was that an enhanced divestiture could give rise to an improved outcome for competition primarily by strengthening the divestiture's ability to act as a challenger, and also by reducing market concentration.

8.10 On the first point, the specific concerns are whether the divestiture has a sufficiently strong balance sheet and funding position, and whether it has sufficient scale – both of which will be necessary for a strong new challenger. On the second point, transferring more PCAs and/or BCAs from LBG to the divestiture would reduce concentration in these markets, specifically by reducing LBG's market share. This would be beneficial because even after the planned divestitures, the PCA and SME markets will still be particularly concentrated (see Table 8.1).

2 Page 200, RBS, 2011, *Interim Results 2011*. Available at: http://www.investors.rbs.com/download/announcements/Q2Announcement2011.pdf.

Table 8.1: Market concentration before the crisis, currently and after the planned divestitures as indicated by the Herfindahl-Hirschman Index (HHI)[3]

	Main PCAs	Savings accounts	Mortgages	Personal loans	Credit cards	SME banking
Pre-crisis HHI (2008)	1290	1120	800	1040	820	1720
Current HHI (2010)	1830	1220	1260	1620	1040	1910
HHI after divestitures	1570	1120	960	1340	1000	1640

Source: Commission analysis of data provided by GfK FRS, TNS and Charterhouse.[4]

3 The Herfindahl-Hirschman index is a measure of market concentration. Higher numbers indicate more concentrated markets. See the Glossary for further details.

4 Assuming that no customers return to their previous bank after being transferred as part of the divestiture, and that the divestiture is not combined with any other banking assets. Based on Commission analysis of personal banking data from the GfK NOP Financial Research Survey (FRS), 5 months ending September for 2000 – 2010 (i.e. May-September for each year from 2000 to 2010), main current accounts (sample size 21,396-24,789), mortgages (7,586-8,518), savings (26,315-33,759), GfK loans (this excludes sub-prime and other specialist lending) (2,555-3,545) and credit cards (15,701-20,081). (The figures in brackets refer to the minimum and maximum sample size over the period specified.) Calculated at the ownership level; for example, LBG is calculated as one brand group. SME banking data for 2008 is from the TNS RI Small Business Banking Survey in Great Britain (businesses with turnover of up to £1mn, sample size 10,694-12,431). SME data from 2010 is from Charterhouse Research UK Business Banking Survey 2010, based on more than 16,000 interviews with businesses conducted between January and December 2010 covering businesses with turnover up to £1bn. Only data for businesses with a turnover of up to £1mn have been used.

Box 8.1: The LBG divestiture ('Project Verde')

As one of the conditions of its receipt of public money during the financial crisis, LBG committed to divest a retail banking business by 30 November 2013.[1] This business, known as 'Project Verde', consists of:

- a PCA market share of at least 4.6%;
- at least 600 branches, including branch infrastructure, staff, customers, customer accounts, and support infrastructure;
- 19.2% of LBG's retail mortgage assets;
- the TSB brand;
- the Cheltenham & Gloucester mortgage and savings network;
- Lloyds TSB Scotland's branches and banking licence;
- supplementary branches in England and Wales, to make up the minimum of 600 branches with a broad geographical coverage; and
- Intelligent Finance, an internet and telephone bank with current account, mortgage and savings customers.

LBG committed to approach potentially interested buyers by 30 November 2011, and to complete the disposal of the divestiture by 30 November 2013. If the disposal has not been completed by that date, the Government is committed to appointing a divestiture trustee to oversee the disposal at no minimum price. The buyer must have no more than 14% of the PCA market after acquiring the divestiture. LBG is also permitted to dispose of the business through an initial public offering (IPO).

On 1 March 2011, LBG announced that it was accelerating the start of the disposal process. On 28 March 2011, it announced the appointment of investment bank advisors for the process, and on 23 May 2011 LBG announced the executive management team that will lead the divestiture programme.

On 4 August 2011, LBG stated that the Verde business consisted of 632 branches and approximately 5.5mn customers, with around £64bn of assets (around £16bn of risk-weighted assets) and £32bn of liabilities. LBG's implementation costs of the disposal will vary depending on the nature of the buyer, but could be up to £1bn. LBG stated that it had received a number of credible initial approaches for the Verde business, and aimed to identify a purchaser by the end of the year.[2]

[1] European Commission, 2009, State Aid No. N 428/2009 – *United Kingdom Restructuring of Lloyds Banking Group*. Available at: http://ec.europa.eu/eu_law/state_aids/comp-2009/n428-09.pdf.

[2] LBG, 2011, *2011 Half Year Results*. Available at: http://www.lloydsbankinggroup.com/media/pdfs/investors/2011/2011_LBG_HalfYear_Results.pdf.

8.11 Respondents to the *Interim Report* offered a variety of views and evidence on the proposal to enhance the LBG divestiture substantially. LBG strongly rejected it on a number of grounds, arguing in particular that the analysis did not justify a structural remedy and that an enhancement of the divestiture would be discriminatory. Some

respondents supported LBG's view, suggesting that the current divestiture is sufficient to remedy the distortions created by the state support to LBG and to create a viable challenger. The specific points raised are addressed more fully in Chapter 7 and Annex 4. Other respondents raised concerns that enhancing the divestiture would reduce the value of the Government's shareholding in LBG. A further group of respondents agreed with the Commission's analysis but called for further divestitures, in some cases even going beyond reversal of the Lloyds TSB/HBOS merger.

8.12 In addition to respondents' views, there have been two important developments since the *Interim Report*. First, LBG claims to have made "considerable progress in relation to the funding requirements of the Verde business",[5] and has an in-principle agreement for up-front third party funding for the new business, should the bidders require it. Second, several actual and potential bidders for the divestiture have stated publicly and to the Commission that they would not want it to be enhanced by the addition of branches from LBG.

8.13 The Commission remains of the view that a substantial enhancement of the LBG divestiture is the best opportunity to improve the structure of the PCA market, and is the most cost-effective way currently available to ensure the emergence of a strong new challenger. However, the evidence and views submitted since the *Interim Report* have led the Commission to conclude that, of the two objectives stated above (creating a new challenger, and reducing market concentration), ensuring the emergence of a strong new challenger is more important and should be prioritised in progressing the recommendations contained in this report. This should be effected by ensuring that the entity which results from the divestiture has a strong funding position and sufficient scale.

Strong funding

8.14 A strong challenger requires a sound funding position, both in terms of the amount of wholesale funding it needs to raise, and the price at which it can access such funds. With a weak funding position relative to its peers, a bank would be unable to be a strong challenger because:

- it would have an incentive to shed loans in order to reduce its reliance on wholesale markets, rather than competing hard to lend; and
- its cost of funding would be higher, making its customer offerings more expensive generally.

8.15 Funding profiles are not easy to predict or compare across the sector, but loan-to-deposit ratios (LDRs) can be used as a proxy to give an indication of banks' dependence on wholesale funding. These are not complete pictures of funding availability: banks' ability and desire to raise wholesale funding varies with business

5 LBG, 2011, *2011 Half Year Results*. Available at: http://www.lloydsbankinggroup.com/media/pdfs/investors/2011/2011_LBG_HalfYear_Results.pdf.

model. Table 8.2 shows LDRs for some comparable UK banks. For LBG and RBS, the retail divisions have been used because the group as a whole does not represent a good comparator.

Table 8.2: Comparison of current loan-to-deposit ratios in UK retail banking[6]

	Loans and advances to customers (or equivalent)	Customer LDR
Nationwide[7]	£149bn	111%
Santander UK[8]	£196bn	129%
RBS UK retail division[9]	£110bn	115%
LBG retail division[10]	£358bn	148%
Co-operative Bank[11]	£35bn	108%
Clydesdale Bank[12]	£27bn	98%

Source: Commission analysis of latest company accounts or results at time of publication.[7][8][9][10][11][12]

8.16 Verde's current LDR, as calculated from LBG's half-year results, is 200%. LBG has submitted evidence that this will be significantly lower by the time the divestiture is completed, and "in line with that of most other UK retail banks".[13]

8.17 In general, bank strategies have shifted from asset-led before the financial crisis to funding-led after the crisis. Post-crisis, many banks target, explicitly or implicitly, reduced LDRs. For example, RBS targets a 100% LDR by 2013, and LBG hopes to reach a LDR below 130% by 2014.[14] In this context, banks that are outliers are likely to face

6 LDRs are calculated as loans and advances to customers divided by customer deposits. The figures in this chart refer to LBG and RBS's existing retail divisions. This is no way relates to the assets that would be included within the retail ring-fence.
7 Nationwide, 2011, *Annual Report and Accounts 2011*. Uses Nationwide definition of LDR, calculated as loans and advances to customers divided by the sum of shares, other deposits and amounts due to customers. Available at: http://www.nationwide.co.uk/pdf/about_nationwide/annual_report2011.pdf.
8 Santander UK, 2011, *2011 Half Yearly Financial Report*. Available at: http://www.aboutsantander.co.uk/media/35346/2011%2006%2030%20-%20santander%20uk%20plc%202011%20half%20yearly%20financial%20report.pdf.
9 Page 36, RBS, 2011, *Interim Results 2011*. Available at: http://www.investors.rbs.com/download/announcements/Q2Announcement2011.pdf.
10 LBG, 2011, 2011 *Half-year results*. Available at: http://www.lloydsbankinggroup.com/media/pdfs/investors/2011/2011_LBG_HalfYear_Results.pdf.
11 Co-operative Bank, 2010, *Building a Better Society: Financial Statements 2010*. Available at: http://www.co-operativebank.co.uk/corp/pdf/Bank_Final2010.pdf.
12 Clydesdale Bank plc, 2011, *Interim Condensed Consolidated Financial Statements*. Available at: http://www.cbonline.co.uk/resources/8/a/8a258680471133ad89b3990e3f5e8a12/interim2011.pdf?lmod=1248809451&CACHEID=8a258680471133ad89b3990e3f5e8a12.
13 Page 38, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.
14 RBS, 2011, *Key Performance Indicators*. Available at: http://www.investors.rbs.com/kpi. Lloyds Banking Group, 2011, *2011 Half Year Results*. Available at: http://www.lloydsbankinggroup.com/media/pdfs/investors/2011/2011_LBG_HalfYear_Results.pdf.

greater pressure to restructure, reducing their balance sheet to fall within the market's expectations for funding requirements. The structure of Verde's balance sheet will therefore constrain its management's discretion to set strategy if it starts out with a high reliance on wholesale funding.

8.18 If the amount or cost of its wholesale funding is considered uncomfortably high, Verde's management is likely to focus on shrinking the balance sheet rather than actively competing for new business. This would have a knock-on impact on its ability to offer attractive prices for consumers on both sides of the balance sheet, at least in its early years. Ensuring that Verde has a funding profile in line with market norms would give its management greater flexibility to determine its strategy for growth, improving its ability to act as a strong challenger to the banks already active in the market.

8.19 In general, deposits are a cheaper source of funding for smaller, less diversified banks, relative to wholesale funding. Within certain bounds, improving Verde's mix of funding in favour of 'sticky' deposits (linked to PCAs) and away from wholesale funding could reduce its costs and improve the stability of its funding position.

8.20 To be considered to have a strong funding position, Verde's LDR should be comparable to or better than those of the banks in Table 8.2, at the time of the transfer of economic ownership to the purchaser. Verde's current funding gap can be closed prior to Verde's disposal if LBG acts to: reduce the mortgages to the extent allowed within the state aid agreement with the EC; increase the deposit books through addition of relationship accounts (PCAs and associated savings); or a combination of both.

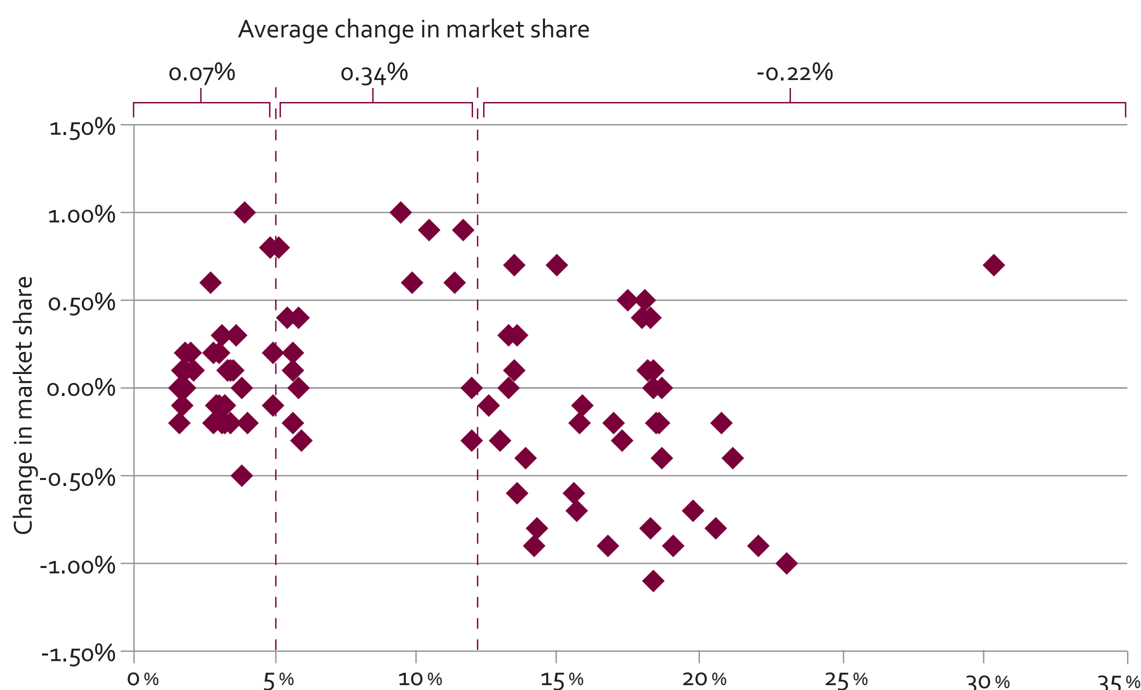
8.21 Improving Verde's funding position as set out above would reduce its cost base, enabling it to set competitive prices for new loans and mortgages and expand across all products. The threat of a weak funding position is that it would be likely to respond by shrinking its assets in its early years of operation, lessening competition and losing customers. It could also be constrained by having management and regulatory attention focused on the funding position, rather than the desire to serve customers and grow. From this, it is clear that a strong funding position strengthens Verde's ability to act as a challenger, whereas a weak funding position damages it.

Sufficient scale

8.22 As well as a strong funding position, the entity resulting from the divestiture will also need to be large enough to exert a competitive constraint on the large incumbents. Evidence from the previous decade shows that small banks (below 5% PCA market share) on average have grown only slowly, with an average annual growth in market share of 0.07%. Banks with a PCA market share of between 5% and 12%, by contrast, grew significantly more quickly, with an average annual growth in market share of 0.34% (although given the relatively small number of challengers, this number is drawn from a small sample). Above 12%, market shares fell on average, indicating that it is around this point that banks begin to act as incumbents and, as their incentives

change, they slowly lose market share. With a PCA market share of 4.6%, Verde is on the borderline of sub-scale banks that have failed to grow significantly in the past, and is smaller than most previous challengers over the past decade as measured by PCA market share (see Figure 8.1).

Figure 8.1: Annual changes in PCA market share, 2000-2010[15]



Source: Commission analysis of data provided by GfK FRS.[16]

8.23 A larger entity would benefit from greater economies of scale, giving it lower costs which could be passed on to customers in the form of better prices. Evidence shows that economies of scale may exist for banks of all sizes, though they may be more important for smaller banks.[17] While LBG might lose some economies of scale if the size of the divestiture was increased, given the relative sizes of the two banks, the effect is likely to be much more significant for Verde, with its assets of around £64bn, than LBG, with its assets of around £980bn.[18]

15 The sample is all UK PCA providers from 2000-2010, excluding PCA providers which had a market share below 1%, and excluding years in which banks merged, so only organic growth is represented. Each data point shows market share for each bank at the beginning of each year, against that bank's change in market share over the course of that year.
16 Commission analysis of GfK NOP Financial Research Survey (FRS), 5 months ending September 2000-2010, main current accounts (21,396-24,789), new main current accounts (1,061-1,487).
17 See, for example, Feng, G. and Serletis, A., 2010, Efficiency, technical change, and returns to scale in large US banks: panel data evidence from an output distance function satisfying theoretical regularity, *Journal of Banking and Finance*, 34(1), pp.127-138.
18 Lloyds Banking Group, 2011, *Half Year Results*. Available at: http://www.lloydsbankinggroup.com/media/pdfs/investors/2011/2011_LBG_HalfYear_Results.pdf.

8.24 In addition, there is a significant risk that Verde's market share will fall further as it may suffer customer attrition from the divestiture process. It also faces more difficult economic conditions than those in which the previous challengers operated: for example, wholesale funding is now much less readily available.[19] It does have potential to grow market share in PCAs and possibly SMEs through the Cheltenham & Gloucester branches, but this is uncertain and will require considerable time and investment.

8.25 Given these factors, there is a real danger that Verde will fall back into the range of small banks that have not exerted a strong competitive constraint in the past, if it remains at its current size. To ensure that the entity resulting from the divestiture has the best possible chance of becoming a strong, effective challenger, its PCA market share should be at least 6%, so that it is well within the scale of previous serious challengers. This would increase its economies of scale, and place it more comfortably within the range of sizes of challengers that have grown significant market share in the past.

8.26 Recommending that the resulting entity has a PCA market share of at least 6% does not undermine or contradict the EC's judgement at the time of the state aid approval process. The EC's objective was to address the distortions to competition brought about by state aid to LBG. The Commission's remit, by contrast, is to promote competition across the UK banking sector. The Commission does not dispute that Verde, as it currently stands, may have the minimum scale to be a *viable* bank; nevertheless, the evidence shows that it should have a greater market share in order to have the highest likelihood of becoming a strong challenger and therefore improving competition.

8.27 The Commission notes that Verde's incentive to act as a challenger will not depend simply on its size, but also on its mix of active and inert customers. Banks with larger shares of active customers are more likely to compete to retain their existing customers and gain more. However, given that existing banks are not eligible to purchase Verde if the resulting entity exceeds 14% PCA market share, it will be small enough to have a strong incentive to compete for new customers, especially if the other recommendations in this chapter increase the proportion of customers who are willing to switch. Hence, the Commission is not making specific recommendations regarding Verde's customer mix.

Recommendations

8.28 How could such an enhancement be achieved? First, it is important to acknowledge the constraints on the Government's ability to use its shareholding in LBG to achieve this outcome (see Box 8.2).

19 See Pages 12-13 of Bank of England, 2011, *Inflation Report August 2011*. Available at: http://www.bankofengland.co.uk/publications/inflationreport/ir11aug.pdf.

8.29 An enhancement to the funding position of the divestiture could be achieved in a number of ways. The best outcome would be the addition of more relationship deposits (PCAs and/or BCAs, and associated savings) by LBG, such that the funding gap is improved and the number of customers within the divestiture is not reduced. But there are a number of ways in which the funding position can be improved, including through reduction of the mortgage book (allowable under the terms of the state aid agreement up to a certain level). The Commission's key concern is that the resulting entity's funding should not be an outlier relative to its peers.

Box 8.2: Use of the Government's shareholdings in LBG and RBS

Do the Government's shareholdings in banks enable it to direct these banks to split themselves up? LBG and RBS remain public limited companies with external shareholders and are therefore subject to the usual rules and regulations around shareholder control, found mainly in the Companies Act 2006.

The framework document agreed between HM Treasury and UK Financial Investments (UKFI) requires that UKFI manage the investments on a commercial basis and not intervene in the day-to-day management decisions of the investee banks.

The role of a bank's board of directors (and not its shareholders) is to manage and run the company. This includes primary responsibility for determining the company's overall commercial strategy. Directors have a number of duties to fulfil regardless of how they were appointed. These are set out in the Companies Act 2006 and include the requirement to promote the success of the company in the long term and to act fairly between shareholders.

In discharging their duties, the company's directors would expect to engage with shareholders (particularly large institutional shareholders) to gauge their views on particular issues but should not simply comply with their directions, particularly if to do so would place the directors in breach of their fiduciary duties. In the case of RBS, the Government's very substantial shareholding might in principle allow it to use a shareholder resolution to enable it to give specific formal directions to the directors, but this would be a highly unusual step and would not necessarily remove the right of the remaining shareholders to complain if the result was prejudicial to their interests.

The Commission concludes that the Government's rights as a shareholder do not in practice put it in a position to require the split up of LBG and/or RBS on competition grounds.

8.30 Turning to scale in the PCA market, there are two broad ways in which this could be increased for the entity resulting from the divestiture.

- First, Verde could be sold as a standalone entity or through an IPO, and more relationship deposits (PCAs and associated savings) could be transferred from LBG to Verde to ensure that Verde had a PCA market share of at least 6%. This would ensure that Verde had sufficient scale to be a strong, effective challenger, and would have a secondary benefit of reducing concentration and LBG's leading market share.

- Second, the existing divestiture could be sold such that it was combined with an existing small player in the market – either by direct sale to such a player, or by sale to a third party who consolidated it with other assets. This would be a less good outcome since it would lead to some consolidation in the market and would do nothing to reduce LBG's leading PCA market share. But it would achieve the primary objective of ensuring that the resulting entity has the scale to be a strong, effective challenger. This route would therefore also be an effective means of improving competition.

8.31 Accordingly, the Commission recommends that the Government reach agreement with LBG such that the entity which results from the divestiture:

- has a funding position at least as strong as its peers, including as evidenced by its LDR relative to its peers' LDRs at the time of the disposal; and

- has a share of the PCA market of at least 6%.

8.32 With an improved funding position and larger size, the entity resulting from the LBG divestiture would be more likely to act as a strong challenger across retail banking markets. As demonstrated in Chapter 7, challengers have had an important impact in the banking sector over the past decade, stimulating competition between all banks. This increase in competition would lead to a combination of lower prices, better products and service, lower costs and greater innovation. The effect can be expected to be considerable since the effect on the new bank's ability to challenge the larger banks would be significant, and there are few remaining challenger banks in the PCA market.

8.33 Changing the characteristics of the divestiture to result in a strong challenger would improve its future earning capacity, and should therefore feed through into a higher sale price. As there would not be significant lost economies of scale given the size of LBG, this would mean that the costs of enhancing the divestiture would be limited to the incremental operational costs of changing the existing disposal process.[20] However, given market and press speculation around the conditions of the sale, it may be that the sale price of the divestiture is lower than its true value.[21] In this case, increasing the size of the divested assets would increase the quantity of assets sold at less than their true value, representing a transfer of value from LBG's shareholders to Verde's new shareholders. (Under these circumstances, LBG's shareholders might prefer an IPO to a sale, since they could have the option to benefit from that transfer by becoming shareholders in Verde.)

20 LBG's 2011 half year results indicate that it has incurred £47mn of costs related to the divestiture in the first half of 2011, out of a potential £1bn final cost. Lloyds Banking Group, 2011, *Half Year Results*. Available at: http://www.lloydsbankinggroup.com/media/pdfs/investors/2011/2011_LBG_HalfYear_Results.pdf.
21 That is, the value which would be achieved in an arm's length transaction without the special circumstances applying to Verde.

8.34 Similarly, improving the funding position of Verde at the expense of worsening LBG's funding position, if not compensated for through an increase in the sale price, could represent a similar transfer. However, the size, diversification and established market presence of LBG is likely to mean that the costs of a less strong funding position are lower for LBG than if they were to be borne by Verde.

Barriers to entry

8.35 The *Interim Report* identified three possible barriers to entry and expansion for small banks:

- prudential capital requirements;
- access to cash handling facilities; and
- access to the payments system.

8.36 The *Interim Report* sought evidence on the extent to which these were acting as barriers to entry, and how any problems might be overcome. The Commission's view is that the first of these barriers may present cause for concern and should be examined more thoroughly by the Prudential Regulation Authority (PRA),[22] working with the OFT. In the other two areas, there is not a strong case for the Commission to make further recommendations in view of existing arrangements and initiatives.

8.37 There may also be barriers to exit in retail banking, due to large banks being considered 'too big to fail', which could discourage new entrants.[23] The Commission's financial stability recommendations, together with parallel developments on bank resolution, would ensure that all banks would be able to fail, no matter how large, and would therefore remove this barrier.

22 Note that 'Prudential Regulation Authority (PRA)' and 'Financial Conduct Authority (FCA)' are used in this section to refer to the Financial Services Authority (FSA) until the creation of the PRA and FCA, and the PRA and FCA thereafter. Where the Commission directs competition recommendations to the 'PRA' or 'FCA', the FSA and OFT should work together to implement these recommendations until the successor organisations are established.
23 See, for example, Pages 162-173 of OFT, 2010, *Review of Barriers to Entry, Expansion and Exit in Retail Banking*. Available at: http://www.oft.gov.uk/shared_oft/personal-current-accounts/oft1282.

Prudential barriers to entry and expansion for small banks

8.38 Chapter 7 set out how prudential capital requirements can be a barrier to entry, requiring newer and/or smaller banks to hold more capital for each unit of assets, and therefore raising their costs (holding all else equal). This stems from three contributing factors (discussed in more detail in Chapter 7):

- if newer banks have less experienced management teams without a successful track record, they may be required to hold more capital against each risk-weighted asset through a 'governance scalar';[24]
- smaller banks are likely to be less geographically and/or sectorally diversified than larger banks, and thus are more likely to be required to hold additional capital against concentration risk;[25] and
- in the calculation of risk-weighted assets, banks without the scale to make it worthwhile investing in complex risk modelling systems, and/or without the track record of past decision-making to feed into those models, will have to use the standardised approach to risk-weighting, which can lead to higher risk-weights for some assets – this is particularly prominent in prime mortgage lending, as shown in Chapter 7 (see Table 7.3).

8.39 The Commission received some evidence from some small banks and new entrants that they felt unduly penalised by capital requirements, especially given that their business models were relatively simple compared to those of larger banks.

8.40 One option to reduce prudential barriers to entry would be to reduce the risk weightings used under the standardised approach, or remove some kinds of capital add-ons for smaller or newer banks. However, reducing the risk weights for certain asset classes would require re-negotiation internationally, and would run counter to other initiatives to improve loss-absorbing capacity.

8.41 The Commission therefore recommends that the PRA work with the OFT to review the application of prudential standards to ensure that prudential requirements for capital and liquidity do not unnecessarily limit the ability of new entrants to enter the market safely and grow. In particular, it should ensure that use of the standardised approach does not penalise banks that are unable to transition to an advanced approach because of the high fixed cost of doing so. This includes, but is not limited to, improving the ability of small banks to use third party data to assess the risk of their loan books[26] or provision of regulated access to generic risk management models,

24 Pages 12-13, FSA, 2007, *Our Pillar 2 Assessment Framework*. Available at: http://www.fsa.gov.uk/pubs/other/Pillar2_framework.pdf.
25 Pages 214-215, BCBS, 2006, *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version*. Available at: http://www.bis.org/publ/bcbs128c.pdf.
26 For example, using a comprehensive and up-to-date database similar to the French FIBEN database, which is a regulated data source on the quality of SME creditworthiness. For more information, see (in French): http://www.banque-france.fr/fr/instit/services/fiben/fiben.htm.

which would enable small banks to develop sophisticated internal risk management practices at lower cost.

Access to cash handling facilities for small banks

8.42 Chapter 7 highlighted the importance of branch networks as a barrier to entry. Business representatives have provided evidence on the importance of bank branches for SME customers, since many smaller businesses need access to cash handling facilities in order to deposit cash at the end of the working day.

8.43 The *Interim Report* raised the idea of branch sharing to allow small banks to provide their customers with cash handling services through the infrastructure of other banks, or of enhancing the existing Post Office service offering to encourage small banks to make use of these facilities.

8.44 Branch sharing could provide access to a wider network for smaller banks, but many small banks responding to the *Interim Report* found the idea unattractive due to concerns that their customers would be targeted by advertising in the shared branches. In addition, the Interbank Agency Agreements (IBAAs) that already exist offer an adequate mechanism for these services to be provided by large banks to small banks where required.[27] Furthermore, the Post Office provides cash handling facilities to a selection of banks – large and small – allowing them access to a wider customer base. Although some banks are put off using these facilities by the prospect of losing control over the quality of service, others use the service successfully, and additional planned investment by the Post Office should lead to improvements. Given this evidence, the Commission does not see a clear case for making recommendations in this area.

Access to the payments system

8.45 In the *Interim Report*, the Commission raised possible concerns about the ability of small banks to access the payments system. There is some evidence to suggest that the ability of banks to access the payments system through incumbents, and the ability of the Payments Council to maintain a level playing field in payments, are not conducive to a competitive market. However, the evidence is not clear-cut, and this was not raised as a substantial barrier by most new entrants. Therefore, the Commission is not making recommendations in this area, beyond suggesting that the Bank of England, in collaboration with the Financial Conduct Authority (FCA) and OFT, should monitor access to the payments system and the effectiveness of the Payments Council in providing adequate governance to ensure innovation and competition.

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27 Interbank Agency Agreements (IBAAs) are bilateral arrangements between banks, which allow banks to use the branch infrastructure of other banks for a fee.

Conditions for consumer choice: switching and transparency

8.46 Poor conditions for consumer choice mean that customers are unable to exert as much competitive pressure on banks as should be the case. In order to address this, customers need to be able to identify good offers in the market and to switch to them without undue difficulty. At the moment, neither is easy to do: Chapter 7 demonstrated how a lack of transparency and perceived riskiness of switching mean that customers are not well placed to compare offers and switch between them.

Switching

A redirection service

8.47 The *Interim Report* provisionally concluded that the switching process for PCAs and BCAs should be improved, as customers perceived switching to be difficult and risky. In particular, this was found to be due to fears that direct debit originators would not update their systems with the new account details for a customer who switched, and that the customer would be penalised for bills that went unpaid as a result. Therefore, the *Interim Report* suggested that some form of safety net could be helpful. This idea received widespread support in consultation responses,[28] and the Payments Council has put forward a specific proposal for an improved process that includes a redirection service as a temporary safety net for transactions that still go to the old (closed) account of customers who switch.

8.48 A number of respondents felt that there was a case for going further in that full account number portability was necessary to lead to effective switching.[29] Under account number portability, a customer's sort code and account number would not change when the customer changed banks, thereby avoiding the need to change any payment or credit instructions. Evidence to the Commission suggested that the effect of account number portability could be achieved through the creation of an 'alias database'. This proposal is for a new database to be created with a new code for each account that would be assigned to each sort code and account number: a customer would give the direct debit originators (and creditors) they deal with the new code, which would never change; when the customer moved banks, the sort code and account number assigned to the customer's code would change and nothing else.[30]

8.49 In the Commission's view, in order to deliver significant benefits a redirection service for personal and small business current accounts would have to:

- catch all credits and debits going to the old (closed) account, including automated payments taken from debit cards as well as direct debits;

28 See, for example, submissions from the British Bankers' Association, Co-operative Financial Services, and Consumer Focus, at http://bankingcommission.independent.gov.uk/?page_id=835.
29 See, for example, Virgin Money, 2011, *Virgin Money Response to ICB Interim Report*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Virgin-Money-response-to-ICB-Interim-Report-040711-FINAL-redacted.pdf.
30 See, for example, Birch, D., 2011, *An Idea for the Independent Commission on Banking*. Available at: http://www.convergenceconversation.com/posts/dave.birch/an-idea-for-the-independent-commission-on-banking.

- be seamless for the customer, so that throughout the process they have complete, problem-free use of their banking services and are not inconvenienced by debits or credits going to the wrong account;
- last for at least 13 months, to catch annual payments;
- continue to send reminders and provide support to direct debit originators to ensure that they update their details for people who have switched accounts;
- guarantee that customers will not suffer loss if mistakes occur in the switching process; and
- be free to the customer.

8.50 From the customer's point of view, a service with these characteristics would result in them being able to transfer their PCA and/or BCA more quickly and with no risk of an automated payment not being made. This would reduce one of the biggest barriers to customers switching their accounts: the risk that mistakes or delay in changing over direct debits, standing orders, salary mandates, and other payments would result in bills going unpaid or funds not being available (e.g. because a salary payment has mistakenly been deposited into an old, closed account). This is a real risk: currently, customers who switch have around seven direct debits on average,[31] and around 8.5% of direct debits that are switched go to the wrong bank[32] – hence there is a 46% chance for a consumer with the average number of direct debits that at least one will go to the wrong bank.[33]

8.51 The reduction, from such a redirection service, in the risk and cost of switching for customers and businesses would increase the pressure on banks to offer better services at lower prices. This would deliver two main benefits: competition between banks would be greater, and consumers who switch would have a smoother experience. In addition, banks and large direct debit originators who switch to automated systems as a result of this investment may make savings due to lower administration costs when a customer switches.

8.52 An improved switching system of this kind must be seen in the context of current market perceptions. Ideally, the new service would help perceptions to change over time. But as market expectations currently stand, half of customers would be no more likely to switch accounts with the new switching system, even if they felt they needed

31 Based on accounts that are currently switched using the automated transfer of direct debit and standing order (ToDDaSO) process. Data provided to the Commission by Bacs.
32 Paragraph 1.7, OFT, 2011, *Personal Current Accounts in the UK: Progress Update*. Available at: http://www.oft.gov.uk/shared_oft/reports/financial_products/PCA_update_March_2011.pdf.
33 Assuming independent probabilities of misdirection, the probability of at least one direct debit going to the wrong bank is $1-0.915^7=0.46$.

to.[34] Market research identified a group of customers for whom the following three conditions held:[35]

- they were open to switching, and saw moving PCA as worthwhile;
- they had not moved because they were put off by the hassle; and
- they would be more likely to move in future if the switching system were introduced.

8.53 This group made up 12% of the total PCA market. While this is significantly higher than the 3.8% of PCA customers who switched accounts in 2010 (only a subset of whom actually opened a new account, transferred all of their activities across, and closed the old account – see Table 7.4) it is still relatively low. Importantly, only a subset of this 12% are actually likely to become switchers in the future: they will still need to overcome obstacles to comparing accounts and identifying the right one.[36] The current lack of transparency on current accounts will also need to be addressed for these customers to be able to move account effectively.

8.54 In the Netherlands, where a similar bank account redirection system (albeit with some significant differences) has been in place since 2004, switching rates are still very low, and there remains a perception among non-switchers that the process would be difficult, despite the fact that those who have switched using the redirection service found it easy. It appears that despite the positive customer satisfaction among those that did switch using the switching service, the existence of the service has not (yet) changed the perception among non-switchers that switching would be difficult, nor has it been transformational in raising switching rates. This is not a reason to conclude that the introduction of a similar service in the UK would not deliver benefits. However, it emphasises the need for such a service to be accompanied by improved transparency, and gives cause to be sceptical about claims that the impact of this measure on its own will be transformational for competition and consumer choice.

8.55 It appears that an effective redirection service, with the characteristics set out in Paragraph 8.49, can be introduced at a reasonable cost to the industry. Preliminary discussions with the Payments Council suggest that these costs could be in the order of £650mn to £850mn. These are predominantly one-off costs – the ongoing maintenance costs would be very low, and may be balanced out by savings from reducing manual processes. These estimates include costs to all those potentially affected by the change, including central payments schemes, banks that are members of these schemes, banks that access these schemes through agency arrangements, and service users of payments systems such as direct debit originators and merchants

34 49% of customers would be no more likely to switch accounts in the future, if they felt they needed to. Page 14, Quadrangle, 2011, *PCA Consumer Research Findings*. Available at: http://www.quadrangle.com/PCA_switching_consumer_research.pdf.
35 Quadrangle, 2011, *PCA Consumer Research Findings*. Available at: http://www.quadrangle.com/PCA_switching_consumer_research.pdf.
36 This is also assuming that they are all reached by publicity informing them of the new service.

that take automated debit card payments. There is significant uncertainty around these costs, which are still subject to testing with banks and service users. In some cases, the direct costs of introducing the redirection service may be one element of wider investments in infrastructure, in which case it will be difficult to attribute costs specifically to the new service. The costs to small business direct debit originators are expected to be unchanged from the current system. The costs to small banks and banks that access payments systems through agency arrangements are still highly uncertain.

8.56 The Commission's conclusion is that there are significant net benefits of such a service. This service may also have a financial stability benefit, as it will facilitate orderly resolution of failed current account providers by enabling the accounts to be switched to another bank easily and reliably.

Recommendations

8.57 The Commission recommends that a current account redirection service should be established, to smooth the process of switching current accounts for individuals and small businesses. To be effective, it should:

- catch all credits and debits going to the old (closed) account, including automated payments taken from debit cards as well as direct debits;
- be seamless for the customer, so that throughout the process they have complete, problem-free use of their banking services and are not inconvenienced by debits or credits going to the wrong account;
- last for at least 13 months, to catch annual payments;
- continue to send reminders and provide support to direct debit originators to ensure that they update their details for people who have switched accounts;
- guarantee that customers will not suffer loss if mistakes occur in the switching process; and
- be free to the customer.

8.58 The redirection service should be fully operational by September 2013. This is a challenging but manageable timeline, and the Government should monitor progress closely to ensure that it is met.

8.59 The redirection service should be introduced in a way that does not impose disproportionate costs on new entrants and banks that access payments systems through agency arrangements. In particular, small banks/building societies and small business direct debit originators should not be penalised by this move to improve the switching system.

8.60 There may be a case for account number portability in due course, but the redirection service would be a cost-effective first step. If it does not achieve its aims, there could be a strong case, depending on cost, for full account number portability to be introduced (potentially through use of an alias database). Once the redirection service has been implemented, the FCA should assess whether it is delivering enough of an increase in willingness to switch to lead to effective competitive tension. If it is not, then the incremental costs and benefits of account number portability should be considered. However, a lack of willingness to switch could also be a result of lack of transparency or other barriers, and these should also be addressed. One significant benefit of account number portability (whether done through making existing account numbers effectively portable, or through the creation of an alias database) is that it would remove the cost of switching to direct debit originators, as well as those who make automatic payments into customers' accounts. However, given the importance of the payments system, it would be critical to ensure that the migration to account number portability did not disrupt the flow of payments or introduce greater operational risks into the payments system.

8.61 This switching service should be available for both personal and small business current account customers. For small businesses wishing to switch banks, switching is perceived to be potentially more difficult where there is borrowing outstanding, especially if it is secured – this was identified in the Competition Commission (CC) inquiry into SME banking in 2002.[37] To ease switching for small businesses, in addition to the redirection service above, a maximum timescale should be introduced for the release of security after repayment of borrowing, and banks should improve the process for transferring security.

Transparency

8.62 The *Interim Report* identified that the switching process is not the only impediment to effective switching: without the ability for customers to compare accounts and identify a better deal, even full account number portability would not lead to strong effective competition – i.e. strong competition to serve customers well.

8.63 Respondents agreed with this assessment of the problem, and put forward a number of potential suggestions to address it, including creating an industry standard for price comparison sites, restricting pricing structures, and making consumer data available electronically to allow customers to use price comparison sites to determine what current account would be best for their pattern of usage. The Treasury Select Committee also identified price transparency as vitally important to competition in retail banking, and suggested that, as a priority, the OFT and banks should examine how to provide information to customers on interest foregone.[38]

37 Page 140, CC, 2002, *The Supply of Banking Services by Clearing Banks to Small and Medium-Sized Enterprises*. Available at: http://www.competition-commission.org.uk/rep_pub/reports/2002/fulltext/462c4.pdf.
38 Paragraph 87, House of Commons Treasury Committee, 2011, *Competition and Choice in Retail Banking, Ninth Report of Session 2010-11*. Available at: http://www.publications.parliament.uk/pa/cm201011/cmselect/cmtreasy/612/612i.pdf.

8.64 The impact of increased transparency would be to facilitate effective switching, in which customers switch to accounts that better suit their needs, compelling banks to offer the prices and services that customers seek. Transparency is a complement to switching: the benefits of the redirection service will be limited unless accompanied by improved transparency, and will be amplified if transparency is increased alongside.

8.65 It has been argued by one bank[39] that the redirection service would transform the PCA market in the same way that mobile number portability transformed the mobile telephony market, and would bring the same competitive pressure to bear on current account providers as currently exists for the utilities industry, where the costs of switching are relatively low. However, experience in the energy and telecommunications industries shows that the benefits of improving the switching process alone will be limited unless transparency is improved at the same time, as set out in the following paragraphs.

8.66 Households were able to switch energy suppliers from late 1998, and there was a considerable amount of switching in the first few years.[40] This was likely due to:

- a large amount of media coverage regarding the new ability to switch;
- the significant benefits that consumers could make from the first time they switched;
- the large amount of doorstep selling; and
- substantial entry in both markets – in particular, the entry of electricity retailers into the gas market and vice versa.

8.67 However, the switching rate for energy markets has fallen in the last few years. Ofgem's research indicates that this is because:[41]

- complex pricing structures reduce consumer engagement;
- an increasing number of tariffs can reduce consumer engagement;
- consumers are affected by a status quo bias;

39 Pages 32-36, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.
40 Between 1998 and 2010, up to 40% of customers switched supplier. But that has been constant for some years and the switching rate is falling – see Paragraphs 2.48 and 2.50, Ofgem, 2011, *Retail Market Review*. Available at: http://www.Ofgem.gov.uk/Markets/RetMkts/rmr/Documents1/RMR_FINAL.pdf.
41 See Ofgem, 2011, *Retail Market Review*. Available at: http://www.Ofgem.gov.uk/Markets/RetMkts/rmr/Documents1/RMR_FINAL.pdf. And Ofgem, 2011, *What Can Behavioural Economics Say About GB Energy Consumers?* Available at: http://www.Ofgem.gov.uk/Markets/RetMkts/rmr/Documents1/Behavioural_Economics_GBenergy.pdf.

- consumers do not have a trigger point at which they would naturally consider switching supplier;
- consumers assume that their supplier puts them on the best deal available; and
- consumers have a limited ability to calculate the benefits from switching and they are less likely to switch when faced with a large number of choices.

Given the opacity of the PCA and BCA markets, these features are likely to exist there as well.

8.68 Ofcom has undertaken a great deal of work on switching in communications markets over recent years, and recently published a strategic review of consumer switching.[42] It includes work on fixed-line and mobile mis-selling, broadband switching and Mobile Number Portability (MNP). Despite the introduction of MNP the switching rate for mobile phones was fairly low – 11% in 2008 and 2009, and only 6% in 2010.[43]

8.69 If consumers face some cost of switching supplier, whether due to the process of switching itself, or the effort required to understand pricing structures and identify the most suitable one for their needs, they will be less inclined to switch even when a better offer is available. Therefore, a bank has a reduced incentive to offer better products as it gains fewer customers from doing so.[44] Hence, increasing transparency to reduce switching costs increases competition and improves consumer outcomes. If the willingness of consumers to switch increases, banks will be under greater competitive pressure and hence may offer better products or prices to consumers. Both the OFT and the CC have recently estimated the benefits that would accrue due to their recommendations to increase transparency and make switching easier.[45] The OFT estimated that the benefits of its switching and transparency measures would be between £211mn and £1,093mn per year. The OFT came to these values by comparing the biggest four banks with challengers in the case of interest rates, and assumed a reasonably low level of change for charges to PCAs. The recommendations proposed in this report are substantial improvements on top of the OFT's measures, and thus would increase these benefits further.

8.70 In addition, improving transparency will help to direct competition better towards effective competition to provide products and services that customers want – 'good'

42 Ofcom, 2010, *Strategic Review of Consumer Switching*. Available at: http://stakeholders.ofcom.org.uk/binaries/consultations/consumer-switching/summary/switching.pdf.
43 Paragraph 4.9, Ofcom, 2010, *Strategic Review of Consumer Switching*. Available at: http://stakeholders.ofcom.org.uk/binaries/consultations/consumer-switching/summary/switching.pdf.
44 The effect of switching costs may be more complex than this. For a detailed summary of how switching costs can affect competition, see Farrell, J. and Klemperer, P., 2007, Coordination and lock-in: competition with switching costs and network effects in Armstrong, M. and Porter, R. eds., *Handbook of Industrial Organization, Vol 3*, pp.1967-2072. The authors conclude that switching costs "probably do make competition more fragile, especially when they coexist with ordinary scale economies" (Page 2005).
45 CC, 2007, *Personal Current Account Banking Services in Northern Ireland Market Investigation*. Available at: http://www.competition-commission.org.uk/rep_pub/reports/2007/fulltext/527.pdf. OFT, 2009, *Personal Current Accounts in the UK: A Follow Up Report*. Available at: http://www.oft.gov.uk/shared_oft/personal-current-accounts/OFT1123.pdf.

competition – rather than using misleading advertising or exploiting complex terms and conditions to sell overpriced or inappropriate products.

Recommendations

8.71 The Commission views transparency and comparability of PCAs and BCAs as a crucial counterpart to improving the switching process: improving the technicalities of switching alone will not lead to an increase in competition unless customers can identify the best account to switch to. The OFT, and the FCA once it has been established, should work with the banks to improve transparency across all retail banking products, and in particular for PCAs and BCAs. Banks should provide data on the cost of their services (including before and after any introductory period) for a sample of representative customer profiles to demonstrate potential costs, and should provide price information in an accessible form in response to any reasonable request from a price comparison site.

8.72 As a first step, the Commission recommends that interest foregone relative to the Bank of England base rate[46] should be incorporated into the annual statements that are currently being introduced in response to the OFT's initiatives on PCAs.[47] Providing transparency on foregone interest is important for two reasons: it will make customers conscious of the overall cost of their account, enabling them to judge whether they are receiving sufficient benefits for that price; and in addition, it will allow free-if-in-credit current accounts to be compared to accounts that charge a management fee but also pay higher rates of interest, encouraging a greater diversity of transparent pricing models. In the current low interest rate environment, interest foregone will appear low, but this will change as the base rate normalises.

8.73 The FCA should carry out customer research to identify the best way to present foregone interest on bank statements, and should require banks to provide this information in the standardised way it identifies. Foregone interest should appear on bank statements as soon as possible, and in any event no later than January 2013. This is a low-cost measure that will provide useful additional information to enable customers to understand pricing structures better.

8.74 In addition, once the OFT's current transparency remedies have been implemented, the Commission recommends that the FCA consider the following options for improving transparency further.

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46 This official rate has advantages of prominence and simplicity. However, it is not necessarily ideal. First, the base rate is a very short-term rate whereas bank deposits, even if instantly withdrawable, typically have longer duration. Second, in some conditions, including those prevailing now, bank funding costs do not track the base rate. Their marginal funding costs have exceeded base rate by as much as 2 percentage points since 2008: see Chart B, Page 16, Bank of England, 2011, *Inflation Report August 2011*. Available at: http://www.bankofengland.co.uk/publications/inflationreport/ir11aug.pdf.

47 See OFT, 2009, *Personal Current Accounts in the UK: A Follow Up Report*. Available at: http://www.oft.gov.uk/shared_oft/personal-current-accounts/OFT1123.pdf. Note that it is not the Commission's intention for this recommendation to replace or delay any of the OFT's existing transparency initiatives.

- Full account usage information from at least the previous 12 months could be made available in electronic form, allowing the development of price comparison models that could identify the optimal current account based on the customer's actual transaction history.[48] For example, the customer could upload their data to a comparison site, which would provide a tailored response showing which products would best suit their situation. This could potentially be done as part of the Government's 'mydata' project.[49] This idea received strong support from consumer groups that responded to the *Interim Report*.[50]

- The FCA could consider how the complexity and number of price tariffs could be rendered more easily manageable.[51] For example, in some industries, suppliers are required to include in their product range one 'vanilla' product type with standardised characteristics that can be compared across the industry. In this case, competition would take place on a small number of price variables easily understood and comparable by consumers.

- As well as standardised, comparable current accounts, the FCA could consider requiring that SME credit product ranges also include a 'vanilla' product based on a reasonably small number of standardised variables, to allow intermediaries or price comparison sites to search across banks to identify the best price.

- The FCA and/or Money Advice Service could create a price comparison tool to assess the key features of current accounts and show which had the lowest annual cost for a customer with a particular set of characteristics.[52] This could provide a template for private sector providers to improve their service in this area. As price comparison sites gain prominence in consumer decision making in financial areas, the FCA should consider a code of practice or a kite-mark scheme to ensure that these sites are providing independent objective advice to consumers.

- Comparison tools could also be developed to take into account non-price characteristics of banking products. The FCA could develop a standard questionnaire addressing non-price attributes of current account providers. One tool in this area is being developed by FairBanking, who provided evidence to

48 This would require banks to publicise a list of all of their charges and for banks to provide customers with a downloadable record of their daily balances and the type of transactions used.
49 Page 17, Department for Business Innovation and Skills and Cabinet Office, 2011, *Better Choices, Better Deals: Consumers Powering Growth*. Available at: http://www.bis.gov.uk/assets/biscore/consumer-issues/docs/b/11-749-better-choices-better-deals-consumers-powering-growth.pdf.
50 Page 4, Which?, 2011, *Which? Response to the ICB Interim Report*. Available at http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Which.pdf.
51 This was also suggested by some respondents to the *Interim Report*. For example, Which?, 2011, *Which? Response to the ICB Interim Report*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Which.pdf. Consumer Focus, 2011, *Consumer Focus Response to the Independent Banking Commission Consultation on Reform*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Consumer-Focus.pdf.
52 This was also recommended in OFT, 2009, *Personal Current Accounts in the UK: A Follow Up Report*. Available at: http://www.oft.gov.uk/shared_oft/personal-current-accounts/OFT1123.pdf.

the Commission on their research to develop a kite-mark indicator for banking products that contribute to 'financial well-being'.[53] The Government and/or FCA could consider supporting the development of such tools.

Pro-competitive regulation

8.75 Chapter 7 set out problems with consumer choice, transparency and misdirected competition. Many of these are long-standing problems that need continuing attention over time, but until now the sector has not been regulated so as to promote competition issues in a sustained way. Competition was not made a primary objective of the Financial Services Authority (FSA), but was rather one of a number of factors to which the FSA was required to 'have regard', subordinated to a range of other objectives. While the OFT and CC have applied general competition and consumer law to the sector – they have conducted a wide variety of market investigations, merger investigations, and other reviews, as set out on Page 24 of the *Issues Paper* – those powers are less effective than pro-competitive sector regulation has the potential to be.

8.76 The current reform of financial sector regulation presents a unique opportunity to change the nature of regulation in this sector, to ensure that regulation is directed at improving competition and choice to the benefit of consumers.

8.77 In response to this opportunity, the *Interim Report* recommended that the FCA should have a clear primary duty to promote competition. In his Mansion House speech on 15 June 2011 the Chancellor of the Exchequer confirmed that "as well as protecting consumer interests, the Financial Conduct Authority will have a new primary duty to promote competition".[54] The following day the Government published a white paper setting out the legislative proposals for the FCA.[55] It proposes that the objectives for the FCA be as set out in Box 8.3. The Government stated that the FCA will be expected to opt for the solution that promotes competition, if there is more than one possible solution to an issue it is investigating. It is generally expected to use its existing rule-making and firm-specific powers to promote competition, though it is also given the additional power to make a request to the OFT, to which the OFT is obliged to respond.

53 See the Fairbanking Foundation, at: http://www.fairbanking.org.uk/.
54 Chancellor of the Exchequer, 2011, *Mansion House Speech*. Available at: http://www.hm-treasury.gov.uk/press_58_11.htm.
55 HM Treasury, 2011, *A New Approach to Financial Regulation: The Blueprint for Reform*. Available at: http://www.hm-treasury.gov.uk/d/consult_finreg__new_approach_blueprint.pdf.

Box 8.3: Excerpt from the draft legislation for the FCA[1]

Part IA, Chapter 1

1B) 1. In discharging its general functions the FCA must, so far as is reasonably possible, act in a way which:

a. is compatible with its strategic objective, and

b. advances one or more of its operational objectives.

2. The FCA's strategic objective is: protecting and enhancing confidence in the UK financial system.

3. The FCA's operational objectives are:

a. the consumer protection objective

b. the integrity objective

c. the efficiency and choice objective.

4. The FCA must, so far as is compatible with its strategic and operational objectives, discharge its general functions in a way which promotes competition.

...

1C) The consumer protection objective is: securing an appropriate degree of protection for consumers.

...

1D) The integrity objective is: protecting and enhancing the integrity of the UK financial system.

...

1E) The efficiency and choice objective is: promoting efficiency and choice in the market for-

a. the services within section 1C(4), or

b. services provided by a recognised investment exchange in carrying on regulated activities in respect of which it is by virtue of section 285(2) exempt from the general prohibition.

[1] Pages 72-76, HM Treasury, 2011, *A New Approach to Financial Regulation: The Blueprint for Reform*. Available at: http://www.hm-treasury.gov.uk/d/consult_finreg__new_approach_blueprint.pdf.

8.78 A number of respondents to the *Interim Report* agreed that the FCA should play a stronger role in promoting competition than the FSA has done in the past.[56] In addition, the Treasury Select Committee, in its report on competition and choice in retail banking published on 24 March 2011, concluded that the current draft of the FCA's objectives is insufficient, and it should have a clear primary duty to promote

56 See, for example, Which?, 2011, *Which? Response to the ICB Interim Report*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Which.pdf.

competition.[57] However, in their responses some of the banks disagreed with this view. While there was general consensus that the FCA should have a role in monitoring competition, some banks disagreed that this should be a primary duty. They felt that it could distract from the FCA's other responsibilities, duplicate action by the competition authorities leading to inefficiency, and be in tension with product regulation. In addition, some banks disagreed with the Commission's suggestions for how the FCA should carry out this objective: they thought that *ex ante* regulatory action was not appropriate for the financial sector. Taking into account respondents' views, the Commission remains of the view that it is vital for the FCA to have a primary duty to promote effective competition.

8.79 With a duty to promote effective competition, the FCA would be expected to act to investigate and tackle existing obstacles, and future threats, to competition and the ability of consumers to make well-informed choices. The FCA would also have to ensure that regulation itself did not obstruct effective competition. Indeed, as the Commission's proposals on financial stability and consumer choice will better align incentives in a variety of ways – from improving risk-taking to enabling customers to switch easily away from banks providing poor service – there may be opportunities for deregulation in the banking industry if market discipline is able to play a more prominent role.

8.80 Among other things, such a duty would give the FCA a clear objective, and greater powers than regulators currently, to secure the implementation of many of the recommendations in this report, including those on the proposed switching redirection service and transparency. The Commission recommends that the FCA should as a priority give attention to these issues.

8.81 The FCA should monitor how well a switching redirection service works, and whether forms of account number portability would in due course bring greater benefit in relation to their cost. (It is to be noted that in telecoms it was the pro-competitive sector regulator that took the initiative to secure number portability.) It should also consider the measures set out in Paragraph 8.74 to improve transparency further, such as improving access to information, requiring product ranges to include a comparable standardised offering, and developing a code of practice for price comparison sites.

8.82 On transparency, and fair dealing more generally, there are existing problems in the marketplace, and new ones will arise in response to the development of new products, services, charging structures, etc. The FSA and the OFT/CC acted against problems in relation to payment protection insurance, but in the existing regulatory framework that was a lengthy process. With a clear duty to promote effective competition, the FCA would be expected to pre-empt such issues if they were to arise in the future, or at least would have the power and incentive to challenge them more rapidly using its regulatory tools. Likewise, it would have the ability to tackle

57 House of Commons Treasury Committee, 2011, *Competition and Choice in Retail Banking, Ninth Report of Session 2010-11*. Available at: http://www.publications.parliament.uk/pa/cm201011/cmselect/cmtreasy/612/612i.pdf.

unarranged overdraft charges, where it was ultimately judged that the OFT's power under the relevant part of general consumer law did not give it scope to make a substantive assessment of the issue. Besides being alert to possible malpractice in areas such as these, the FCA would act positively to improve customers' ability to understand and compare products.

8.83 The FCA would also monitor market features that could act as barriers to entry and expansion, including access to critical infrastructure and access to customer information.

Recommendations

8.84 The Commission welcomes the Government's commitment to give the FCA a new primary duty to promote competition.

8.85 The Commission believes, however, that this policy should be given more certain effect by revising the draft objectives in Box 8.3 above. That text is liable to be read as making the competition aspect of the remit subordinate to the strategic and operational objectives. Replacing the efficiency and choice objective with a competition objective – "promoting effective competition" in markets for financial services – would avoid this potential problem. That would be entirely consistent with promotion of efficiency and choice because they are advanced by effective competition.

8.86 The Commission is of the view that the competition duty (point 4 in Chapter 1B of the draft bill) should be kept, in addition to stating competition clearly as an operational objective. While this may appear duplicative, it makes clear that in pursuing *any* of its operational objectives – not just the competition objective – the FCA should use competition as a means of achieving them wherever possible. This is important, as competition will generally be the most effective way for the FCA to achieve its consumer protection objective, and will also be relevant to pursuit of its market integrity objective.

8.87 Separately, the Commission observes that the FCA's draft strategic objective is "protecting and enhancing confidence in the UK financial system", the practical meaning of which is unclear. The fundamental issue is to make markets work well – in terms of competition, choice, transparency and integrity. The Government should reconsider the strategic objective in order to provide greater clarity. If markets are working well, then consumers will have justified confidence in them.

Market investigation reference

8.88 The *Interim Report* considered whether there was a case for the relevant authorities to refer any banking markets to the CC for independent investigation and possible use of its powers to implement remedies under competition law. There have been a number of investigations by the competition authorities over the last decade or so, as the Commission recognised in this report and its previous publications. However, this

does not preclude further investigation, given the persistent problems identified in these markets.

8.89 The Enterprise Act 2002 provides that the OFT may make a market investigation reference to the CC if it "has reasonable grounds for suspecting that any feature, or combination of features, of a market in the United Kingdom for goods or services prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the United Kingdom or a part of the United Kingdom."[58]

8.90 On the basis of the evidence presented above, in Annex 4, and in the *Interim Report*, the Commission concludes that there is sufficient evidence to suspect that there are features of the PCA market which prevent, distort or restrict competition. Besides the market being concentrated, there are other features present that restrict competition, such as high barriers to entry, low levels of transparency and high switching costs. Since the OFT's 2008 review of the PCA market, and its investigation of the Lloyds TSB/HBOS merger, there has been an increase in concentration and a reduction in the number of challengers able to exert a competitive constraint on the larger incumbents.

8.91 This analysis also demonstrates that there are features of the BCA market which prevent, restrict or distort competition. These features are similar to the PCA market in nature, and are present to a similar, and in some cases greater, extent in the BCA market.

8.92 There is less evidence over the last decade that the same features exist in the mortgage market. In particular, the ease of switching mortgages and the availability of intermediaries means that consumers are much better able to move between providers. However, the mortgage market remains in a state of flux. Competition in the mortgage market in the future is therefore contingent on developments over the next few years. Accordingly, the competition authorities should continue to monitor this market.

8.93 It is clear that a number of developments are in train which have the potential to address many of the features of the PCA and BCA market that prevent, restrict, or distort competition – including the recommendations contained in this report. It would therefore not be sensible for the Commission to recommend an immediate market investigation reference of the PCA and/or BCA markets. But such a reference could well be called for depending how events turn out in the next few years, and specifically whether:

- a strong and effective challenger has resulted from the LBG divestiture;

58 *Enterprise Act* 2002. s.131(1). Available at: http://www.legislation.gov.uk/ukpga/2002/40/section/131. See also OFT, 2006, *Market Investigation References*. Available at: http://www.oft.gov.uk/shared_oft/business_leaflets/enterprise_act/oft511.pdf.

- ease of switching has been transformed by the early establishment of a robust and risk-free redirection service; and
- a strongly pro-competitive FCA has been established and is demonstrating progress to improve transparency and reduce barriers to entry and expansion for rivals to incumbent banks.

8.94 If one or more of these conditions is not achieved by 2015, a market investigation reference should be actively considered if the OFT has not already made one following its proposed review in 2012 of the PCA market.[59]

59 Page 24, OFT, 2011, *Personal Current Accounts in the UK, Progress Report*. Available at: http://www.oft.gov.uk/shared_oft/reports/financial_products/PCA_update_March_2011.pdf.

PART III: RECOMMENDATIONS
Chapter 9: Recommendations

9.1 This chapter brings together the Commission's recommendations and summarises them in the following three sections:

- retail ring-fence;
- loss-absorbency; and
- competition.

These recommendations should apply to all UK banks and building societies. More details on these recommendations are set out in the preceding chapters.

Retail ring-fence

9.2 The Commission recommends the implementation of a retail ring-fence, with the purpose, objectives and principles set out immediately below.

Purpose and objectives

The purpose of the retail ring-fence is to isolate those banking activities where continuous provision of service is vital to the economy and to a bank's customers in order to ensure, first, that this provision is not threatened as a result of activities which are incidental to it and, second, that such provision can be maintained in the event of the bank's failure without government solvency support. A retail ring-fence should be designed to achieve the following objectives at the lowest possible cost to the economy:

- make it easier to sort out both ring-fenced banks and non-ring-fenced banks which get into trouble, without the provision of taxpayer-funded solvency support;
- insulate vital banking services on which households and SMEs depend from problems elsewhere in the financial system; and
- curtail government guarantees, reducing the risk to the public finances and making it less likely that banks will run excessive risks in the first place.

This can be done by following the five principles below.

Principles

1. **Mandated services**. Only ring-fenced banks[1] should be granted permission by the UK regulator[2] to provide mandated services. Mandated services should be those banking services where:

a) even a temporary interruption[3] to the provision of service resulting from the failure of a bank has significant economic costs; and

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

Mandated services currently comprise the taking of deposits from, and the provision of overdrafts to, individuals[4] and small and medium-sized organisations.[5]

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

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

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

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

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

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

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

a) any service which is not provided to customers within the European Economic Area;

b) any service which results in an exposure to a non-ring-fenced bank or a non-bank financial organisation,[6] except those associated with the provision of payments services where the regulator has deemed this appropriate;[7]

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

d) any service which would result in a requirement to hold regulatory capital against market risk; [8]

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

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

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

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

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

4. **Legal and operational links**. Where a ring-fenced bank is part of a wider corporate group, the authorities should have confidence that they can isolate it from the rest of

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

the group in a matter of days and continue the provision of its services without providing solvency support.

As a result:

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

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

c) the wider corporate group should be required to put in place arrangements to ensure that the ring-fenced bank has continuous access to all of the operations, staff, data and services required to continue its activities, irrespective of the financial health of the rest of the group;[9] and

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

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

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

a) its relationships with any entities within the same group which are not ring-fenced banks should be treated for regulatory purposes no more favourably than third party relationships;[10]

b) all transactions (including secured lending and asset sales) with other parts of the group should be conducted on a commercial and arm's length basis[11] in line with sound and appropriate risk management practices;

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

9 For example, the ring-fenced bank could directly own all the relevant infrastructure, or the infrastructure could be placed in a subsidiary which was bankruptcy-remote from the rest of the group.
10 Where there is more than one ring-fenced bank within the same corporate group there need not be any restrictions on transactions between them. 'Sub-consolidation' of regulatory requirements across ring-fenced banks would also be acceptable.
11 I.e. transactions should be valued as if they had been carried out between unrelated parties, each acting in his own best interest.

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

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

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

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

   i) one is the Chair; and

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

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

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

Loss-absorbency

9.3 The Commission makes the following recommendations on loss-absorbency.

Equity

- Ring-fenced banks with a ratio of risk-weighted assets (RWAs) to UK GDP of 3% or more should be required to have an equity-to-RWAs ratio of at least 10%.

- Ring-fenced banks with a ratio of RWAs to UK GDP in between 1% and 3% should be required to have a minimum equity-to-RWAs ratio set by a sliding scale from 7% to 10%.

Leverage ratio

- All UK-headquartered banks and all ring-fenced banks should maintain a Tier 1 leverage ratio of at least 3%.
- All ring-fenced banks with a RWAs-to-UK GDP ratio of 1% or more should have their minimum leverage ratio increased on a sliding scale (to a maximum of 4.06% at a RWAs-to-UK GDP ratio of 3%).

Bail-in

- The resolution authorities should have a primary bail-in power allowing them to impose losses on long-term unsecured debt (bail-in bonds) in resolution before imposing losses on other non-capital, non-subordinated liabilities.
- The resolution authorities should have a secondary bail-in power to enable them to impose losses on all other unsecured liabilities[12] in resolution, if necessary.

Depositor preference

- 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.

Primary loss-absorbing capacity

- UK-headquartered global systemically important banks (G-SIBs) with a 2.5% G-SIB surcharge, and ring-fenced banks with a ratio of RWAs to UK GDP of 3% or more, should be required to have capital and bail-in bonds (together, primary loss-absorbing capacity) equal to at least 17% of RWAs.
- UK G-SIBs with a G-SIB surcharge below 2.5%, and ring-fenced banks with a ratio of RWAs to UK GDP of in between 1% and 3%, should be required to have primary loss-absorbing capacity set by a sliding scale from 10.5% to 17% of RWAs.

Resolution buffer

- The supervisor of any (i) G-SIB headquartered in the UK; or (ii) ring-fenced bank with a ratio of RWAs to UK GDP of 1% or more, should be able to require the bank to have additional primary loss-absorbing capacity of up to 3% of RWAs if, among other things, the supervisor has concerns about its ability to be resolved at minimum risk to the public purse.

12 Liabilities secured with a floating charge only should also be subject to the secondary bail-in power.

- The supervisor should determine how much additional primary loss-absorbing capacity (if any) is required, what form it should take, and which entities in a group the requirement should apply to, and whether on a (sub-)consolidated or solo basis.

Competition

9.4 The Commission makes the following recommendations on competition.

Market structure

The Commission recommends that the Government reach agreement with Lloyds Banking Group (LBG) such that the entity which results from the divestiture:

- has a funding position at least as strong as its peers, including as evidenced by its loan-to-deposit ratio (LDR) relative to its peers' LDRs at the time of the disposal; and

- has a share of the personal current account (PCA) market of at least 6%.

Barriers to entry

The Commission recommends that the Prudential Regulatory Authority (PRA) work with the Office of Fair Trading (OFT) to review the application of prudential standards to ensure that prudential requirements for capital and liquidity do not unnecessarily limit the ability of new entrants to enter the market safely and to grow. In particular, it should ensure that use of the standardised approach to calculating risk weights does not penalise banks that are unable to transition to an advanced approach because of the high fixed cost of doing so.

Switching

The Commission recommends that a current account redirection service should be established, to smooth the process of switching current accounts for individuals and small businesses. To be effective, it should:

- catch all credits and debits going to the old (closed) account, including automated payments taken from debit cards as well as direct debits;

- be seamless for the customer, so that throughout the process they have complete, problem-free use of their banking services and are not inconvenienced by debits or credits going to the wrong account;

- last for at least 13 months, to catch annual payments;

- continue to send reminders and provide support to direct debit originators to ensure that they update their details for people who have switched accounts;
- guarantee that customers will not suffer loss if mistakes occur in the switching process; and
- be free to the customer.

The redirection service should be fully operational by September 2013. The Government should monitor progress to ensure that this deadline is met. The redirection service should be introduced in a way that does not impose disproportionate costs on new entrants and banks that access payments systems through agency arrangements. In particular, small banks/building societies and small business direct debit originators should not be penalised by this move to improve the switching system.

To ease switching for small businesses, in addition to the redirection service above, a maximum timescale should be introduced for the release of security after repayment of borrowing, and banks should improve the process for transferring security.

Transparency

The Commission recommends that the OFT, and the Financial Conduct Authority (FCA) once it has been established, should work with the banks to improve transparency across all retail banking products, and in particular for PCAs and business current accounts (BCAs). Banks should provide data on the cost of their services (including before and after any introductory period) for a sample of representative customer profiles to demonstrate potential costs, and should provide price information in an accessible form in response to any reasonable request from a price comparison site.

As a first step, the Commission recommends that interest foregone relative to the Bank of England base rate should be incorporated into the annual statements that are currently being introduced in response to the OFT's initiatives on PCAs.[13] The FCA should carry out customer research to identify the best way to present foregone interest on bank statements, and should require banks to provide this information in the standardised way it identifies. Foregone interest should appear on bank statements as soon as possible, and in any event no later than January 2013.

In addition, once the OFT's current transparency remedies have been implemented, the Commission recommends that the FCA consider other options for improving transparency further, including:

13 See OFT, 2009, *Personal Current Accounts in the UK: A Follow Up Report*. Available at: http://www.oft.gov.uk/shared_oft/personal-current-accounts/OFT1123.pdf. Note that it is not the Commission's intention for this recommendation to replace or delay any of the OFT's existing transparency initiatives.

- making account usage data available to customers in electronic form, enabling it to be used as an input by price comparison sites;
- requiring product ranges to include an easily comparable standardised product;
- improving price comparison tools for PCAs and creating a code of practice for comparison sites; and
- developing comparison tools for non-price product characteristics.

Financial Conduct Authority

The Commission welcomes the Government's commitment to give the FCA a new primary duty to promote competition. To clarify this duty, the Commission recommends that in the FCA's draft objectives, the efficiency and choice operational objective should be replaced with an objective to "promote effective competition" in markets for financial services. That would be entirely consistent with promotion of efficiency and choice because they are advanced by effective competition. The duty to discharge its functions in a way which promotes competition (Chapter 1B, point 4 in the draft bill) should also be kept, to make clear that in pursuing *any* of its operational objectives – not just the competition objective – the FCA should use competition as a means of achieving them wherever possible.

In addition, the Government should reconsider the FCA's strategic objective to provide greater clarity on the fundamental issue of making markets work well – in terms of competition, choice, transparency and integrity.

Market investigation reference

The Commission is not recommending an immediate market investigation reference to the competition authorities of the PCA and/or BCA markets. But such a reference could well be called for depending on how events turn out in the next few years, and specifically whether:

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

If one or more of these conditions is not achieved by 2015, the Commission recommends that a market investigation reference should be actively considered if the OFT has not already made one following its proposed review in 2012 of the PCA market.[14]

14 Page 24, OFT, 2011, *Personal Current Accounts in the UK, Progress Report*. Available at: http://www.oft.gov.uk/shared_oft/reports/financial_products/PCA_update_March_2011.pdf.

Glossary

Asset

An 'asset' is an economic resource that is expected to provide future economic benefits. In the case of a bank, many of its assets will consist of loans to individuals and companies.

Bacs

Bacs – originally known as Bankers' Automated Clearing Services – is an industry body responsible for the schemes behind the clearing and settlement of automated payments in the UK.

Bail-in/bail-inable debt/bail-in bond

'Bail-in' refers to the imposition of losses at the point of failure (but before insolvency) on bank liabilities ('bail-inable debt') that are not exposed to losses while the institution remains a viable, going concern. Whether by way of write-down or conversion into equity, this has the effect of recapitalising the bank (although it does not provide any new funding). 'Bail-in bond' refers to long-term unsecured debt that is subject to the primary bail-in power recommended by the Commission.

Basel III

'Basel III' is a comprehensive set of reform measures, developed by the BCBS, to strengthen the regulation, supervision and risk management of the banking sector. These international standards aim to: improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source; improve risk management and governance; and strengthen the transparency and disclosure standards of banks.

Basel Committee on Banking Supervision (BCBS)

The Basel Committee on Banking Supervision provides a forum for regular co-operation on banking supervisory matters among its members, and develops international guidelines and supervisory standards. The Basel Capital Accord is the agreement first reached in 1988 by central banks from a number of countries, including the UK, to establish consistency in international capital standards. It was subsequently amended in 2004 (Basel II) and in 2010 (Basel III).

Big Four

Barclays, HSBC, LBG (Lloyds TSB and HBOS before 2009) and RBS.

Bond

Essentially, a loan that can be traded as an asset in itself. Governments, companies and others issue bonds to raise money; in doing so, they incur an obligation to repay the bondholder in accordance with the terms of the bond, which will typically provide for repayment of principal after a certain period of time, and payment of interest while the bond is outstanding. Once issued, bonds – including the right to receive repayments of principal and payments of interest – can be traded on established markets.

Building society

A 'building society' is a legal entity which instead of being owned by external shareholders (like a company) is a mutual society owned by its members – its savers and borrowers. Building societies undertake similar activities to those of retail and commercial banks. However, their business model has (in part because of statutory restrictions) tended to be more conservative, consisting principally of taking in retail deposits and making loans in the residential mortgage market. One consequence of building societies being owned by their members rather than by external shareholders is that building societies cannot issue new equity, instead relying on retained profits to generate capital to support growth and absorb losses.

Capital

A bank's 'capital' comprises equity and debt instruments that absorb losses before depositors and other creditors. Regulators require banks to hold minimum amounts of capital relative to their risk-weighted assets to cover unexpected losses.

Capital conservation buffer (CCB)

The 'capital conservation buffer' is an extension to the Basel III 'hard' minimum equity requirement (breach of which would be likely to result in a bank being put into resolution), designed to absorb losses during periods of stress. While banks are allowed to operate within the buffer, doing so imposes regulatory constraints on their ability to make distributions (e.g. dividends, employee bonuses). The closer their capital ratio is to the hard regulatory minimum, the greater the constraints on distributions.

Capital Requirements Directive IV (CRD IV)

The European Commission's legislative package designed to implement the Basel III capital and liquidity standards, replacing the current Capital Requirements Directives (2006/48 and 2006/49) with a directive and a regulation.

Challenger bank/challenger

'Challenger banks' in a market for banking services are those that are large enough to be a threat to the incumbent providers in that market, but small enough to have an incentive to compete for new customers.

Close-out netting

If a number of transactions between two counterparties are governed by a single agreement that is subject to 'close-out netting', then on the termination (or 'close-out') of the agreement, the counterparties' rights and obligations under those transactions are valued on a basis laid down in the agreement and set off against each other (or 'netted'). The result is a single payment due from one party to the other.

Collateral

Property provided by one party to a loan or other financial transaction to the other to provide protection against default. If the party providing collateral does default, the other party retains the collateral.

Commercial banking

The provision of banking services – principally deposit-taking, payment services and lending – to companies. However, the provision of banking services to SMEs is typically included in retail banking, and for large corporations to some extent in wholesale and investment banking.

Common Equity Tier 1 (CET1)

The highest quality form of regulatory capital, comprising common equity (i.e. shares) and retained earnings (net of various technical deductions). CET1 forms part of Tier 1 capital.

Consolidated basis

If regulatory requirements are applied to a corporate group on a 'consolidated basis', then all exposures between the entities within that group are netted off and the requirements are then applied to the group as a whole.

Contingent capital/contingent convertible capital/cocos

'Contingent capital' is debt that is designed to convert into equity ('contingent convertible capital instruments', or 'cocos') or be written down on some trigger – for example, a bank's equity-to-RWAs ratio falling below a certain level – while a bank is still viable. Debt that converts (or is written down) at the point of failure is bail-inable debt.

Counter-cyclical capital buffer

An extension of the capital conservation buffer under which regulators may require banks to hold additional capital during good times, both to slow the growth of credit and to build reserves to absorb losses during bad times.

Counterparty

A person who is a party to a contract.

Credit default swap (CDS)

A 'credit default swap' is a financial contract under which one party sells protection to another party against the occurrence of a defined 'credit event' – including restructuring and default – in respect of a specified borrower. The CDS buyer pays a premium to receive protection against default by the borrower; the CDS seller receives the premium and in return guarantees the credit risk of the borrower. If a party holds a security issued by the borrower, it may want to protect itself against default by the borrower on that security by entering into a CDS to buy credit protection. Alternatively, a party may simply choose to speculate on the performance of the borrower by buying or selling a CDS without having any other exposure to the borrower.

Creditor

A person or organisation to whom money is owed.

Creditor hierarchy

In the event of a company insolvency, creditors have a claim on the remaining assets of the company. The 'creditor hierarchy' specifies the order in which assets are distributed to creditors. Those higher up the ranking will have a prior claim on the remaining assets.

Depositor preference

Under 'depositor preference', the claims of other unsecured creditors of a bank are subordinated to those of depositors. This means that in an insolvency, depositors will be paid out ahead of other unsecured creditors.

Derivative

A 'derivative' is a financial contract the value of which is derived from one or more underlying assets or indicators such as equities, bonds, commodities, currencies, interest rates and market indices.

Discount window facility (DWF)

An exchange facility introduced by the Bank of England, which is designed to help credit institutions deal with short-term idiosyncratic and system-wide liquidity shocks. For a fee, the DWF allows a bank to exchange a wide range of collateral (which may be untradeable at the time) for gilts, which the bank would then be able to lend out in the market (thus helping maintain its liquidity levels).

Dodd-Frank Act

The Wall Street Reform and Consumer Protection Act – known as the 'Dodd-Frank Act' – was signed into law in the US in July 2010. The aim of the Act is to promote financial stability and address the 'too big to fail' problem in the US financial sector. The key changes include an overhaul of the regulatory and supervisory structure, introduction of formal liquidation responsibilities, increased transparency, and the implementation of the 'Volcker rule', which

limits the extent to which insured deposit-taking institutions can carry out proprietary trading.

Equity

The shareholders' interests in a company, equal in value to the net assets of the company – i.e. the value of a company's assets less the value of all non-equity liabilities. It is through their equity holdings that shareholders are entitled to the company's profits (in the form of dividends) and control over the running of the company (through shareholder voting rights).

Financial Collateral Arrangements Directive

A European Union Directive (2002/47/EC) which introduces a framework to reduce credit risk in financial transactions through the provision of securities and cash as collateral.

Financial intermediation

The activity of channelling funds from savers to borrowers.

Financial Services Compensation Scheme (FSCS)

The Financial Services Compensation Scheme provides compensation to customers of deposit-taking financial institutions primarily authorised in the UK that are no longer able to meet their claims. The amount reimbursed by the FSCS will depend on the claim and the type of customer (e.g. retail deposits receive 100% compensation up to £85,000; and certain retail investments up to £50,000).

Financial Stability Board (FSB)

The Financial Stability Board, whose mandate is provided by the G20, is made up of a number of national financial authorities and international standard setting bodies. Its aim is to co-ordinate the development of effective regulatory, supervisory and other financial sector policies.

Funding

The financing of a bank's operations. Most funding for retail and commercial banking activities is usually provided by customer deposits. Where a bank has a funding gap – fewer deposits than loans – it will typically meet this through borrowing in the wholesale funding markets. Banks also get an important part of their funding from capital, including equity.

Global systemically important banks (G-SIBs)/G-SIB surcharge

'Global systemically important banks' are banks that will in due course be identified as such under a proposed methodology published for consultation by the BCBS in July 2011.[1] The consultation paper proposes that G-SIBs be required to have additional loss-absorbency – a 'G-SIB surcharge' – in the form of equity.

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

Hedge fund

An investment fund (often organised as a private partnership) that has few restrictions on the nature of its investments and transactions. Accordingly, a hedge fund enjoys significant latitude in the investment techniques (such as the use of derivatives and short positions) and broader aspects of its business model (such as charging structure and investment lock-in periods) that it can employ to generate profits and manage risk.

Herfindahl-Hirschman Index (HHI)

The Herfindahl-Hirschman Index is a measure of market concentration that takes account of differences in the size of market participants, as well as their number. The HHI is calculated by adding together the squared values of the percentage market shares of all firms in the market. A higher number indicates a more concentrated market.

Interbank Agency Agreements

Bilateral arrangements between banks, which allow banks to use the branch infrastructure of other banks for a fee.

Leverage/leverage ratio

'Leverage' refers to the ratio of assets to equity (or another measure of capital). 'Leverage ratio' is the inverse of leverage. So a bank with 100 of assets and 5 of equity has leverage of 100/5 = 20 times, and a leverage ratio of 5/100 = 5%.

Liability

A 'liability' is a claim on the assets of a company. In the case of a bank, many of its liabilities will consist of deposits made by individuals and companies.

Liquidity

A measure of how readily an asset, or a portfolio of assets, can be bought or sold in the market without affecting its price. Liquidity in a market is characterised by a high level of trading activity. Assets that can be easily bought or sold are known as liquid assets.

Mark-to-market

Under 'mark-to-market' accounting, the value at which an asset or liability is accounted for is based on its current market price (rather than the price at which it was acquired).

Maturity transformation

Activity performed by financial institutions in using short-term (often demand) liabilities to fund longer-term assets.

Moral hazard

'Moral hazard' arises when a party has incentives to alter its behaviour because it is not fully exposed to the consequences of its actions.

Non-viable

A bank becomes 'non-viable' when it reaches the point at which it can be put into resolution. For a UK bank that is licensed to accept deposits, the trigger for putting the bank into resolution under the Special Resolution Regime is (broadly) that the regulator determines that it is failing, or is likely to fail, to meet its minimum regulatory requirements.

Pari passu

Securities or obligations are '*pari passu*' when they have equal rights to payment in liquidation.

Payments systems

'Payments systems', or services, enable individuals and companies to transfer funds from an account at one bank to an account at another bank.

Primary bail-in power

The Commission's recommendations on loss-absorbency include that resolution authorities should have the power to impose losses in resolution on long-term unsecured debt before other (non-capital) liabilities are required to take losses. This is the 'primary bail-in power'.

Primary loss-absorbing capacity

'Primary loss-absorbing capacity' consists of: (i) equity; (ii) non-equity capital; and (iii) bail-in bonds with a *remaining* term of at least 12 months.

Proprietary trading

Own-account trading activities unrelated to customer needs.

Recovery and resolution plan (RRP)

A firm's 'recovery and resolution plan' identifies options to return the firm to financial strength and viability should it come under severe stress, and provides the authorities with information on the firm's businesses, organisation and structure to enable an orderly resolution to be carried out should it become necessary.

Repurchase agreement (repo)

An agreement whereby one party sells a security to another party, and agrees to buy it back at a later time (often the following day). The economic effect of a repurchase agreement is therefore similar to that of a secured loan. For the party selling the security (and agreeing to repurchase it in the future) it is a repurchase agreement; for the party on the other end of the transaction (buying the security and agreeing to sell in the future), it is a reverse repurchase agreement.

Resolution/resolvability

In general terms 'resolution' refers to the process whereby the authorities seek to manage the failure of a bank in a safe and orderly way that minimises any adverse impact on the rest of the financial system and the wider economy. Measures to improve the ease with which banks can be put into resolution – their 'resolvability' – are central to several ongoing financial regulatory reform initiatives.

Resolution buffer

The Commission's recommendations on loss-absorbency include that a supervisor should be able to require a bank to hold an additional buffer of loss-absorbing capacity – a 'resolution buffer' – if the supervisor has any concerns about the resolvability of the bank.

Retail banking

The provision of banking services – principally deposit-taking, payment services and lending – to individuals and SMEs.

Retail ring-fence/ring-fence

The isolation of certain retail banking services in an independently capitalised entity.

Ring-fenced bank

'Ring-fenced banks' are independently capitalised banks that are exclusively permitted to provide certain services. Safeguards limit their exposure to other activities.

Ring-fence buffer

The Commission's recommendations on loss-absorbency include that ring-fenced banks above a certain size should be required to hold an additional buffer of equity – a 'ring-fence buffer' – above the Basel III minimum equity requirements.

Risk weight/risk-weighted assets (RWAs)

An asset's 'risk weight' is a measure of its riskiness; the riskier the asset, the higher its risk weight. A 'risk-weighted asset' is an asset adjusted for risk by the application of a risk weight.

Secondary bail-in power

The Commission's recommendations on loss-absorbency include that resolution authorities should have the power to impose losses in resolution on all unsecured liabilities remaining once all primary loss-absorbing capacity has been wiped out. This is the 'secondary bail-in power'.

Securitisation

The process of packaging cash flows from a pool of assets – for example, residential mortgages – into securities and selling these to investors.

Shadow banking sector

Non-bank institutions that conduct banking activities. Examples of such institutions can include hedge funds, securities dealers and insurers.

Solo basis

If regulatory requirements are applied to an entity on a 'solo basis', then they are applied to that entity on an individual basis. Exposures between that entity and any other companies in the same group are not netted off.

Special Resolution Regime (SRR)

The 'Special Resolution Regime' was introduced in the UK by Part 1 of the Banking Act 2009. It sets out a permanent framework providing tools to the authorities for dealing with distressed banks and building societies.

State aid

'State aid' is the provision of government support to companies. A company which receives government support typically obtains an advantage over its competitors. The EU Treaties generally prohibit state aid unless it is justified by reasons of general economic development.

Sub-consolidated basis

If regulatory requirements are applied to a number of entities within a group on a 'sub-consolidated basis', then all exposures between those entities are netted off and the requirements are then applied to those entities in aggregate.

Systematic risk

Risk that is correlated with average asset returns in the economy.

Systemic risk

The risk of significant disruption to the financial system as a whole. Systemic risk is exacerbated by interconnections between financial institutions and markets.

Tier 1/Tier 2 capital

Classification of different types of regulatory capital. Under Basel III, Tier 1 capital comprises common equity, retained earnings, preference shares and some types of debt instruments that convert into equity or can be written down. Tier 2 capital comprises certain other types of debt instruments that can similarly convert or be written down.

Too big to fail/too big to save

Financial institutions whose collapse would have such adverse impacts on the financial system and the wider economy that they will be bailed out by the government rather than be allowed to go insolvent are 'too big to fail'. If a country has such a large banking system that

there is a risk that a taxpayer-funded bank bail-out would threaten the public finances, banks that are 'too big to fail' become 'too big to save'.

Universal bank

A bank, or banking group, that undertakes a combination of retail, commercial, wholesale and investment banking activities.

Verde/Project Verde

The divestiture of a retail banking business agreed by LBG, the UK Government and the European Commission as one of the conditions of LBG's recapitalisation by the UK Government.

Wholesale and investment banking

The principal activities of wholesale and investment banking are the provision of wholesale lending to large corporations (wholesale banking) and the provision of assistance (including underwriting) to institutions such as governments and corporations in raising equity and debt finance, providing advice in relation to mergers and acquisitions, acting as counterparty to client trades and market-making (investment banking). An investment bank might also undertake trading on its own account (proprietary trading) in a variety of financial products (such as derivatives, fixed income instruments, currencies and commodities). Not all investment banks accept deposits.

Annex 1: Summary of responses to the *Interim Report*

A1.1 The Commission published its *Interim Report* on 11 April 2011, and launched a 12 week consultation on the proposals contained within that document. The Commission received over 170 submissions in response to this consultation and extends its thanks to those from academia, financial services, business, trade unions, consumer groups, and charities and also to those members of the public who made their views known. The Commission has published all non-confidential responses on its website.

Financial stability measures: structure

A1.2 The views received on the proposal to ring-fence UK retail operations were mixed. Some responses felt that this was the right solution, pointing to the balance between costs to the banks of this reform against the benefits of continued diversification within institutions. Views from this perspective were concerned about the design, but agreed in principle that this would enhance resolvability and reduce the implicit government subsidy to banks. Some responses felt that the ring-fence and higher capital might encourage more productive investment in the UK economy, though others argued that it would be very expensive and have an adverse impact on the economy. Views against the ring-fence were divided. A number of respondents felt that ring-fencing is not sufficiently radical to remove the implicit guarantee, and hence called for a full split. Within this group, there were some who accepted the ring-fence if a full split was not to take place. A smaller number of respondents were against any form of structural change at all. Some of this group argued that enhanced recovery and resolution plans, other reforms and improved management would be sufficient to enable banks to fail in an orderly manner. A further group of responses rejected the ring-fence and split questions altogether, and argued that only more fundamental reforms to remove the ability of banks to increase the money supply through the creation of credit could prevent future crises and bank failures.

A1.3 Where responses focused on the design of the ring-fence itself, there was general agreement that it should be mandated to provide some basic retail and SME services such as current accounts, but there was much more debate on how wide a range of activities should be within the fence: some favoured a narrow ring-fence including only retail activities while others favoured the inclusion of a wide range of corporate banking activities. There was a general but not total consensus that trading and market making activity should not be allowed within the ring-fence, though a recognition that treasury functions needed to be included to ensure risk management. A small number of responses recommended using the Building Societies Act as a guideline for defining the ring-fence, particularly in relation to the use of hedging instruments.

A1.4 A limited number of responses were concerned with governance within the ring-fenced bank. Responses were mixed, with a number calling for unlimited liability on directors, and enhanced sanctions for misbehaviour. Others felt that some level of independence for the board of the ring-fenced bank would be desirable.

Financial stability measures: loss-absorbency

A1.5 There was much debate over the question of capital levels in the ring-fenced bank (and the rest of the bank, in cases where the ring-fence includes just a part). A good number of responses were very concerned that the UK would be too far ahead of other countries in setting higher capital for the ring-fenced bank, and felt that such requirements should be in line with international standards as agreed through the Financial Stability Board and the Basel Committee on Banking Supervision processes. Others felt that there was not sufficient equity capital available to meet higher requirements. On the other hand, many respondents did not think the *Interim Report* went far enough, and called for much higher capital, of up to 20% of risk-weighted assets, for significant institutions. Some felt that higher capital made for safer banks and so reduced implicit government subsidies, some felt it was an alternative to ring-fencing, and others felt that it could have benefits for the more productive parts of the economy. There was some recognition that the rest of the bank could have lower capital than the ring-fenced bank, but this was far from a universal view.

A1.6 Turning to other loss-absorbency measures, there was widespread support for bail-inable debt in principle, though some scepticism over whether it would work in practice: a common view was to see bail-inable debt and extra capital as interchangeable, with more capital being required if bail-in did not seem to work. Most responses on this topic emphasised the desire to see debt holders take losses in crises. There was less support for contingent convertible debt, largely due to concerns around how to design triggers, and the potential depth and liquidity of markets for the instruments.

A1.7 There was general support for depositor preference, with many recognising that retail depositors were least well placed to assess banks' financial health. However, some did raise concerns that it could prompt a shift to secured funding in the ring-fenced bank, which could lead to over-encumbrance of assets and therefore reduce the assets available to meet unsecured creditor claims in insolvency. There was a particular concern raised by pension funds on their position should depositor preference be implemented. It remained, however, a widely supported measure.

Competition measures

A1.8 On competition proposals, respondents offered a wide variety of views. Some found the Commission's analysis of the retail banking market unconvincing, seeing it as very competitive. Those providing such views also often rejected the idea of enhancing the divestiture of Lloyds Banking Group, suggesting that the current divestiture was sufficient to remedy state aid and to create a viable challenger. There was also

concern over the implications to the value of the Government's shareholding. Others, however, agreed with the Commission's analysis and called for an increased divestiture, in some cases with the aim of effectively reversing the Lloyds TSB/HBOS merger. There was strong support for enhanced switching, including a faster switching service that might include account number portability, though some doubted the benefits to competition of improved switching. Barriers to entry including the time to obtain banking licences, access to the payments system and cost of capital were all highlighted to the Commission by some respondents, though others felt there was evidence that new entrants were making headway in the sector. Some respondents suggested that the banking system would be more stable if it were more oligopolistic, citing Canada and Australia as examples.

A1.9 There was general support for more transparency in product pricing and fees across retail bank offers in general. Some also wanted to see easier comparison between different bank products, perhaps through third party comparison websites. There was concern raised about bank branch closure in rural and isolated communities. Respondents suggested that the Post Office might be able to play a fuller role in providing banking services, while others wanted to see more shared banking services.

A1.10 Views on the Commission's suggestion that the Financial Conduct Authority should have a primary duty to promote effective competition were mixed. Some, but not all, respondents supported the proposal for the new body to have more robust competition objectives.

Competitiveness

A1.11 The Commission received fewer views on this issue than in response to the call for evidence in its *Issues Paper* from September 2010. Some respondents were concerned that the UK should not introduce reforms in excess of other jurisdictions as this would threaten the City's primacy as a financial centre. They were particularly concerned that higher capital requirements would cause banks to leave the UK. However, others felt that a stable, clear regulatory regime was more important, and that making UK banks safer could enhance competitiveness. They also recognised a difference between the domestic UK market and the City's international role, and did not see the ring-fence as a threat to the UK's leading position in financial services.

Annex 2: Other financial stability and competition reforms

Financial stability

A2.1 During the course of the Commission's work, there have been significant developments both internationally and in the UK to improve the stability of the financial system. Measures undertaken include tougher capital and liquidity rules, greater cross-border co-ordination on banking supervision, and improved resolution for large systemic firms, among others. An outline of this work was provided in the *Interim Report* in April. This annex sets out a summary and update of progress on those work-streams that are particularly relevant to the Commission's remit.

Macro-prudential regulation

A2.2 The financial crisis exposed gaps in regulation of the banking system both nationally and internationally. This has led to an increased focus on macro-prudential frameworks to monitor movements in systemic risk over time and between institutions. The Financial Stability Board (FSB), the Bank for International Settlements (BIS) and the International Monetary Fund (IMF) continue to work together to develop effective macro-prudential policies and frameworks to strengthen the resilience of the financial system. This work includes collating data and techniques for identifying systemic risk, and developing an effective macro-prudential toolkit and relevant governance arrangements for the use of such tools.[1] Data from banks and national supervisors is also being harmonised, extended and reported more regularly to update the BIS international banking statistics database used to identify systemic risks.[2]

A2.3 As part of a wider restructuring of the UK regulatory system, the Financial Policy Committee (FPC) – a new committee of the Bank of England – is in the process of being set up, to take responsibility for macro-prudential regulation in the UK. The FPC's core aim will be to identify and monitor emerging risks across the financial system, and it will also provide recommendations to the UK authorities and directions to the UK regulators in relation to oversight of the financial system and the use of macro-prudential tools.[3] The interim FPC, which was set up earlier this year,

1 For more details, see the FSB, IMF and BIS update for G20 Finance Ministers and Central Bank Governors, 2011, *Macroprudential Policy Tools and Frameworks*. Available at: http://www.financialstabilityboard.org/publications/r_1103.pdf.
2 FSB and IMF, 2011, *The Financial Crisis and Information Gaps: Implementation Progress Report*. Available at: http://www.financialstabilityboard.org/publications/r_110715.pdf.
3 For more details of the FPC's responsibilities, see HM Treasury's consultation document and white paper on the subject (HM Treasury, 2011, *A New Approach to Financial Regulation: The Blueprint for Reform*. Available at: http://www.hm-treasury.gov.uk/d/consult_finreg__new_approach_blueprint.pdf).

undertakes preliminary analysis of the policies that should form part of the FPC's toolkit, and has already provided its first set of recommendations for banks and the Financial Services Authority (FSA). These recommendations include encouraging banks to build their capital base (including monitoring the distribution of earnings), and improved data collection by the FSA of banks' sovereign and banking sector exposures, as well as increased oversight of their exposures to opaque funding structures.[4]

Loss-absorbency

A2.4 In order for a bank to have the ability to operate smoothly throughout the credit cycle, it must have the ability to absorb losses as its capital levels deteriorate during economic downturns. One of the key developments in strengthening the loss-absorbency of banks has come from the Basel Committee on Banking Supervision (BCBS) in the form of the Basel III rules, which were first published in December 2010. Basel III focuses on improving the loss-absorbency of banks by introducing tougher capital requirements, which predominantly look to increase the quality, as well as the quantity, of loss-absorbing capital that banks are required to hold.

A2.5 Basel III places greater emphasis on common equity – the highest quality form of capital – by raising minimum common equity requirements to 4.5% of risk-weighted assets (RWAs) and introducing two buffers – a capital conservation buffer and a counter-cyclical buffer – both to be made up of common equity. The counter-cyclical buffer is intended to be used by national authorities to curtail lending and a build up of systematic risk during credit booms. Basel III also recognises some non-equity capital instruments, provided that they can be written down or converted into equity if the national regulator deems a bank to be non-viable.

A2.6 All of the capital rules discussed above are expressed relative to RWAs. In order to avoid an over-reliance on risk weight calculations, Basel III proposes a minimum leverage ratio of 3% of Tier 1 capital to unweighted assets as a backstop. The proposed ratio will then be monitored by the authorities, and if deemed appropriate, will be introduced as a binding measure from 2018. If implemented, this would require banks to hold Tier 1 capital of at least 3% of unweighted assets, with the aim of curtailing a system-wide build-up of leverage – an issue which was missed in the run-up to the crisis.[5]

A2.7 The Basel III rules will be implemented in the UK through amendments to the Capital Requirements Directive – known as 'CRD IV', a draft of which was recently proposed by the European Commission.[6] As currently drafted, the detailed rules on minimum capital requirements, to be set out in a separate Regulation, will be maximum

4 See the minutes of the interim FPC's June meeting for more details and the full list of recommendations. Available at: http://www.bankofengland.co.uk/publications/records/fpc/pdf/2011/record1106.pdf.
5 A summary of the Basel III capital rules is provided in Box 4.2.
6 For more detail on CRD IV see Box 5.1. The Directive is expected to come into force in 2013.

harmonised, meaning that national authorities will not generally be able to apply permanently higher regulatory standards across the board.

A2.8 A recent consultation paper published jointly by the BCBS and the FSB discusses imposing loss-absorbency surcharges on global systemically important banks (G-SIBs), in order to reflect their role in the global financial system.[7] The 'G-SIB surcharge', based on a measure of banks' systemic importance, is calibrated using the following criteria:

- cross-jurisdictional activity – includes loans and deposits to banks and non-banks in other countries (for those within the same group as well as outside it). This data is reported to national regulators, and is fed into the BIS for consolidated international banking statistics;
- size – measured as a bank's total assets (including certain off-balance sheet items) relative to the total assets of all banks within the sample;
- interconnectedness – calibrated using trading and non-trading book asset and liability exposures to other financial institutions, as well as the extent to which a bank is dependent on the wholesale market for funding purposes (wholesale funding ratio);
- substitutability – the systemic importance of a bank is highlighted by the lack of its substitutability as both a market participant and a client service provider (e.g. its role in the payments system). Substitutability is measured through the value of assets under custody, the amount of payments sent through the key payments systems and the value of debt and equity instruments underwritten by the bank, all relative to the banks in the sample; and
- complexity – defined as a bank's activities in the over-the-counter derivatives market (for derivatives which are not cleared through a central counterparty), the proportion of assets that are classified as Level 3 assets,[8] and the value of financial securities in the trading book and available for sale securities.

A2.9 The G-SIB surcharge of common equity will range from 1%-2.5%, with scope for a further 1% in the future, reflecting the impact of an institution's failure on the global financial system and the wider economy based on the criteria outlined above. A number of large UK banks are expected to be subject to these surcharges. The principle behind the surcharge is similar to that outlined by the Commission in the *Interim Report,* reflecting the international consensus on the concerns and complexities of systemically important banks.

7 BCBS, 2011, *Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement.* Available at: http://www.bis.org/publ/bcbs201.pdf.
8 Level 3 assets are those which are required to be fair valued, but are illiquid, and are therefore difficult to value. As a result, these are likely to face serious market valuation problems in times of stress, affecting the market's confidence in the institution.

A2.10 Other countries in Europe have also undertaken measures to strengthen the loss-absorbency of banks. For example, Switzerland is imposing tougher capital requirements for systemically important banks, comprising 10% common equity and up to 9% 'contingent convertible capital' – debt that converts into equity in certain circumstances. This package of proposals – known as the 'Swiss Finish' – has been approved by the lower house of the Swiss parliament, and will be debated by the upper house in September 2011.

A2.11 Sweden and Ireland have also announced tougher capital requirements for large national banks. Spain has focused on raising the requirements for a number of credit institutions operating in the country (predominantly savings banks), with new legislation due to come into force by the end of September 2011.[9]

Liquidity

A2.12 In the run up to the crisis, insufficient emphasis was placed on managing the risk that funding sources might cease to be available, including a freeze of the wholesale markets. In practice, this was the trigger for several bank failures internationally, as well as in the UK. Recent reforms proposed by the BCBS, including new quantitative requirements as part of Basel III, are intended to address this issue (see Box A2.1).

A2.13 The UK is already well advanced in strengthening the liquidity standards of banks through the FSA's enhanced liquidity regime, and the Bank of England's Discount Window Facility, which assists banks in times of short-term liquidity shortages.[10]

9 Bank of Spain, 2011, *Press Release.* Available at: http://www.bde.es/webbde/en/secciones/prensa/Notas_Informativ/anoactual/presbe2011_9e.pdf.
10 The work carried out by the FSA and the Bank of England on liquidity is summarised briefly in Chapter 3 of the *Interim Report*.

Box A2.1: BCBS liquidity reforms

The recent crisis highlighted the importance of prudent liquidity risk management. In response, in 2008 the BCBS published its *Principles for Sound Liquidity Risk Management and Supervision,* to promote stronger governance, risk management, disclosure and robust supervision of banks' liquidity management frameworks.[1] To complement these principles, the BCBS proposed, as part of Basel III, two *minimum* quantitative standards for funding liquidity: the Liquidity Coverage Ratio and the Net Stable Funding Ratio.[2]

Liquidity Coverage Ratio (LCR)

The LCR promotes the short-term resilience of banks' funding profiles. It requires banks to maintain an adequate level of unencumbered, high-quality liquid assets that could be used to meet liabilities as they fall due over a one month horizon under a combined market-wide and idiosyncratic liquidity stress scenario, as specified by supervisors. These assets must be easily and immediately convertible to cash at little or no loss of value, and have the following characteristics: low credit and market risk; ease and certainty of valuation; low correlation with risky assets; and listed on a recognised exchange. The permissible assets are categorised into two levels, reflecting their quality and convertibility into cash.

Table A2.1: Assets that qualify as 'liquid' under the LCR

Level	Quality	Typical instruments	Permissible proportion
Level 1	Best	• Cash • Government and central bank debt issued by countries with a strong credit rating • Central bank reserves	No upper limit (i.e. can be 100% of stock)
Level 2	Second best	• High quality non-financial corporate bonds (subject to a 15% haircut) • High quality third-party covered bonds (subject to a 15% haircut)	Max 40% of stock

Net Stable Funding Ratio (NSFR)

The NSFR promotes the resilience of banks' funding profiles over a longer time horizon than the LCR. A factor (from 0% to 100%) is applied to banks' assets to estimate the required stable funding (RSF) that would be needed to fund those assets over a one year period. Banks are required to demonstrate that they have sufficient available stable funding (ASF) to meet the RSF. ASF can be made up of equity, preference shares, liabilities with maturities over one year and shorter-term deposits and wholesale funding that are expected to remain with a bank during an extended idiosyncratic stress event. Each category of ASF is assigned a factor (from 0% to 100%) reflecting its 'stability'.

[1] BCBS, 2008, *Principles for Sound Liquidity Risk Management and Supervision.* Available at: http://www.bis.org/publ/bcbs144.pdf.

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

Resolution

A2.14 The crisis highlighted the interconnectedness of large cross-border banking institutions, as well as the issue that some banks are considered to be 'too big to fail'. Significant work has been carried out by national regulators to improve the resolvability of banks – predominantly through recovery and resolution plans (RRPs), sometimes known as 'living wills'. Internationally, the FSB has focused on the resolution of systemically important financial institutions (SIFIs), as outlined in its recent consultation paper.[11] The paper sets out a number of recommendations to facilitate resolution, including the creation of national resolution authorities and cross-border cooperation arrangements, as well as improved RRPs, and the removal of obstacles to resolution. Among other tools for effective resolution, the FSB is consulting on giving authorities bail-in powers and on potential international convergence on the ranking of deposits.[12]

A2.15 In the UK, the FSA is also in the process of consulting on RRPs for deposit-takers and large investment firms.[13] The FSA's proposals cover the implementation of governance arrangements (e.g. regular review of the RRP framework), key recovery plan options (e.g. disposal of businesses, raising of additional equity and use of central bank facilities), criteria for recovery options (e.g. credibility and speed of implementation), and the intervention conditions (e.g. triggers to be set by banks above the point of early intervention by the regulator). In order to ease resolution, firms will need to report their interbank exposures, their derivatives and securities financing positions (and counterparties), and the mapping of economic functions and interdependencies across the various different entities within a banking group. Firms will also be expected to identify any barriers to resolution (for example, separation of critical functions), and provide a set of measures on how these will be overcome. Banks will have until Q3 2012 to finalise credible RRPs, with some of the data to be shared with the relevant international regulators for improved cross-border resolution.

A2.16 The FSA's consultation paper also sets out some high-level proposals for resolving large investment businesses, specifically in relation to client money and custody assets. The paper discusses the introduction of a number of measures to facilitate swift reimbursement to clients by insolvency practitioners in the event of failure of the institution.

A2.17 Alongside the consultation document, the FSA published a discussion paper which highlights some of the key barriers to resolution for banking groups.[14] Potential issues include structural barriers – for example the location of critical economic functions

11 FSB, 2011, *Effective Resolution of Systemically Important Financial Institutions.* Available at: http://www.financialstabilityboard.org/publications/r_110719.pdf.
12 The EU Crisis Management Framework, on which the European Commission consulted on earlier this year, also discusses similar proposals. The legislative proposal is expected towards the end of 2011.
13 FSA, 2011, *CP11/16: Recovery and Resolution Plans.* Available at: http://www.fsa.gov.uk/pubs/cp/cp11_16.pdf.
14 Page 51 onwards of FSA, 2011, *Discussion Paper: Recovery and Resolution Plans.* Available at: http://www.fsa.gov.uk/pubs/cp/cp11_16.pdf.

within the group (such as current accounts, payments systems, etc.) and the legal structure of the group (e.g. branch versus subsidiary structure) – as well as operational and financial interdependencies between the various entities within a group. The resolvability of trading books would also act as a barrier to resolution, due to the potential direct and indirect losses imposed on creditors in the event of insolvency. The industry practice of netting agreements (rather than maintaining separate contracts) substantially complicates this process, with concentration in trading book activity making the potential consequences of a disorderly wind-down significantly more severe.[15] The combination of these factors makes standard insolvency procedures, controlled wind-downs and sales of trading books complicated and costly. However, international reforms in the derivative markets (as outlined below) would assist the authorities in resolving large investment institutions through a combination of these options.[16]

A2.18 The US is also looking to improve the resolvability of SIFIs through the Dodd-Frank Act. Among other measures, this includes reviewing the US Bankruptcy Code and extending the powers of the Federal Deposit Insurance Corporation (FDIC) to seize, break up and wind down failing companies and creating the Orderly Liquidation Authority for insolvent financial firms.[17] The Dodd-Frank Act also makes it more difficult for the Government to bail out banks. This is addressed in two parts of the legislation: (i) the Federal Reserve Board is prohibited from lending to any specific firm beyond what is generally available to all financial institutions in the US; and (ii) the FDIC is not able to take an equity interest in any FDIC-insured financial company, or any subsidiary of such a company. However, the market seems to be sceptical as to whether in times of crises, SIFIs would really be allowed to fail. One rating agency has pointed out that "under certain circumstances and with selected SIFIs, future extraordinary government support is still possible", for example through new, over-riding legislation.[18]

Shadow banking

A2.19 Not all firms that conduct banking activities are banks, and non-bank institutions that conduct such activities (for example credit intermediation and maturity transformation) are collectively referred to as the 'shadow banking' sector. Examples of such entities include structured investment vehicles, which provide alternative sources of funding and liquidity to banks, and certain types of hedge funds. As the shadow banking sector was not subject to the same degree of regulation as banks prior to the crisis, authorities were unable to monitor the build-up of risk and leverage

15 According to the FSA's discussion paper, in June 2010, the 14 largest dealers across the world accounted for 80% of the total notional contract amounts outstanding in the global over-the-counter derivatives market.
16 In addition, the paper reviews the use of contractual and statutory bail-in to recapitalise a failing firm (either before, or at the point of non-viability), and considers the combination of the two approaches as a method to prevent firm failure.
17 Federal Reserve Bank, 2011, *Study of the Resolution of Financial Companies under the Bankruptcy Code.* Available at: http://www.federalreserve.gov/publications/other-reports/files/bankruptcy-financial-study-201107.pdf.
18 Standard & Poor's, 2011, *The US Government Says Support for Banks Will be Different "Next Time" – But Will It?* Available at: http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245314573699.

within the system, and were therefore unaware of the potential spillover effects on the stability of the regulated banking sector.

A2.20 As a result, the G20 asked the FSB to identify the different aspects of the shadow banking system and assess measures to improve oversight of the sector, as well as its interconnectedness with the regulated banking sector. In April 2011, the FSB set out its first steps in defining the shadow banking system, asking national supervisors to identify credit intermediation outside the regular banking system that raises (i) systemic risk concerns (in particular maturity/liquidity transformation, leverage and flawed credit risk transfer) and/or (ii) regulatory arbitrage concerns. In addition, the FSB members have also attempted to improve oversight of the shadow banking system by collecting quantitative and qualitative information on both the 'micro' and 'macro' elements of the sector. The 'micro' perspective focuses on specific entities within the system in order to identify the scale of exposures of certain institutions, as well as the interconnectedness between the banking and the shadow banking sectors. The 'macro' (system-wide) perspective is aimed at understanding the size and growth rate of financial assets within the sector. While significant progress has been made, some information gaps have already been identified.[19] As proposed in the recent FSB update, the shadow banking system will be monitored through five regulatory categories: (i) banks' interactions with shadow banking entities; (ii) money market funds; (iii) other shadow banking entities; (iv) securitisation; and (v) activities related to securities lending/repos.[20]

Market infrastructure

A2.21 Financial derivatives (such as interest rate swaps) can transfer risk from one counterparty to another who is more willing or able to bear it. However, increased use of financial derivatives in the run-up to the crisis led to increased interconnectedness between banks, resulting in a build-up of systemic risk, which was exacerbated by the lack of transparency in interbank transactions. A number of workstreams are currently underway with the aim of standardising the financial market infrastructure and improving transparency by encouraging more derivative trades to be centrally reported and/or cleared through central counterparties. However, as a recent FSB progress report suggests, discrepancies exist in the extent to which various jurisdictions have implemented these reforms, delaying the process of international convergence. In particular, different approaches to transaction data reporting and collateralisation practices make international oversight of derivative transactions more complicated. The FSB is concerned that, due to these discrepancies, certain jurisdictions will not meet the end-2012 G20 deadline of standardisation, greater transparency and greater use of exchange platforms and central counterparties.[21]

19 FSB, 2011, *Shadow Banking: Scoping the Issues.* Available at: http://www.financialstabilityboard.org/publications/r_110412a.pdf.
20 FSB, 2011, *The Financial Stability Board's Work on Shadow Banking: Progress and Next Steps.* Available at: http://www.financialstabilityboard.org/press/pr_110901.pdf.
21 FSB, 2011, *OTC Derivative Market Reforms: Progress Report on Implementation.* Available at: http://www.financialstabilityboard.org/publications/r_110415b.pdf.

Regulatory institutional reform

A2.22 At international, European and national levels, significant reforms are taking place in order to improve the supervision of banks, especially large, cross-border institutions. The UK in particular is undergoing a transformation of the regulatory infrastructure, by moving to a 'twin peaks' approach to supervision, which will result in the splitting up of the FSA into a conduct and a prudential regulator – the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) respectively. The former will be a stand-alone institution, while the latter will be a subsidiary of the Bank of England. This, combined with its responsibility for macro-prudential oversight (through the FPC), will enable the Bank to identify and monitor emerging risks to the financial system both systemically and at the level of individual firms. In addition, the Bank of England will also have central responsibility in dealing with crises, building on its existing powers under the Special Resolution Regime. Since the publication of the *Interim Report*, HM Treasury has published a draft bill outlining the proposed reforms in more detail, which is now undergoing Parliamentary pre-legislative scrutiny with a view to it being finalised later this year.[22]

A2.23 The Bank of England and the FSA have also issued an outline of how the PRA will carry out its supervision of banks.[23] The paper highlights that the PRA's objective will be to promote the safety and soundness of regulated institutions, including by minimising the effect of their failure on the UK financial system (through judgement-based decisions). Among other measures, the PRA will be able to achieve this through early intervention, having the power to restrict a firm's activities, limit capital distributions, change the composition of boards and tighten liquidity and/or capital requirements in order to encourage recovery of the institution. Early discussions with the Bank of England and the Financial Services Compensation Scheme (FSCS) would take place to ensure an orderly resolution of the institution, if it were to become unviable.

Remuneration

A2.24 Weaknesses in the capital and accounting frameworks prior to the crisis enabled some bank employees to be remunerated on the basis of reported profits that were neither time-adjusted nor risk-adjusted, and led to employee incentives that were not always aligned with the long-term interests of the bank. The FSA's Remuneration Code, first introduced in August 2009, and revised in January 2011 to reflect European legislation, looks to address these issues.[24] The Code requires remuneration policies and practices to be consistent with and promote effective risk management. Restrictions on the mix (e.g. salary vs. bonus), form (e.g. cash vs. shares) and timing of employee remuneration will apply to all senior management and staff "whose professional activities have a material impact on the firm's risk profile".

22 HM Treasury, 2011, *A New Approach to Financial Regulation: The Blueprint for Reform.* Available at: http://www.hm-treasury.gov.uk/d/consult_finreg__new_approach_blueprint.pdf.
23 Bank of England and FSA, 2011, *The Bank of England, Prudential Regulation Authority: Our Approach to Banking Supervision.* Available at: http://www.fsa.gov.uk/pubs/speeches/boe_pra.pdf.
24 FSA, 2010, *Press Release.* Available at: http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/180.shtml.

Competition

A2.25 This part of the annex provides an update on the work of other parties regarding competition in banking. The *Interim Report* discussed the work up until the end of March 2011, so this annex only considers the work carried out since then.[25]

Retail banking

A2.26 In April 2011, the Treasury Select Committe (TSC) published its report *Competition and Choice in Retail Banking*.[26] In the report the Committee concluded that the pre-conditions for effective competition in the retail banking market are not present. The TSC highlighted in particular a lack of price transparency and comparability in the personal current account (PCA) market, as well as the difficulty of switching. The report calls on the Government to make promoting competition a primary objective of the FCA. It also recommends a "public interest test" based on competition considerations for proposed future divestitures of Government-held stakes in the banks. The TSC also made the following recommendations specifically to the Commission:

- to examine the impact of free-if-in-credit banking, and the appropriate actions to increase transparency and improve consumer choice;
- to review the concept of neutral branches and improved Interbank Agency Agreements with the aim of reducing barriers to entry to business banking;
- to assess the tax treatment of equity and debt, as well as competition arising from non-bank lenders;
- to address the negative impacts on competition of banks that are considered to be 'too big to fail', and which, as a result, benefit from lower funding costs; and
- to examine the case for further structural reform beyond the Lloyds Banking Group (LBG) and Royal Bank of Scotland (RBS) divestitures and ensure that the sale of the Government's stakeholdings are completed with the primary aim of improving competition, rather than raising Government revenue.

A2.27 The competition points above have been addressed in Part II of this report, and the tax treatment of equity and debt is discussed in Part I and Annex 3.

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25 Page 59, *Interim Report*.

26 House of Commons Treasury Committee, 2011, *Competition and Choice in Retail Banking, Ninth Report of Session 2010-11*. Available at: http://www.publications.parliament.uk/pa/cm201011/cmselect/cmtreasy/612/612i.pdf.

Personal current accounts

A2.28 The Office of Fair Trading (OFT) continues to monitor the PCA market. It published its most recent update in March 2011.[27] This found that there has been further progress in the PCA market, specifically around improving consumer control over the use of unarranged overdrafts. The OFT intends to conduct a more comprehensive review of the market in 2012.

Credit default swaps

A2.29 The European Commission has initiated two competition investigations into the credit default swap (CDS) market in Europe.[28]

- It will examine whether 16 investment banks and Markit, the leading provider of financial information in the CDS market, have colluded and/or may hold and abuse a dominant position in order to control the financial information on CDS.
- It is investigating a number of agreements between nine CDS dealers and ICE Clear Europe, the leading clearing house for CDS. Here, the European Commission will investigate in particular whether the preferential tariffs granted by ICE Clear Europe to the nine firms have the effect of locking them into the ICE system to the detriment of competitors.

Other workstreams

A2.30 Other ongoing reforms include changes to accounting standards, deposit insurance and credit rating agencies, as discussed in the *Interim Report*.

A2.31 In addition, in July 2011, the TSC published a report regarding the work of the Commission.[29] As part of its investigation, the TSC received evidence from banks, consumer representatives and members of the Commission. As the review was based on the Commission's *Interim Report*, the TSC did not reach a definitive view on the outlined proposals, but rather made a number of recommendations to be considered by the Commission during the final phase of its work.

27 OFT, 2011, *Progress Update: Personal Current Accounts in the UK.* Available at: http://www.oft.gov.uk/shared_oft/reports/financial_products/PCA_update_March_2011.pdf.
28 European Commission, 2011, *Press Release: Antitrust: Commission Probes Credit Default Swaps Market*. Available at: http://europa.eu/rapid/pressReleasesAction.do?reference=IP/11/509&format=HTML&aged=0&language=EN&guiLanguage=en.
29 House of Commons Treasury Committee, 2011, *Independent Commission on Banking, Nineteenth Report of Session 2010-12*. Available at: http://www.parliament.uk/documents/commons-committees/treasury/CRC%20HC%201069%20-%20Nineteenth%20Report%20-%20ICB.pdf.

A2.32 On financial stability, the TSC made the following recommendations:

- the Commission should publish additional quantitative evidence on its choice of a retail ring-fence over other structural reform options (or a *laisser-faire* approach), and its effects on the cost of credit and the competitiveness of the UK;
- the *Final Report* should include analysis of issues relevant to the ring-fence, such as corporate governance, resolution of wholesale businesses and the regulatory costs of policing the ring-fence; and
- the Commission should reach an agreement with the banks on the minimum level of the implicit government guarantee and the key beneficiaries of this guarantee.

A2.33 On competition, the TSC made the following recommendations:

- competition should be a primary objective of the new FCA;
- the Commission should consider whether an enhanced divestiture by LBG is really necessary, and confirm whether it has examined the case for further divestiture of branches from other banks; and
- the Commission should develop further the proposals on transparency and switching.

A2.34 The Commission has paid careful attention to all these recommendations, and sought to address them in this report. In particular, a cost-benefit analysis of the Commission's financial stability reform package is provided in Chapter 5 and Annex 3 (including additional analysis of the implicit government guarantee, and of other reform options including full separation), and the details of the ring-fence recommendations are set out in Chapter 3. The competition proposals highlighted by the TSC are assessed in Chapter 8 of this report.

Annex 3: The economic impact of the Commission's financial stability recommendations

Introduction and summary

A3.1 The Commission's recommendations to improve UK financial stability are far-reaching, and would have important effects throughout the economy. The aim of this annex, which provides more detailed analysis to support aspects of Chapters 2 to 5, is to set out how the recommendations would improve financial stability and the nature of the associated costs. It covers the following aspects in turn:

- the economic importance of banks[1] and the costs of banking crises;
- an examination of the effects of the proposals on:
  - the diversification of banks' assets;
  - the liquidity and funding of banks;
  - the interconnectedness of the banking system; and
  - the ability of banks to bear losses;
- how, and the extent to which, banks currently benefit from an implicit government guarantee;
- the nature and broad magnitude of costs which could arise (i) for banks affected by the proposals, and (ii) for the economy as a whole; and
- a summary of reasons to expect that the proposals would promote UK financial stability both effectively and efficiently compared with alternative approaches.

A3.2 First, a brief recap of the proposals may be useful. The aim of the reforms is to secure greater financial stability through a combination of measures affecting the structure and loss-absorbency of banks.

A3.3 On structure, the proposal is for a ring-fence which would allow vital banking services such as deposits of individuals and SMEs to be provided continuously, without the provision of taxpayer support, and insulate them from shocks elsewhere in the financial system. This would locate key domestic retail banking services inside the ring-fence, and require global wholesale/investment banking to be outside. Provision

1 References in this annex to banks are also applicable to building societies.

of straightforward banking services to large European non-financial companies would be allowed within or outside the ring-fence.

A3.4 The ring-fence would need to be strong in order to provide these benefits. Accordingly, where they were part of a wider corporate group, ring-fenced banks would need to have independent governance and meet regulatory requirements for capital, liquidity, and funding on a standalone basis. The permitted extent of relationships with other parts of the group would be no greater than regulators generally allow with third parties, and would have to be conducted on an arm's length basis. For all ring-fenced banks, exposures to financial companies would be strictly limited and some limits would also apply to the amount of wholesale funding they could raise.

A3.5 Turning to loss-absorbency, the proposals aim to make banks much better able to absorb losses which they experience, so that they are less likely to fail and easier and less costly to deal with when they do fail. The proposals are for:

- large ring-fenced banks to have equity of at least 10% of risk-weighted assets (RWAs), with equity requirements on other parts of banks in line with internationally agreed levels;
- a leverage limit requiring all banks to have Tier 1 capital of at least 3% of total assets, tightened to above 4% for large ring-fenced banks so as to ensure that the 10% equity requirement is not met through excessively low risk-weights;
- the authorities to take bail-in powers and for insured depositors to be preferred in insolvency, in both cases in order to allow bank debt to absorb losses more easily than it has done in the past; and
- large retail and other activities of UK banking groups both to have 'primary loss-absorbing capacity' of at least 17%-20% of RWAs. This capacity could be met with equity, other capital, and/or long-term unsecured debt (bail-in bonds).

A3.6 Together, and building on other reforms under way, the reforms would curtail the implicit government guarantee and therefore provide creditors with a much stronger incentive to curb excessive risk-taking by banks. The reforms would also insulate key domestic banking services from global shocks. At the same time, they have been designed in order to preserve significant benefits of universal banking.

The economic importance of banks and the costs of banking crises

A3.7 The financial system has three broad functions: to facilitate payments; to intermediate funds between savers and borrowers; and to help manage financial risks. Banks are central to all three functions. Bank deposits are the chief means of payment within the economy, and banks are the only members of cash payment systems. Bank loans are

the principal, and in some cases only, form of credit available to many households and firms, and banks help to issue and make markets in securities – the other main source of external funding in the economy. Lastly, banks take one or both sides of most derivative contracts, the means by which many financial risks are hedged.

A3.8 The core functions of banks – taking deposits and making loans – are to some extent complementary, in that they are produced more efficiently together than separately. Current accounts and overdrafts (a key form of loan for many businesses and households) are economically similar products that require banks to make liquidity available to the customer on demand, the only difference being which party is in credit with the other. To the extent that the liquidity demands from these activities are less than perfectly correlated, banks can economise on costly liquid asset buffers by providing them together (Kashyap et al. (2002)). The customer relationships, gathering of information and operational infrastructure involved in providing current and savings accounts can be used to provide loans more efficiently. These synergies are valuable.

A3.9 Banks fund illiquid, risky loans with demand deposits. This makes society's savings more liquid than the investments they fund and, by establishing a hierarchy of claims on banks' assets, gives investors a degree of choice about how much of the underlying risk they want to accept (Benston and Smith (1976)). The tranching of debt and equity claims makes the senior liabilities created less sensitive to information about the assets they fund, which makes those liabilities easier to trade and settle payments with (Gorton and Pennacchi (1990)). But it also makes banks fragile: leverage leaves their solvency vulnerable to a relatively small fall in asset values; while the mismatch between the maturity of assets and liabilities can create liquidity problems costly enough to bankrupt an otherwise solvent institution.

A3.10 Bankruptcy is particularly costly in the case of banks. The process of bankruptcy typically involves freezing the bankrupt firm's liabilities while running its operating business in such a way as to maximise the resources available to creditors. But this is essentially impossible for banks, because the liquidity of a bank's liabilities is central to the value it creates. Furthermore, the liquidation of assets that can follow bankruptcy also destroys value, because valuable relationships between the bank and its debtors are destroyed.

A3.11 As well as being fragile in themselves, the nature of banks' relationships with each other makes the banking *system* fragile. Banks are connected to each other directly through counterparty relationships in funding and derivatives markets, and indirectly through holdings of similar assets and the issuance of liabilities to similar or related creditors. This means that banks tend to fail at the same time, either because the failure of one causes the failure of others, or because it indicates an underlying problem in debt markets or the real economy to which several banks are exposed.

A3.12 Disorderly bank failure can accordingly impose very large costs on the economy, much wider than just those experienced by the bank's owners and creditors. The

social costs of financial crises result from the associated interruption in the flow of financial services – credit, payment and insurance. In particular, a disruption to the supply of credit can have adverse effects on both demand, as the volume of investment in the economy contracts, and the supply capacity of the economy, as the capital stock is smaller than it would otherwise be, and is directed to less efficient users. It is much worse if a large part of the banking system fails at once than if a small part fails, as in the latter case the survivors would be better able to step into the breach.

A3.13 The costs that the failure of a large bank, or of a large number of small banks, would impose on the economy as a whole prompt governments to provide support in the event of stress – as the UK Government did during the recent crisis. The outlay of government funds can be large enough to generate substantial social costs in itself because of its implications for taxation and other public expenditure, and possibly for the terms on which government can borrow. And the prospect of this support makes it cheaper for banks to take risks, as their creditors, anticipating a bail-out, do not charge banks properly risk-reflective rates for funding.

The effects of the recommendations on the banking system

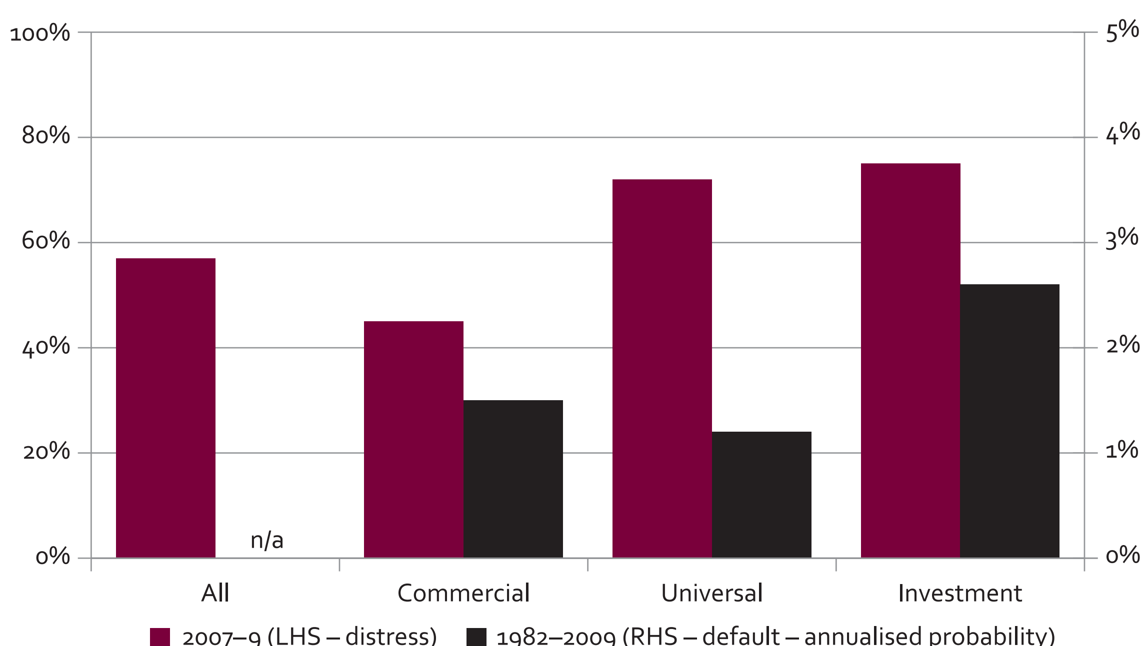
The diversification of banks' assets

Asset riskiness

A3.14 The volatility of a bank's profits is a key determinant of its risk of failure. Most forms of banking entail some risk, which is inherent in economic activity. During the recent crisis, banks of all kinds failed. Figure A3.1 shows that distress was widespread among commercial, investment and universal banks alike, with commercial banks least likely to be distressed, in relative terms, and investment banks most likely (Ötker-Robe et al. (2011)). On the other hand, Barclays Capital (2011) find that between 1988 and 2009 as a whole, universal banks defaulted less frequently than retail banks, which in turn defaulted less frequently than investment banks. Standard and Poor's (2011a, p2) believe that investment banking is inherently riskier than other financial activities: "highly confidence-sensitive funding supporting highly levered credit and market exposures gives these firms an inherently higher risk and less stable industry-risk profile than commercial or retail banks". Gambacorta and Marques-Ibanez (2011) find that banks with a greater proportion of non-interest income and more wholesale funding – i.e. those that least resembled traditional retail banks – restricted loan growth more during the recent crisis period. And IMF (2011) find that US and European banks with a high proportion of trading income were more likely to have received official support in the recent crisis. In its public response to the *Interim Report*, Santander (2011, p4) stated that "a retail bank's assets … are less volatile in value". Whatever the relative riskiness of different forms of bank activities, it is clear that, under the Commission's recommendations, both ring-fenced and non-ring-fenced banks would be able to conduct business with risks.

A3.15 The introduction of a ring-fence would alter the balance of the shocks to which UK retail banks are susceptible. Ring-fenced banks would be less directly exposed to falls in the value of trading and foreign assets than universal banks currently are. The obverse of this is that these banks would become more exposed to UK loan values. To the extent that future macro-prudential policy is successful in moderating the UK credit cycle, it may have a greater effect on UK financial stability under a ring-fence than otherwise.

Figure A3.1: Frequency of distress and default for different kinds of bank[2]



Source: Ötker-Robe et al. (2011) and Barclays Capital (2011).

Diversification benefits of universal banking

A3.16 The ability to combine different kinds of banking activities may yield diversification benefits. An individual bank can reduce the riskiness of its business through diversification, if the returns on the additional activities are not too much riskier than existing activities, and are less than perfectly correlated with them.

A3.17 Diversification does not as a general matter require corporate integration. By holding the shares of both companies in their portfolios, investors can under certain circumstances capture the benefits without the need for a merger at the corporate level. In practice, the conditions under which this can be done perfectly and costlessly are unlikely to hold for banks. Most importantly, the private cost of bankruptcy for

2 'Distress' is defined in Ötker-Robe et al. (2011) as a situation when a bank has at least one year of negative return on assets or if it was a recipient of government support during 2007–09 (the period dictated by data availability). While all banks had access to emergency liquidity facilities provided by central banks, the support here refers to capital injections and asset restructuring. The Barclays Capital (2011) analysis involves some important and arguable judgements about what constitutes 'failure' in the context of bail-outs.

banks is very high (James (1991)), so in states of the world where one part of the bank makes profits that would be sufficient to rescue the other from insolvency, the bank will be worth more as one company than as two. Furthermore, the net profits of banks depend not only on the gross returns on their assets, but also on the cost of their liabilities. These may behave differently when banks are combined if there are synergies between certain conjunctions of assets and liabilities.

A3.18 The sign and scale of any diversification benefit is an important empirical question. Within the academic literature, Laeven and Levine (2007) find that diversified banking conglomerates are worth less than the sum of their parts, perhaps because the managers are harder to discipline. Schmid and Walter (2009) also find a diversification discount in general for financial companies, but find a market capitalisation premium from the conjunction of commercial and investment banks. Van Lelyveld and Knot (2009) study bank-insurance conglomerates in the European Union, and find no universal diversification discount or premium. Baele et al. (2007) find that some kinds of diversification reduce the idiosyncratic risk and increase the franchise value of European banks. Standard and Poor's (2011b) document the support that investment banking divisions' earnings provided to universal banks during 2009, when their retail and commercial banking divisions were in some cases performing poorly.

A3.19 In their public response to the Commission's *Interim Report*, HSBC (2011) noted (but did not quantify) the existence of diversification benefits between corporate and household exposures. RBS (2011) suggested that non-ring-fenced banks could be downgraded on account of their lack of diversity, and that ring-fenced banks would also suffer, but that downgrades would be limited by a strengthened perception of official support. Standard Chartered (2011, p29) stated that "[t]he universal banking model provides resilience by helping to diversify risks across different sectors, clients and geographies." In summary, the belief that functionally universal banks offer diversification benefits is held by a number of market participants, including some universal UK banks, but the available quantitative evidence is limited and mixed.

Asset diversification benefits under the ring-fence

A3.20 Relative to full separation, the ring-fence would allow banks to retain a large portion of any diversification benefits that universal banks may currently enjoy. Different parts of the group would be able to recapitalise each other subject to meeting regulatory minima – when the transfer of capital is likely to be socially valuable.[3] Furthermore, the Commission's loss-absorbency recommendations would make bankruptcy less likely and less costly (see below), reducing the benefits of a co-mingled balance sheet to the extent that they relate to the private costs of bankruptcy: well-capitalised, resolvable banks would gain less from diversification.

A3.21 Moreover, ring-fenced banks would be able to lend to a wide variety of borrowers across the corporate and household sectors, affording more opportunities for

3 By contrast, private incentives and the public interest might well diverge with respect to depleting capital in the ring-fenced bank below levels judged safe for regulatory purposes to transfer it to wholesale/investment banking.

diversification than a narrow ring-fence would permit. Non-ring-fenced banks would be able to hold many of these assets too, along with many others, and could own ring-fenced banks themselves. So the Commission's structural reform recommendations – a broad ring-fence, rather than a narrow one or full separation – are compatible with retaining a large portion of the diversification benefits that universal banking may bring. Furthermore, the option to place many kinds of activity (including residential mortgages and loans to large non-financial companies) on either side of the ring-fence would also facilitate the retention of diversification benefits, in that these assets could be placed where they are most valuable for the bank.

Diversity and systemic risk

A3.22 Banks hold capital against the total risk on their balance sheets, be it systematic[4] or idiosyncratic. Resilience to systematic risks is especially important because a common shock can by definition threaten a large part of the banking system at once.

A3.23 There is some evidence to suggest that universal banks and investment banks tend to be more systematic than retail banks, i.e. that their performance is more closely correlated with the market as a whole. Wagner (2010) shows why diversified banks are likely to be more systematic, and that while diversification may be good for individual banks and their owners, it may be bad for the economy. Consistent with this, Baele et al. (2007) find that diversified banks are more systematic. Knaup and Wagner (2010) measure the systematicity of banks by the sensitivity of their share prices to deep out-of-the-money S&P index put options (a measure of the probability of an adverse event), and find that uninsured deposits and 'non-traditional activities' – characteristics which predominate in investment banks – are strong predictors of underperformance in a crisis. In other words, investment banks' share prices are more sensitive than those of other banks to the risk of a crash. Likewise De Jonghe (2010) finds that the tail betas of banks – a measure of their underperformance in a crisis – are larger for banks with more 'non-traditional activities'.

A3.24 Universal banks can transmit common shocks, through their co-mingled balance sheets, from investment to retail banking and *vice versa*. In particular, with investment banking more exposed to global shocks than retail banking, the ring-fence, by insulating retail banking from this source of common shocks, would reduce the exposure of UK retail banks to this important source of shocks. For a given level of capital in the retail banking system, the likelihood of many retail banks failing at the same time – the eventuality with the greatest social costs – would be reduced.

Summary

A3.25 There is mixed evidence to support the assertion that diversification reduces the idiosyncratic risk of banks. There is also evidence that diversification in general, and the addition of investment banking activities to retail banking activities in particular,

4 In what follows, the term 'systematic' is taken to mean 'correlated with average asset returns in the economy', whereas the term 'systemic' refers to a risk to or of the financial system.

engenders greater systematicity in banks, which may be bad for the system as a whole. The Commission's recommendations aim to allow universal banks to benefit from a large degree of diversification, by allowing very considerable flexibility in where to locate assets, and allowing capital transfers when this would not cause healthy parts of banks to fail – in other words, diversification which is valuable not just to shareholders but also to the wider economy. Situations in which the ring-fence would constrain the freedom to transfer capital are ones where private interests and the public interest tend to diverge. Thus the recommendations would help make retail banking less systematic, reducing the risk of a systemic retail banking crisis.

The liquidity and funding of banks

Liquidity production by the banking system

A3.26 Banks are able to fund illiquid assets with short-term, liquid liabilities because different customers will typically want to withdraw funds at different times. Diversification – in this case the extent to which customers' liquidity demands are asynchronous – is therefore important on the liability side of bank balance sheets, as well as on the asset side. The production of liquidity in this fashion is socially valuable, because it allows savers to withdraw funds when they want, rather than when the investments they ultimately fund pay off (Diamond and Dybvig (1983)).

A3.27 The ring-fence would allow banks to retain some liability diversification benefits. Ring-fenced banks could use a mixture of retail deposits and wholesale funding (including deposits from large companies) subject to appropriate limits. Non-ring-fenced banks would also have some flexibility, although they would not be able to use retail deposits. In terms of matching assets and liabilities (as distinct from issues relating to the current scope of the implicit government guarantee) this restriction should not be costly – indeed, one bank chief executive has made clear his view that retail deposits never have, and never will, fund the investment banking activities of his bank.[5] But to the extent that providers of wholesale funding to universal banks attribute some value, *in extremis*, to the diversification benefit of retail deposits as an alternative funding source, then some cost might arise as banks adjust their balance sheets to compensate for this loss of diversification.

A3.28 As a result, to the extent that the ring-fence has a material impact on the liquidity diversification benefits of integrated universal banks, those banks might be able to achieve somewhat less maturity transformation under a ring-fence than otherwise. They would then have to issue fewer liquid liabilities – i.e. more long-term debt in place of some deposits or short-term debt – or hold a larger buffer of liquid assets – i.e. more central bank money, government debt and high-quality private securities in place of some illiquid loans to risky borrowers. A reduction in the degree of liquidity transformation by the banking system means that the public must have somewhat less liquid savings, or more liquid investments. However, the associated costs are

5 Q244, Bob Diamond's evidence to the Treasury Select Committee, 2011. Available at: http://www.publications.parliament.uk/pa/cm201012/cmselect/cmtreasy/1069/11060803.htm.

likely to be relatively small, as discussed below. And the calibration of the new Basel (and Financial Services Authority (FSA)) liquidity requirements suggests that there was too much liquidity transformation conducted by banks in the run-up to the crisis in any case.

Trapped funding

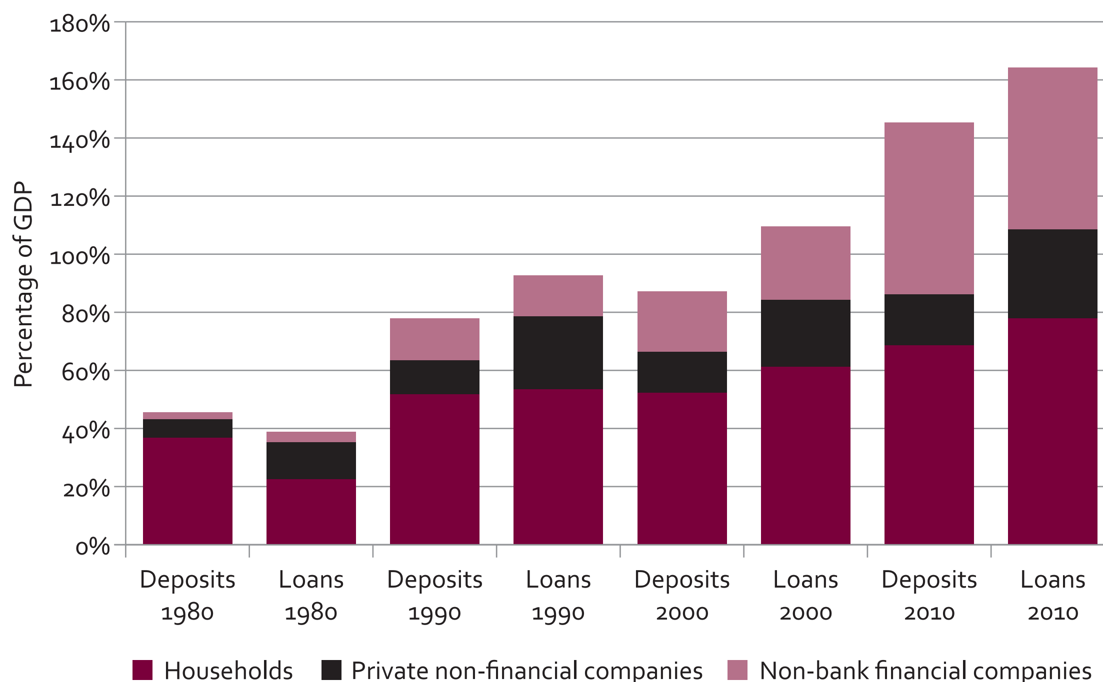
A3.29 The ring-fence would prevent retail deposits from funding assets other than loans to the public and non-financial private sectors in the European Economic Area (EEA).[6] Restrictions on how deposits are invested is intrinsic to forms of separation, and could in principle 'trap' deposits in ring-fenced banks if they were constrained to hold a narrow range of assets, either forcing them to fund lower-quality permitted assets, possibly inflating a credit bubble, or to be invested in government bonds and central bank balances, depriving the private-sector economy of credit.

A3.30 With the proposed ring-fence design, however, this is a non-issue – the relatively broad design of the ring-fence avoids such costs. 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. (An alternative ring-fence that, for example, excluded corporate loans might have run a risk of being over-funded.) While the relationship between deposits and loans currently varies between banks, and over time (see Figure A3.2), their business models can adjust through time as necessary to avoid any issue of trapped funding.

A3.31 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. Two features of the ring-fence provide flexibility in this regard. First, ring-fenced banks would be able to lend to the non-financial sector throughout the EEA, a universe of potential assets much larger than existing loans. Second, wholesale funding would have many alternative destinations, including non-banks, non-ring-fenced banks and foreign banks. Any incipient shortage of suitable assets for ring-fenced banks would tend to reduce the yield that ring-fenced banks could offer on their liabilities relative to competing sources. This would tend to draw funding away from ring-fenced banks. Given the flexible ring-fence design proposed, the risk that funding would be inefficiently trapped in ring-fenced banks accordingly seems very low indeed.

6 Subject to a carve-out for assets held for treasury management purposes.

Figure A3.2: Sterling deposits and lending of UK banks



Source: Bank of England, Office of National Statistics, Commission calculations.

The interconnectedness of the banking system

A3.32 Universal banks are highly connected to each other through interbank lending and derivatives markets, although the size of economic exposures is typically mitigated somewhat by collateral and netting. These markets help banks to dissipate idiosyncratic shocks and hedge idiosyncratic risks. For example, if deposits flow from bank A to bank B, the interbank market provides a channel for bank B to lend the money back to bank A, so that bank A does not have to liquidate assets to meet the claims of depositors (Bhattacharya and Gale (1987)).

A3.33 This insurance allows banks to economise on potentially costly capital and liquidity reserves. But as a result, banks end up less well stocked to deal with common shocks, which intra-system risk sharing by definition cannot help to mitigate. To use an analogy, being able to borrow a cup of sugar from one's neighbour means one might store less at home, but this would leave the whole street more vulnerable to a shortage if the supermarket shelves empty unexpectedly.

A3.34 Furthermore, the connections between banks can also lead to contagion – one bank bringing others down – of four broad kinds.

- Liquidity hoarding: if banks fear that they will lose the ability to borrow at some point in the future, they may hoard liquidity today. The interbank market can seize up, even for potentially solvent borrowers, and the supply of credit to the real economy is restricted (Acharya and Merrouche (2010)).

- Counterparty losses: if a bank that owes money to other banks fails, it imposes losses on those other banks, such that they may also fail (Upper (2007)). The widespread use of collateral and netting has limited the size of these exposures, as has the dramatic shrinkage of the unsecured interbank market. However, uncertainty about the magnitude and location of counterparty exposures may in some circumstances reduce the availability of funding for fundamentally sound banks.

- Informational contagion: the distress of, or losses revealed by, one bank can cause market participants to revise their views of others, causing them to withdraw funding even from fundamentally sound banks (Acharya and Yorulmazer (2007)).

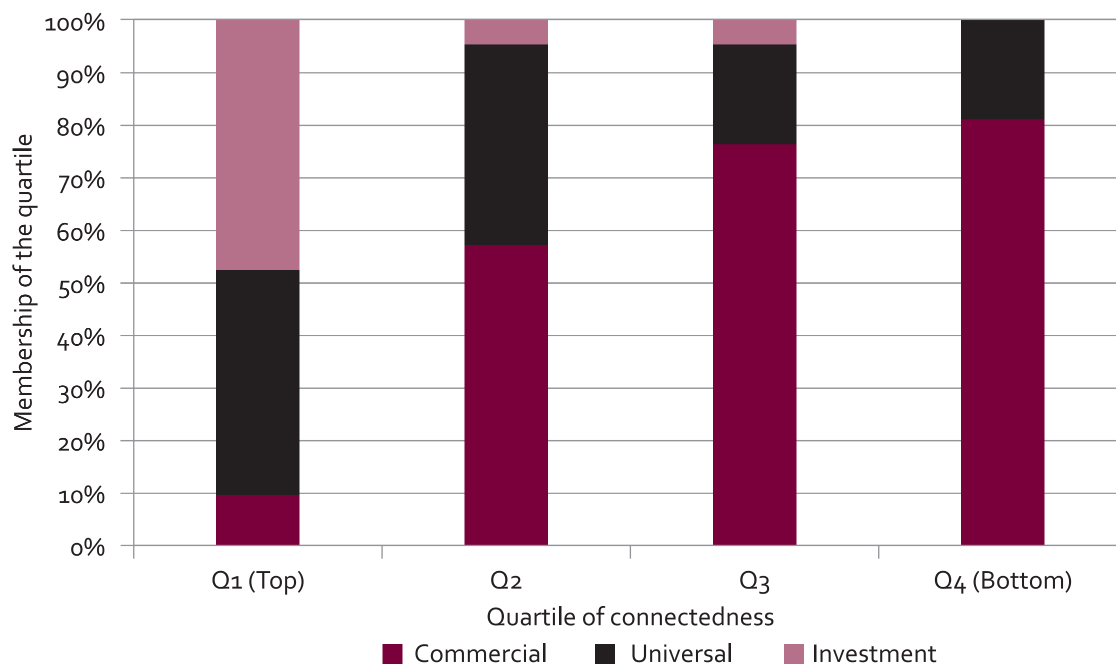
- Fire sales and common creditors: banks can be indirectly linked through third parties. If they have creditors in common, losses imposed by one bank can cause the creditor to withdraw funds from the other, causing a liquidity crisis. And if they hold the same assets, distressed sales by one bank can inflict mark-to-market losses on others (Shleifer and Vishny (1992)).

A3.35 The trade-offs that connectedness present have informed the design of the ring-fence. The rules aim to restrict exposures of ring-fenced banks to the rest of the financial system[7] to those necessary to provide products to non-financial customers within the EEA and to participate in the payments system. In their evidence to the Commission, HSBC (2011) noted that where hedges had previously been available naturally, or provided internally, they would be externalised with ring-fencing, leading to a counterparty risk where none existed previously.

A3.36 Nonetheless, ring-fenced banks would be less connected to other banks than universal banks currently are. Non-ring-fenced banks, in contrast, would remain highly interconnected to the extent that dealings with financial counterparties are intrinsic to the business of investment banking (Figure A3.3).[8] In this sense, problems of connectedness would be contained to those parts of the financial system where it is necessary, and the stability of ring-fenced banks would be improved as a result. The risks borne by ring-fenced banks would also be more transparent and thus more amenable to market and regulatory scrutiny.

7 Ring-fenced banks may have exposures to other ring-fenced banks, subject to third-party limits.
8 Other reform initiatives, in particular moves to increase the use of central counterparties, will play a valuable role in reducing interconnectedness outside the ring-fence.

Figure A3.3: Degree of connectedness for different kinds of bank[9]



Source: Ötker-Robe et al. (2011)

The ability of banks to bear losses

A3.37 The following section discusses the economic impact of the Commission's recommendations to improve banks' ability to absorb losses:

- an increase in the share of bank assets funded with common equity;
- the introduction of a bail-in regime to make it easier for bank creditors to suffer losses without insolvency of the bank;
- the requirement of a minimum amount of unsecured long-term debt, on which losses can be imposed ahead of other non-capital liabilities; and
- preference for insured depositors in insolvency.

A3.38 Alongside the ring-fence, the aim of these proposals is to reduce the probability and impact of bank failure and curb incentives for excessive risk-taking. This section addresses these two aspects in turn, before considering the impact they would have on bank funding costs and the liquidity transformation performed by the banking system.

9 Based on a global sample of 84 bank balance sheets from 2000-2009 (12 investment banks, 25 universal banks and 47 commercial banks). Of the 12 investment banks in the sample, 10 are in the top quartile of connectedness. Connectedness is calibrated with respect to: (i) securities holdings in U.S. dollars; (ii) wholesale funding in U.S. dollars; and (iii) the wholesale funding ratio.

The probability of bank failure

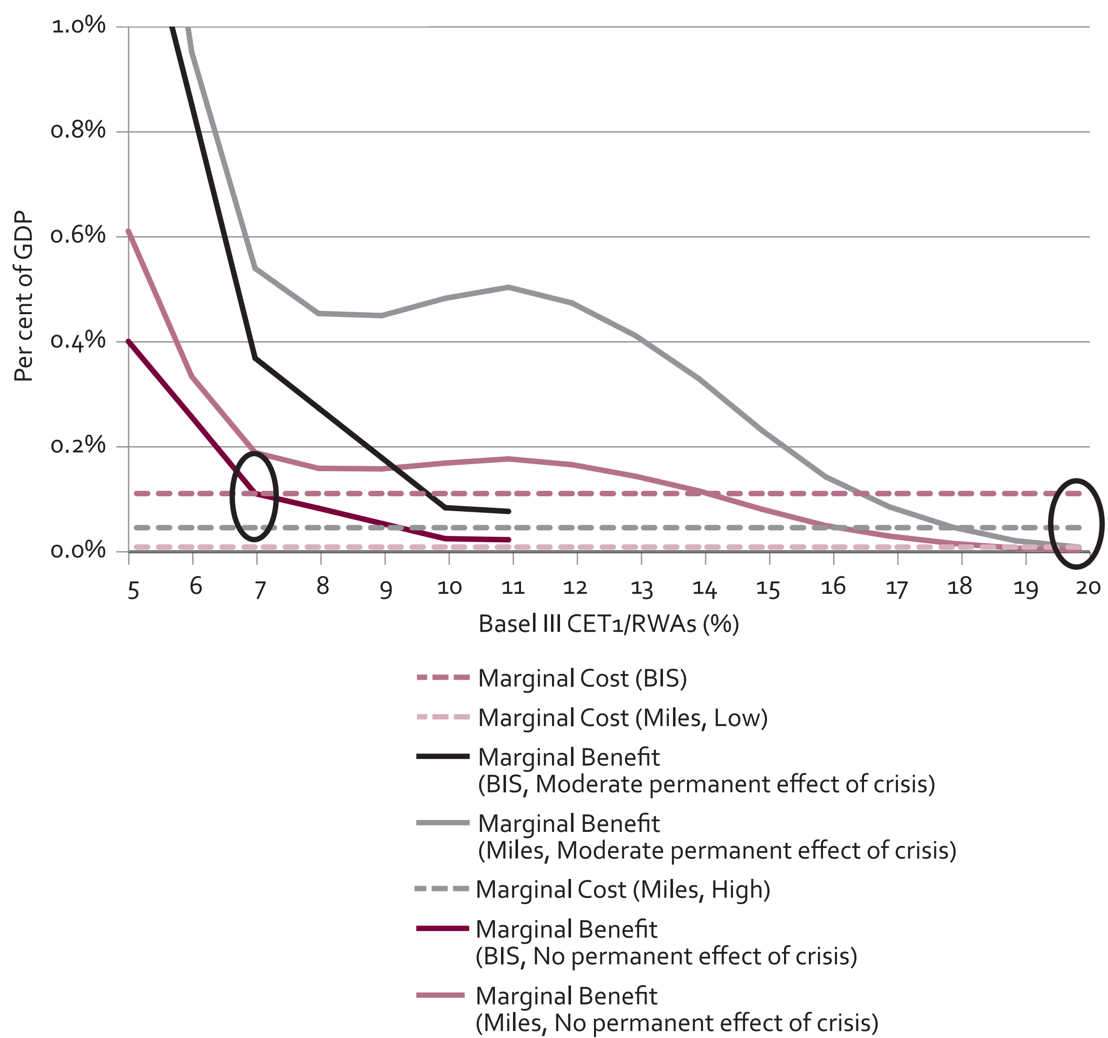
A3.39 The share of a bank's assets that is funded with equity determines how much it can lose before becoming insolvent. Other things equal, therefore, the more equity that banks issue, the less frequently they will fail. Furthermore, Gambacorta and Marquez-Ibanez (2011) find that in times of stress the more capital banks have, the more loans they continue to supply.

A3.40 The Commission welcomes recent moves at the international level to increase the loss-absorbency of bank liabilities, in particular the Basel III reforms and global systemically important banks (G-SIB) proposals. When implemented, these reforms will increase the common equity capital ratios of banks by several times relative to pre-crisis minima. The Commission proposes to increase further the equity ratios of large UK ring-fenced banks to at least 10% of RWAs. For those banks which face a 2.5 percentage point increase in equity requirements by virtue of their being G-SIBs, this could represent a small additional increase, albeit with reduced scope to transfer capital intra-bank by virtue of the ring-fence. For those to which the baseline Basel III requirements would otherwise apply, this represents a 3 percentage point increase in equity capital requirements.

A3.41 Figure A3.4, taken from Annex 3 of the *Interim Report*, shows the results of two recent studies (BCBS (2010a) and Miles et al. (2011)) that quantify the benefits of reduced frequency of financial crises and consequent increase in average GDP that would result from an increase in bank equity capital. On all but the most conservative estimate shown, the marginal benefits are significantly positive up to 10% Common Equity Tier 1 (CET1)/RWAs.[10] This reflects the high costs of financial crises (see below), the material residual possibility that they will occur at these levels of capital, and the powerful effect that more equity has in mitigating this risk. Consistent with this, Figure A3.5 shows that the equity requirements proposed by the Commission would have covered the losses of many banks in the recent crisis, but also that many banks made losses close enough to these requirements to put them in resolution, or in excess of them, which would leave them insolvent.

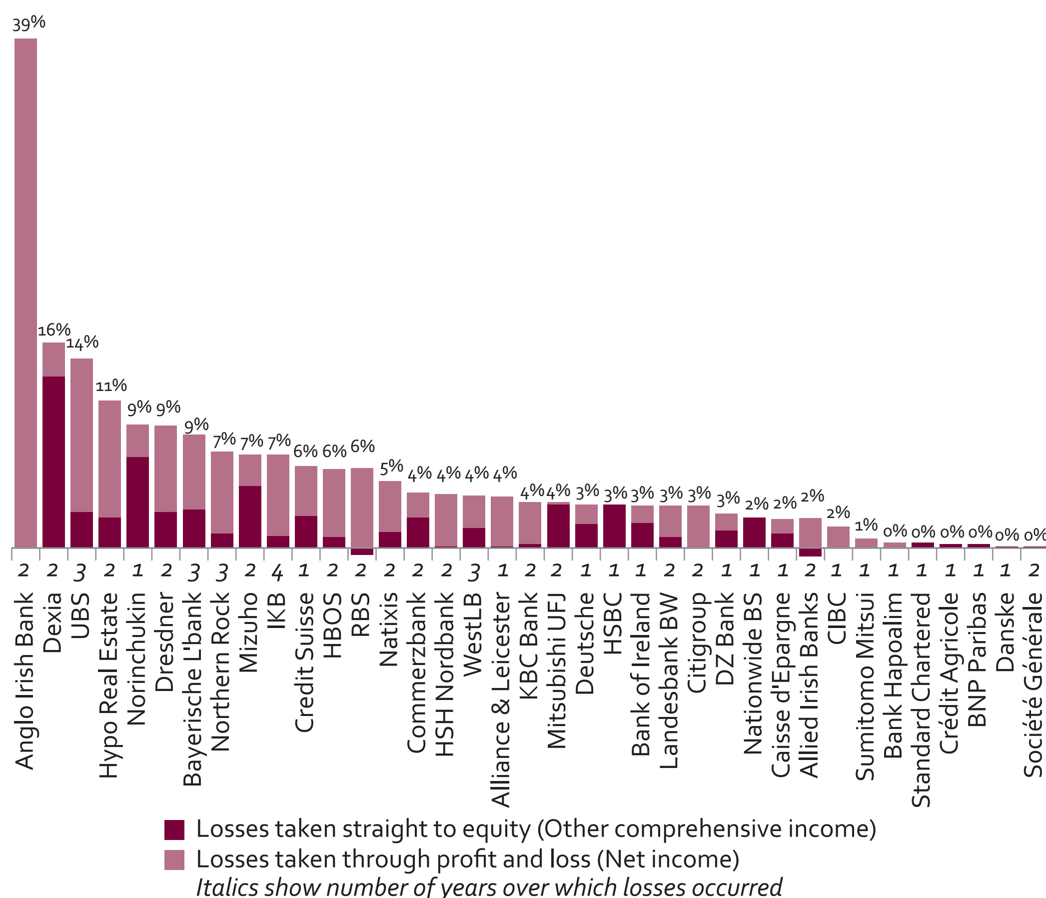
10 A report by RiskMetrics, contained in HSBC's response to the Interim Report (HSBC (2011)) examines the sensitivity of the results in Miles et al. (2011) to some of the assumptions made to get them, finding that it is possible to generate lower numbers for the optimal amount of capital in the banking system. However, because only a subset of these assumptions are examined, it is not possible to conclude from the study that the Miles et al. (2011) estimates are biased downwards, only that they are uncertain.

Figure A3.4: Marginal costs and benefits per percentage point of bank capital



Source: BCBS (2010a), Miles et al. (2011).

Figure A3.5: Losses suffered by banks in the crisis as a percentage of RWAs (2007-2010)



Source: Bankscope, Commission calculations.[11]

A3.42 As well as increasing the capacity of banks to absorb losses when they occur, the Commission's package of loss-absorbency measures would reduce incentives for banks to take excessive risks in the first place. Bank shareholders would absorb more losses as a result of bad investment decisions before the bank is resolved, at which point debt investors would bear losses, rather than the taxpayer. The prospect of bank investors bearing the full risks of their investments would encourage them to lend more prudently to banks, reducing the scale of losses that banks may ultimately incur, and/or effectively demand that banks protect them with more equity. This would tend to limit the scale of losses that banks might ultimately incur in bad times.

11 The sample includes banks that suffered the largest gross losses in the crisis (as listed on the Bloomberg 'WDCI' page) and which also suffered losses net of earnings over at least one year during the period. The losses shown in Figure A3.5 are calculated cumulatively (over a period of up to four years) as the maximum decline in the book value of bank equity, expressed as a percentage of RWAs at the beginning of the period. They represent the sum of realised losses (which reduce 'net income') and unrealised losses (which reduce 'other comprehensive income'). 'Other comprehensive income' relates predominantly to unrealised gains or losses on 'available for sale' securities. To the extent that some of the unrealised losses in Figure A3.5 may be offsetting previous unrealised gains, the impact of these losses on bank viability may appear overstated.

A3.43 The Commission's proposals are designed to minimise the risk that the prospect of bank investors incurring losses more readily could precipitate liquidity problems. First, the increased equity cushion would afford creditors a greater degree of protection against bankruptcy costs, reducing the incentive to run. Second, the proposal to bail in long-term creditors first (after other non-equity capital providers) would provide further reassurance to short-term creditors, those who are more able to withdraw their investments. Third, the bail-in regime is itself designed to mitigate the private (as well as wider) costs of bankruptcy, reducing the prospective value destruction which might set off a run in the first place. Furthermore, the improvements in bank solvency that would result from the proposals would make it easier for the Bank of England to provide liquidity to illiquid banks.

The impact of bank failure

A3.44 As well as making bank failure less likely, the Commission's loss-absorbency proposals are designed to make failure less costly for the economy as a whole. The ability to impose losses on bank creditors in resolution would reduce the pressure on the authorities to intervene to support banks. The fiscal risks that bank bail-outs engender, which can have large economic costs, would be mitigated. The seniority of insured deposits would also reduce fiscal risks, and reduce the transmission of losses from one bank to others through their obligation to ensure the long-run solvency of the Financial Services Compensation Scheme (FSCS).

Bank funding costs

A3.45 Increases in bank equity requirements would be costly for those banks that would have to issue more equity as a result. But this cost would probably be small for the economy. While the returns banks must pay on equity are larger than those on debt, increasing the share of equity in bank liabilities tends to reduce the cost of both equity and debt, by making them both less risky. This effect moderates the rise in the average cost of funding. Under certain circumstances, an increase in equity funding will have no effect at all on average funding costs (Modigliani and Miller (1958)). The same logic applies to changing the priority of different debt instruments, and therefore to the costs of depositor preference.

A3.46 However, in practice the effect is not zero. First, the returns on debt are deductible from taxable profits, whereas the returns paid to shareholders are not. More equity therefore means banks pay more tax – a cost to the banks but not, in the first instance, to society. Second, the yield on bank debt is lowered by guarantees. An increase in bank equity reduces the value of this guarantee – a private cost to the bank, but again one that is offset by a reduction in the contingent liability of the government. The second-round impact of these private costs on the economy as a whole is discussed below.

A3.47 Capital structure affects incentives on managers, and from this perspective there is merit in banks issuing both debt and equity. Bank creditors focus on downside risks, whereas shareholders benefit from upside risks. This makes bank creditors act

differently to shareholders, and in particular to exert more control when banks are performing poorly. A combination of debt and equity may therefore induce good risk-taking incentives (Dewatripont and Tirole (1994)).

A3.48 Further arguments against the logic that the average cost of bank funding is insensitive to its composition include points that insured depositors are insensitive to bank risk, and that depositors represent valuable customer relationships, not just debt liabilities. While both of these are true, their implications are limited. Depositor preference would significantly reduce the relevance of insured depositors being risk-insensitive by increasing the risk-sensitivity of many other bank creditors. And the increases in loss-absorbency the Commission proposes can generally be met without reducing the amount of deposits banks issue.

A3.49 The *transition* to higher loss-absorbency may involve costs for holders of existing bank liabilities over and above higher tax and the loss of implicit guarantee. Raising equity can signal to prospective investors that the prospects of the firm are not good, such that existing equity holders – who are in control of the firm – may not be willing to provide further external financing. And, when existing debt is risky, raising extra equity will in the first instance transfer some value away from existing shareholders to creditors (Myers (1977)).[12] However, the theoretical point about signalling would appear not to apply when equity increases are required of a number of banks, and in any case amount to transfers from existing owners to new ones, rather than an aggregate cost for society.

A3.50 One argument against large increases in equity or bail-in debt that does carry some force relates to the prospect of harmful regulatory arbitrage. If pushed too far, the tightening of regulation on UK banks could lead to an undesirable transfer of activity out of them to other banks. In particular, there is some evidence to suggest that foreign providers of credit tend to be quicker to reduce lending in a crisis (Giannetti and Laeven (2011)). Therefore, there is a point beyond which the substantial benefits of greater loss-absorbency must be balanced by the risk of instability that excessive reliance of foreign lending could bring if other countries allowed their banks to run with lower levels of capital and loss-absorbing debt. A rise in costs in the banking sector might also cause some activities to move to non-banks. Such migration is dangerous when, as occurred on a large scale in the run-up to the recent crisis, the risks are not properly shifted out of the banking sector but rather connected back to it. But it can be beneficial when risks are genuinely shifted, insulating core banking services from them. The prospect of these kinds of arbitrage has moderated the Commission's loss-absorbency recommendations, which have been designed to minimise any additional incentive and scope for them.

A3.51 A related argument is that the removal of the implicit government guarantee could make UK banks less competitive *vis-à-vis* other banks which might continue to enjoy an implicit guarantee, particularly in wholesale/investment banking markets. If other countries provide such subsidies to their wholesale/investment banking business, it

12 This is the 'debt overhang' problem discussed in Chapters 4 and 5.

does not mean that the UK should do so, particularly given the damaging incentives and risks that such subsidies create.[13]

Government guarantees of bank liabilities

A3.52 Some bank deposits have been explicitly guaranteed in the UK since 1982. But as the recent crisis began in 2007, the guarantee of bank deposits was expanded, and other kinds of bank liability – such as some senior debt – were also offered explicit guarantees for the first time. Governments in the UK and elsewhere also expanded the scope of liquidity support to banks and markets, and in some cases provided large capital injections and asset guarantees. These actions were taken, particularly after the failure of Lehman Brothers, to avoid the adverse consequences of allowing further failures of major financial institutions. Such actions are typical in periods of financial distress (Laeven and Valencia (2008)).

A3.53 Consistent with these and previous interventions to protect bank creditors from losses, it is widely believed that bank debt funding costs are cheapened by an implicit government guarantee. Credit rating agencies typically and explicitly assign higher ratings to banks in view of the prospect of government support, and the associated extent and value of the increase in ratings is higher on average now than before the crisis. Box A in Annex 3 of the *Interim Report* discussed a range of estimates of how much this was worth and concluded that, while this quantity is hard to measure and likely to vary a great deal over time, the evidence is consistent with a reduction in UK banks' funding costs of considerably in excess of £10bn per year currently.

A3.54 The lower bound of this range lies above an estimate from a study commissioned by RBS and produced by Oxera (2010). The central estimate in that study is derived with an option-pricing methodology and is £6bn per year, broadly based on data averaged across most of the past decade. Oxera discuss the sensitivity of this estimate to the amount of money banks must lose before intervention, and the shape and dispersion of the distribution of their losses. A further key sensitivity, not explored in the study, relates to the risk-free interest rate used to price the guarantee. The value of the guarantee is highly sensitive to this parameter. For example, if a 3% rate is employed instead of the 5% value used in the study, the estimated value of the guarantee triples to around £18bn using Oxera's methodology. (At the current 10-year gilt yield of 2.5% the number would be higher still).

A3.55 Haldane (2010) estimated the value of the guarantee to be £57bn per year between 2007 and 2009. At the end of 2010, given changes in balance sheets, credit ratings and market prices, the guarantee would be valued at around £40bn on this method. The implicit subsidy is naturally highest during periods of most stress if governments offer more support, as the UK Government has done since 2007. So while there is a high degree of uncertainty about the value of the implicit guarantee of bank liabilities, updating these two methods for the most recent data causes the estimates they produce to converge somewhat.

13 For further discussion of this point, see Paragraphs 5.77 to 5.86.

A3.56 The implicit guarantee is chiefly apparent in a cheapening of debt funding costs, and has a number of important consequences. Debt is made artificially cheaper than equity, compounding the distortion that results from their asymmetric tax treatment, further encouraging banks to be more leveraged. To the extent that large banks benefit from a stronger guarantee, the banking system tends towards a greater degree of concentration than otherwise. On the asset side, banks face less discipline from their creditors in taking risk, and could be incentivised to invest in projects which are not worthwhile on average, but risky enough to have at least some chance of making money (Gropp et al. (2010)). This results in a misallocation of capital in the economy. In addition to this capital fragility, banks are also encouraged to take on a greater degree of maturity mismatch (Keister (2010)).

A3.57 When the guarantee is called upon in the form of bank bail-outs, the fiscal costs can be very large indeed. These costs represent transfers in the first instance, but can nonetheless be economically costly. Bail-outs transfer resources from taxpayers to holders of bank debt. Raising the taxes needed to pay for them, and/or cutting other public expenditure, may generate further costs. Moreover, when the fiscal costs of a bailout are sufficient to bring the creditworthiness of the government into question,[14] the collateral economic damage can be very large,[15] as the recent examples of Iceland and Ireland (see below and Figure A3.6) illustrate vividly. Weakened public finances can further exacerbate risk, as efforts to prop up failing banks can, by increasing the risk of government bonds, cause problems for otherwise healthy banks (CGFS (2011)).

A3.58 Set against this, in the event of stress in the banking system, bail-outs might well be better than the perceived consequences of allowing banks to fail in a disorderly fashion: this is why they take place.[16] With bail-outs, the supply of financial services is maintained to some degree, and the costly liquidation of bank assets is prevented. In practice, liquidity and solvency problems are intertwined (Morris and Shin (1998)). Keister (2010) argues that a zero-bail-out policy would cause financial intermediaries to become too liquid from a social point of view, investing too little in illiquid but productive assets in order to guard against the risk of a bank run. In that paper, the optimal policy is to permit some bail-outs but deal with the excessive risk-taking this engenders in advance (in this case with a tax on the short-term liabilities encouraged by the prospect of a bail-out).

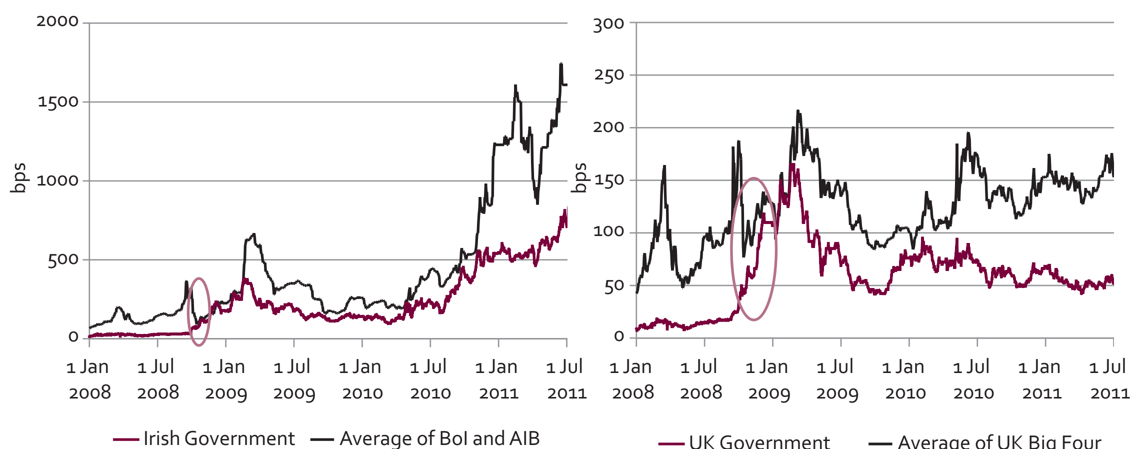
A3.59 In its response to the *Interim Report*, Barclays (2011, p1) stated that they do not agree with the "…premise [that a subsidy exists] and, therefore, do not believe there are any benefits in attempting to attach a value to it…". However, Barclays accept that a contingent liability exists for the government and add that "[i]t is unclear whether any such contingent liability effectively lowers the funding cost for banks and, if it does, that there are specific benefits for certain banks or type of bank…" and that "taxpayers expend no money as a result of this [contingent liability]". They go on to

14 Acharya et al. (2011).
15 Borensztein and Panizza (2009), Levy-Yeyati and Panizza (2006).
16 And it is why, on top of adequate capital buffers, banks need to be resolvable so that the alternative is not disorderly failure.

say that "the shared objective of all stakeholders is to eliminate any potential contingent liability".

A3.60 While a contingent liability of the government to provide support to the banks does not require actual taxpayer expenditure unless called upon, by definition a contingent liability requires expenditures in certain contingencies. Moreover the liability might then be very large. As of late August 2011, the Government had made a loss on a mark-to-market basis on its capital injections into banks of about £35bn or 2.5% of GDP. Some other countries have made very much larger losses, to the point where the solvency of their governments has been compromised (Ötker-Robe et al. (2011)). Figure A3.6, based on a chart appearing in Acharya et al. (2011), shows how credit risk was transferred from banks to the government in the UK and Ireland at the time the extraordinary crisis-related interventions were announced in October 2008. Insofar as the risk that bail-outs pose to the public finances raises the Government's borrowing costs, the implicit guarantee will increase public spending even when there are no direct outlays.

Figure A3.6: Irish sovereign vs. Irish bank CDS spreads (LHS) and UK sovereign vs. UK bank CDS spreads (RHS)



Source: Datastream, Commission calculations. 'BoI' is Bank of Ireland, 'AIB' is Allied Irish Bank. UK Big Four are Barclays, HSBC, LBG and RBS. The averages are simple unweighted averages.

A3.61 Standard Chartered (2011, p8) stated that they "…would challenge the validity of the methodologies used to estimate such subsidies. Our analysis of Credit Default Swap ("CDS") spreads before the crisis indicates very little state subsidy. Market participants thought that the probability of bank failure was incredibly small, not that governments would step in if a bank did fail. By contrast, current CDS spreads indicate that creditors do believe they are at significant risk of loss. Neither data set supports the notion of an embedded support from the taxpayer." They added that "we are not persuaded of the ICB's conclusion that all UK banks benefit from a public guarantee of considerably more than £10bn per year. We do not think that the ICB has undertaken sufficient analysis to be able to support this assertion."

A3.62 Recent events have demonstrated beyond any doubt that governments provide banks with implicit guarantees and that these guarantees are periodically called upon. Whatever view is taken of the extent to which bank behaviour was distorted by such guarantees in the run-up to the financial crisis, it will be distorted in the future unless policy curtails them. Furthermore, the outlays to rescue banks have been costly, whether or not the prospect of them introduced a costly distortion in the past.

A3.63 Consistent with this, a wide range of market participants claim that the Commission's financial stability recommendations would together have the effect of substantially reducing the impact of the implicit guarantee on bank funding costs, particularly for non-ring-fenced banks. Moody's (2011) state that "The ring-fencing proposals would likely lead to a further reduction in our assumptions of systemic support included in the senior debt ratings of these [major UK] banks". RBS (2011a) foresee a substantial effect from the ring-fence and loss-absorbency recommendations combined. JP Morgan Europe Credit Research (2011, p1) state that "ring-fencing of retail operations will be a transformational change for the UK banks and will most likely lead to the undermining of sector ratings, particularly for the entities excluded from the retail ring-fence", and anticipate that "the ratings associated with the non-ring-fenced entity should tend towards the standalone ratings of such institutions." HSBC Global Research (2011) reach a similar view. If, contrary to all the evidence reviewed above, the Commission and these analysts were wrong and there was actually no value to the implicit guarantee, then the bulk of the cost the Commission has associated with ring-fencing would not materialise, reducing the private cost of the ring-fence while protecting against any implicit subsidy returning at some point in the future.

The cost of the recommendations to banks and the wider economy

The cost to banks

Explanation of how these costs arise

A3.64 Consider a world with no implicit government guarantee of bank liabilities, and a tax system that does not favour debt funding over equity funding. Much of the Commission's recommendations would then be privately costless for banks (and the liability structures of banks would be quite different to begin with).

- An increase in the loss-absorbency of bank liabilities, through an increase in the share of equity funding and an improvement in the loss-absorbency of debt, would not increase the weighted average cost of bank liabilities.[17] So none of the loss-absorbency recommendations would impose any cost on banks. To the extent that expected bankruptcy costs were reduced, the cost of bank liabilities would indeed fall.

17 There might be some frictional costs due to investor preferences for equity and different tranches of debt. For the relatively small changes to the proportion of equity funding in the Commission's proposals, these costs might be close to zero.

- Any limited loss of asset diversification due to the ring-fence recommendation could be offset without cost by replacing a modest proportion of debt funding with equity.

A3.65 The ring-fence recommendation could, however, result in two forms of cost.

- A reduction in liability diversification could impose some cost to the extent that regulators or investors require either ring-fenced banks or non-ring-fenced banks to reduce the mismatch of maturities between their assets and liabilities, either by extending the maturity of their liabilities or by holding a greater quantity of liquid assets.

- There would probably be some increase in operational costs, for instance as a result of the requirement for the ring-fenced bank to have an independent board.

A3.66 In reality, the tax system does create a bias that favours debt funding over equity. This increases the private cost of the recommendations in the following ways.

- Banks have an incentive to minimise the proportion of equity funding to the higher of their (internal) economic capital requirement and (external) regulatory capital requirement. To the extent that the recommendation that a ring-fenced bank should fund itself with equity of at least 10% of RWAs would cause such banks to replace debt funding with equity funding, this would result in a private cost to them.

- Any reduction in asset diversification can no longer be offset without cost by using more equity funding. Some private cost would arise, either from replacing some debt funding with (more expensive) equity funding or from bearing the cost of more expensive debt funding. In the absence of more equity, any loss of asset diversification would cause an increase in the price of bank debt to reflect any increase in the probability that individual entities incur costs of financial distress.

A3.67 Removing an implicit government guarantee may result in the following additional costs to banks.

- Ring-fencing and the primary bail-in recommendation would together remove or substantially reduce investor expectations that such liabilities would benefit from an implicit government guarantee, thereby increasing the private cost of these liabilities for banks. By the same token, however, the cost of replacing debt with equity would fall.

- A similar effect would result from the secondary bail-in recommendation, although the cost would be lower because the value of the implicit government guarantee for such liabilities would be smaller (as there are more liabilities which absorb losses first).

- Depositor preference could also carry some private cost, as it would strengthen investor expectations of the willingness of authorities to trigger a secondary bail-in and increase investor estimations of the loss given default (LGD) of non-preferred liabilities. But this could be offset with a reduction in the cost of insured deposits if the FSCS cut its levies, as would be appropriate to the extent that its risk is reduced.

- In the absence of an implicit government guarantee, some banks might need to strengthen their financial position in order to compete effectively in wholesale markets against other banks that continue to benefit from such implicit state support.

Quantifying the costs: introduction

A3.68 The recommendations form a package, the cost of which would be less than the sum of the component parts due to their complementary nature. For example, both the ring-fence and bail-in recommendations should reduce the value of the implicit government guarantee. The cost should also be considered in the context of the wider package of international reforms for banks.

A3.69 What follows is a summary of the nature of each cost and an analysis of quantitative cost estimates suggested by banks and bank analysts. These cost estimates are uncertain and necessarily based on a number of subjective judgements – not least the balance of activities conducted within and outside a ring-fenced bank. Nonetheless, they may provide some insights into the true costs of the recommendations.

A3.70 As discussed in Chapter 5,[18] none of these estimates cost precisely the package of recommendations contained in this report, with variance between: assumptions on the impact of other reforms, methodological approach, and the extent of the Commission's proposed reforms. The analyst reports also have varying coverage, with focus on the big UK banks where the costs would very largely (but not exclusively) reside – but they do serve as one guide to the range of possible costs. Broadly, those analyst estimates relevant to the package of reforms proposed suggest that the annual pre-tax cost for the major UK banks could be from £2bn up to £10bn, with an average estimate of around £6bn. This is equivalent to approximately 0.1% of the funded assets, 33% of the pre-tax profit and 10% of the profit before tax and staff costs of the largest UK banks.[19] There are several potential mitigating actions that the banks could take to reduce the magnitude of this impact on profitability.

A3.71 The Commission has also received more detailed confidential cost estimates from the banks for various scenarios including ring-fencing. These cannot be published. But broadly, while they support the analysts' views about the general drivers of cost, they indicate clearly that the top end of the above range is an over-estimate of the private

18 Paragraphs A3.70-A3.74 are largely a restatement of Paragraphs 5.59-5.63 in Chapter 5.

19 Based on 2010 data as stated in company accounts.

costs. There are several reasons why some of the analysts' estimates may be too high, including:

- most of the analyses attribute little, if any, value to the diversification benefits retained by ring-fencing as proposed relative to full separation – in reality, the ability to transfer excess capital around the group in normal conditions should provide substantial advantages to creditors and capital providers compared to full separation;
- the freedom to place some assets on either side of the fence should also lower costs;
- price adjustments for bank debt are informed by spread differentials typically based on recent market observations, which may reduce when current stresses ease, as the financial position of banks improves in light of reforms which are already in train, and as the aggregate reform agenda is clarified; and
- the higher private cost estimates do not take account of management actions which would almost certainly be taken to reduce costs.

A3.72 However, some of the lower analyst estimates may under-estimate private costs. Some estimates do not cover all of the big UK banks affected by the reforms. The estimates also do not include all elements of the proposed recommendations, although none of the excluded elements are expected to have significant incremental private costs (principally, this is because once implicit government guarantees have been assumed to be removed, changes to the order in which liabilities take losses – from depositor preference and bail-in – should have no significant effect on the average cost of funding).

A3.73 There would also be some one-off costs arising from implementation of the ring-fence, for example from establishing the legal arrangements of the ring-fence, dealing with tax and pensions issues etc. Relative to the ongoing costs, these are likely to be small.

A3.74 Considering all of the evidence received, a plausible range for the annual pre-tax cost to UK banks of the proposed reform package is £4bn-£7bn, with at least half of these costs arising from curtailing the implicit government guarantee. Within this range the uncertainties are sufficiently high that it would not be sensible to attempt to gain greater precision. This range still does not take account of mitigating management actions which could lower it further. On the other hand, if the government guarantee is higher, the costs to banks could also be higher, but the costs to the economy would not.

A3.75 The following sections set out some of the published analyst estimates of costs to banks and how they might arise, notwithstanding the caveats above. Where possible, references to confidential estimates provided by the banks are used in commentary.

For the avoidance of doubt, where the specific source of a cost estimate is identified in what follows, those sources are analyst reports already in the public domain and not cost estimates provided by banks to the Commission, although these have also informed the Commission's views about the nature and scale of any costs, particularly where noted in the text. For example, unless specified otherwise, cost estimates sourced from RBS and HSBC below are from reports published by their bank equity analysts, not from the banks themselves.

Quantifying the costs: reduction in value of the implicit government guarantee

A3.76 Most analysts agree that the largest element of private cost would arise from higher wholesale funding costs for non-ring-fenced banks. Some analysts attempt to break this cost down into two components: a reduction in value of the implicit government guarantee; and a reduction in asset diversification. Others consider the combined effect. The costs of a reduction in asset diversification appear overestimated (as discussed below). The Commission believes that the majority of the higher wholesale funding costs would arise from a reduction in value to banks of the implicit government guarantee.

A3.77 The private benefit of an implicit government guarantee at any point in time can be considered as the product of the following three factors:

- the outstanding amount of a bank's debt which is sensitive to its credit risk;
- the extent to which investors' expectation of potential government support for a bank leads them to reduce their perception of its credit risk; and
- the premium that investors would otherwise have demanded for accepting the higher credit risk of the bank in the absence of the expected government support.

A3.78 Credit ratings are often used to estimate the size of this benefit. The difference between a bank's standalone and support rating (the rating that agencies publish incorporating their view of the likelihood of state support) may be considered a proxy for the second bullet point above. Table A3.1 illustrates how this is currently reflected in the credit ratings of the four largest UK banks.

Table A3.1: Difference between standalone and support ratings for the four largest UK banks[20]

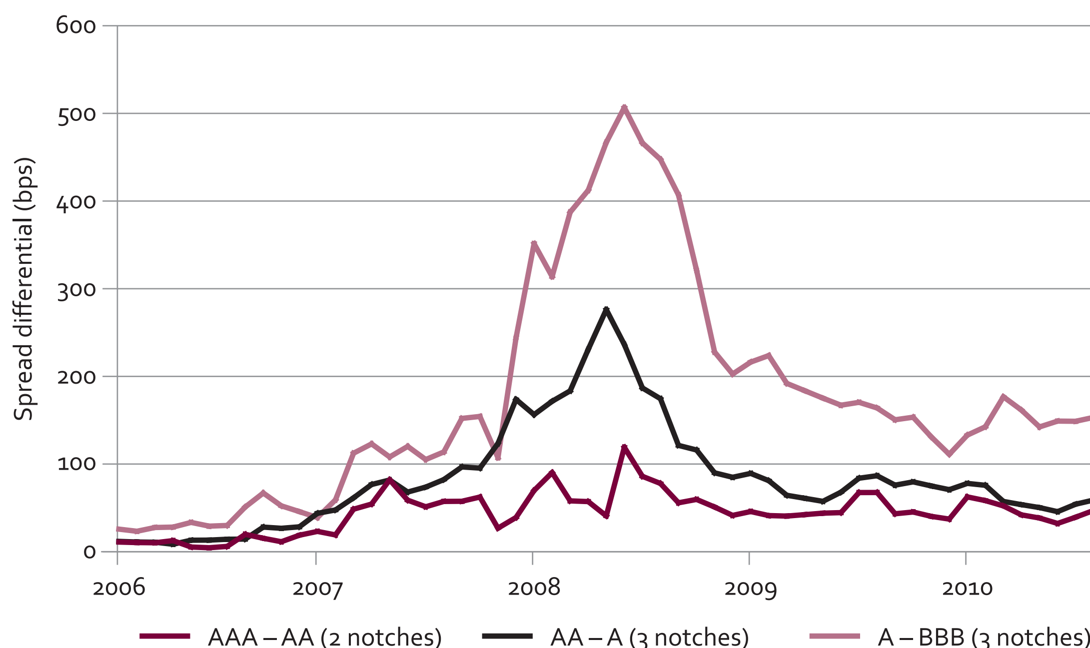
Moody's ratings for main debt-issuing bank entities	Barclays Bank plc	HSBC Bank plc	LTSB Bank plc	RBS plc
Long-term rating (with support)	Aa3	Aa2	Aa3	Aa3
Bank Financial Strength Rating (BFSR)	C	C+	C-	C-
BFSR-equivalent long-term rating (without support)	A3	A1	Baa1	Baa2
Support notches[21]	3	2	4	5

Source: Moody's, 31 August 2011[22]

A3.79 The difference in the cost of debt funding for banks with different credit ratings is an indicator of the third bullet point above. Figure A3.7 shows how this has evolved over the past five years. It shows that the cost differentials were low before the crisis, rose gradually as the crisis approached and dramatically during it, and remain more elevated now than pre-crisis. It also shows that the cost differentials typically increase further down the credit curve (i.e. the BBB vs. A differential is greater than the A vs. AA differential).

20 HSBC Bank plc also enjoys a further notch of support from its parent, HSBC Holdings plc, which would not change with the removal of the implicit government guarantee and therefore is not included here.
21 A 'notch' refers to the difference between two credit ratings: moving from AA (Aa2) to AA- (Aa3) represents a one-notch downgrade; moving from AA (Aa2) to A (A2) represents a three-notch downgrade (passing through AA- (Aa3) and A+ (A1)).
22 Available at: http://www.moodys.com.

Figure A3.7: Spread differential by credit rating between financial issuers of senior unsecured debt



Source: Autonomous Research, iBoxx.

A3.80 Some analysts model the impact of the proposals to reduce the value of the implicit government guarantee as if the proposals were to take effect in 2013. In some of these analyses, banks are assumed to be strong enough by this date that they do not derive any value from an implicit government guarantee, so there is no cost to them from its curtailment.

A3.81 Other analyses assume an immediate implementation, which would result in a private cost to banks that currently derive some value from an implicit government guarantee. This is typically expected to reduce significantly the implicit government support attributed to non-ring-fenced banks' debt, while not completely eliminating it, on the assumption that such banks may still be considered too complex to be allowed to fail. However, it is supposed by some analysts that ring-fenced banks would receive government support and hence their debt would be less affected than that of non-ring-fenced banks, if at all. The only explicit estimate from an analyst (HSBC Global Research (2011)) of the cost of curtailing the implicit government guarantee which is expected to fall on non-ring-fenced banks is based on a three notch downgrade. This results in a 100 basis point[23] increase in long-term wholesale funding spreads at an annual cost of £3.5bn in total for Barclays, LBG and RBS.

23 JP Morgan's European Bank Bail-In Survey Results (JP Morgan (2010)) cited an average investor risk premium of 87 basis points for the senior unsecured debt of an A-rated bank under a bail-in regime, broadly comparable to this figure.

A3.82 The Commission has previously stated its aim of eliminating any value that banks derive from an implicit government guarantee and, in this context, this means removing any expectation amongst investors of the potential for government support. The recommendations are complementary to other reforms in achieving this objective. In aggregate, these reforms should significantly reduce the value of the implicit government guarantee with respect to creditors of *both* ring-fenced banks and non-ring-fenced banks, although the private cost of this would largely be felt in non-ring-fenced banks.

A3.83 Extending the HSBC analysis referenced above to include long-term senior unsecured wholesale funding of ring-fenced banks would increase their annual cost estimate from £3.5bn to £4.6bn. Given that this estimate excludes any expected impact on UK banks other than Barclays, LBG and RBS, uses moderate estimates of the number of support notches removed, and does not capture any impact on short-term debt, it may be considered too low as an estimate of the effect on UK banks in aggregate. On the other hand, its use of recent market data – to the extent that this reflects wider funding spreads than future through-the-cycle averages – may create an upward bias. Overall, the Commission believes that this range provides a reasonable approximation of what the private costs of curtailing the implicit government guarantee might be.

A3.84 How might this cost of curtailing the implicit government guarantee relate to the assessment above (see A3.52 to A3.63) that the guarantee to UK banks may be worth more than £10bn per year? Although the levels of uncertainty in both sets of figures (due, for instance, to changes in spreads over time – see Chart A3.7) is sufficiently high that it would not be sensible to attempt a precise reconciliation, several possible explanations for the difference could be considered.

A3.85 First, some banks have argued that the estimate of over £10bn may be too high. The weight of the evidence does not, in the Commission's view, tend to support this explanation, although the lower estimates of the private costs of the Commission's proposals may provide another reason to be cautious about estimates of the implicit guarantee currently being very much higher than £10bn. Second, the estimates of the cost to banks of curtailing the implicit guarantee as a result of the Commission's recommendations (as set out in A3.83) may be too low. This is possible, but it should be noted that any increase in the cost to banks on account of curtailing the implicit guarantee would be a private cost, not a cost to the wider economy. Third, the cost of the Commission's proposals is incremental to the costs banks already expect to incur as a result of other regulatory changes under way, including the Basel III capital requirements and proposed G-SIB surcharges. These other reform initiatives also reduce the value of the implicit guarantee by increasing loss-absorbency. The Commission has formulated its proposals as a reinforcement and extension of other reforms under way, and has paid close attention to their cumulative effect (for more details of these see Box 2.1 and Annex 2, and Chapter 3 of the *Interim Report*). The cumulative cost of the Commission's recommendations and other actions should approximate the total value of the implicit guarantee to the banks. As an illustration, it would not be unreasonable to suppose that the Commission's recommendations

would reduce it by half and other reforms by a similar amount. Further, it is possible that even cumulatively the reforms proposed by the Commission and others will not entirely eliminate the value to banks of the implicit guarantee, though in the Commission's view any residual subsidy will be small if its recommendations are implemented. In fact, there remains a possibility that the implicit subsidy becomes a net implicit cost if bank creditors fear they may be forced to absorb losses via resolution and bail-in resulting from regulators using their discretion to deem a bank non-viable at a point earlier than that at which creditors would consider appropriate. Then the incentive distortion arising from the implicit guarantee would be eliminated in any case.

Quantifying the costs: reduction in asset diversification

A3.86 The second area of possible private cost is costs which might arise from a loss of diversification as a result of structural separation.

A3.87 As discussed above and in Chapter 5, the empirical evidence about the scale of any diversification benefits of universal banking is limited and mixed. Nonetheless, structural separation of any form could be expected to result in changes in banks' asset concentration and volatility. Depending on the nature of any such changes, this could lead bank creditors to adjust the price at which they are willing to lend to each bank, based on changes in their estimates of the expected loss (EL) of such lending.[24] To at least some extent, banks could offset an increase in EL by holding more equity, to provide bank creditors with a greater buffer of protection before they would bear losses.

A3.88 The cost of any impact would therefore be dependent on:

- the direction and magnitude of the change in EL (typically considered in terms of movements in credit ratings); and either
- the magnitude of the price adjustment that bank creditors were expected to make in response to this change in EL (typically considered in terms of the difference in funding spreads between different credit ratings); or
- assuming an increase in EL, the amount and incremental cost of additional equity that the bank could hold to offset this.

A3.89 The extent of any such impact would depend on the type of separation required. As discussed in Chapters 3 and 5, the ring-fence proposal has been designed with a view to preserving any such diversification benefits as may exist, other than those which might jeopardise the continuous provision of vital retail banking services without the provision of taxpayer support.

24 EL is the product of probability of default (PD), loss given default (LGD) and exposure at default (EAD). Both the PD and LGD expectations of bank creditors might change as a result of the Commission's recommendations.

A3.90 Where might such costs arise? Analyses reviewed by the Commission do not typically allocate such a cost to ring-fenced banks – the positive impact of having equity of 10% of RWAs and lower asset volatility are considered at least to offset any increase in asset concentration. Some analysts have assumed that ring-fenced banks would continue to benefit from some sort of implicit government support. As discussed above and in Chapter 3, the Commission rejects the idea that the debt of ring-fenced banks would be implicitly guaranteed – indeed, ring-fenced banks would be relatively straightforward to resolve. The Commission does not believe, on balance, that its proposals would increase the funding costs of ring-fenced banks. The combination of: rating agency views of the relative riskiness of investment banking and retail and commercial banking; the ability of ring-fenced banks to retain significant sectoral and geographic diversification; and the ability to transfer surplus capital around a banking group (in contrast to a full separation), suggests that the ring-fence proposals could indeed strengthen the credit ratings of ring-fenced banks, thus enabling them to borrow wholesale funds more cheaply.[25]

A3.91 However, the recommendation that large ring-fenced banks should have equity of at least 10% of RWAs and Tier 1 capital of at least 4.06% of assets might result in some private cost, if this would require such banks to replace debt funding with equity funding. This would be mitigated to the extent that the stability benefit of more equity funding is reflected in (downward) adjustments to the average cost of debt and equity.

A3.92 The analyses concur that there could be a material cost to non-ring-fenced banks from structural separation. This is consistent with an expectation that they would be more concentrated in more volatile assets and thus riskier.

A3.93 The Commission agrees with this broad picture about where any costs would be most likely to fall. How big might any costs be? The magnitude of any impact on non-ring-fenced banks, while considered under a number of different approaches which yield different results, is estimated by some analysts to be equivalent to a downgrade of the credit rating of some non-ring-fenced banks by up to 2 notches. There is high uncertainty around these estimates, and they would also vary significantly as a function of the creditworthiness of individual non-ring-fenced banks and their broader groups.

A3.94 Estimates of how much funding costs would increase in response to this increase in EL are shown in Table A3.2. These can vary widely between individual banks in the same analysis and between different types of analysis. The former reflects differences in: recently observed funding spreads;[26] expected profitability of non-ring-fenced banks; and different assumptions about the type of assets in non-ring-fenced banks. The latter reflects differences in how the increased funding costs have been estimated – for example, some figures appear to be substantially inflated by capturing some of

25 Approximately 40% of (90) respondents to JP Morgan's UK Bank Ring-Fencing Proposals Survey (JP Morgan (2011)) expected the credit rating of ring-fenced banks to increase by at least one notch.
26 Proxied by 5-year senior credit default swap (CDS) spreads.

the implicit government guarantee to the extent that: rating downgrades are stated to capture both loss of diversification and "explicit removal of sovereign backing" (Citigroup (2011)); subordinated debt holders may have much lower expectations of government support than senior debt holders (Credit Suisse (2011)); and the relative rating of universal and investment banks from 2002-2007 may have been influenced by a greater degree of expected government support for the former (JP Morgan Europe Credit Research (2011)).[27] Estimates offered to the Commission by the banks themselves of the impact on funding spreads, covering not only loss of asset diversification but also loss of the implicit government guarantee, fall within the lower part of the range offered by analysts, with this effect generally limited to long-term unsecured funding of non-ring-fenced banks.

Table A3.2: Analyst estimates of the increase in term senior unsecured funding spreads for non-ring-fenced banks (basis points)

Analyst	Approach	Barclays	HSBC	LBG	RBS
Autonomous	Higher EL due to higher anticipated LGD for investment banking assets	28-47	11-29	8-39	30-74
Citigroup	Higher EL based on assumed 1-2.5 notch rating downgrade	50	20	90	110
Credit Suisse	Higher EL proxied by that of bank subordinated debt	128	45	192	185
JP Morgan (Credit)	Higher EL based on comparative (implied) relative rating of universal and investment banks	100	n.a.	166	166
JP Morgan (Equity)	Higher EL from greater leverage that would be required to generate return on equity comparable to peers	153	69	126	129
Morgan Stanley	Not stated	100	100	100	100
RBS	Higher EL based on assumed rating downgrade from AA to A and historical spread between a utility parent and ring-fenced affiliate	60	60	60	n.a.

Source: Published analyst research reports.

27 Many of the analysts explicitly have not attempted to disaggregate estimates of costs that might arise from a reduction in asset diversification from costs that might arise from a reduction in the value of the implicit government guarantee.

A3.95 The cost of these increased funding spreads, shown in Table A3.3, is typically estimated by applying them to the relevant quantum of bank debt, which in turn is dependent on the size of non-ring-fenced banks. Some analyses focus solely on term senior unsecured debt while others also make (typically smaller) adjustments for short-term debt. HSBC analysts alternatively estimate the cost of holding more equity to offset the increase in EL that would otherwise be expected to occur due to a rating downgrade.

Table A3.3: Analyst estimates of the annual cost of increased funding spreads or having additional equity to prevent a rating downgrade (£bn)

Analyst	Barclays	HSBC	LBG	RBS	Total
Autonomous	0.9-1.4	0.3-0.9	0.2-0.7	0.8-1.5	2.3-4.6
Citigroup	0.6	0.2	0.3	1.2	2.2
Credit Suisse	1.3-2.0	n.a.	0.3-1.8	1.3-2.7	4.4-5.5
HSBC	1.2-2.0	n.a.	0.1-0.2	1.1-1.8	2.4-4.0
JP Morgan (Equity)	0.9-1.5	0.1-0.3	0.5-1.4	0.9-1.2	2.4-4.3
Morgan Stanley	2.4-2.8	2.1	1.5-1.6	2.5-2.7	8.6-9.1
RBS[28]	0.2	0.4	0.1	n.a.	0.7
Mean of central estimates	*1.2*	*0.7*	*0.7*	*1.6*	*4.3*
Median of central estimates	*1.2*	*0.4*	*0.7*	*1.2*	*3.4*

Source: Published analyst research reports. Credit Suisse entry in the 'Total' column reflects lowest and highest aggregate cost estimates under three scenarios – these are different to a simple sum of the minimum and maximum estimates for the individual banks.

A3.96 The central tendency of these estimates – £3.5bn-£4bn – would greatly overstate the costs associated with any reduction in asset diversification for a number of reasons:

- the increase in funding costs is estimated in some cases by spread differentials typically based on recent market observations, which may turn out to be higher than future through-the-cycle averages and which do not reflect the higher levels of equity that the banks will need to hold to comply with Basel III and G-SIB requirements (and, as noted above, banks' own estimates of funding spread

28 The RBS estimates are based on more flexible assumptions about exposures between ring-fenced banks and non-ring-fenced banks than the Commission's final recommendations and may therefore be subject to a downward bias.

impacts, covering both diversification and implicit guarantee, fall within the lower part of the range offered by analysts);

- universal banks would be able to retain a large part of any diversification benefits under the Commission's proposals. Most of the analyses do not consider the value of any asset diversification benefits retained in a retail ring-fence structure as opposed to a full separation. While the ring-fence does restrict the flow of capital within the group, it only does so when the regulatory limits of the bank providing capital would be breached. Subject to that, capital can flow freely, and this should provide significant comfort to its creditors compared to a full separation;

- under the ring-fence proposal, banks would retain a very considerable degree of flexibility in determining where best to place major asset classes (for instance, household mortgages and corporate loans), and this should also mitigate costs significantly; and

- because they have not all attempted explicitly to disaggregate costs, some of the analyst estimates capture some costs associated with a reduction in the implicit government guarantee, which should be considered separately (this might help reconcile the cost estimates with those of the size of the implicit guarantee and might also explain some of the difference between some of the cost estimates offered and the weak empirical evidence on diversification benefits of universal banking).

Quantifying the costs: reduction in liability diversification

A3.97 The analyses do not allocate a cost to ring-fenced banks for potential loss of diversification of funding sources (liabilities). Ring-fenced banks would retain the flexibility to diversify funding across liabilities including retail deposits, corporate deposits and wholesale funding.[29] And to the extent that they rely solely on retail deposit funding, this has proved historically to be the most stable funding source and is treated accordingly in regulatory liquidity rules. The Commission agrees that ring-fenced banks should not incur a material cost in this regard, and believes that they might benefit to the extent that they could reduce the maturity of their liabilities or hold fewer liquid assets while still meeting regulatory liquidity requirements.

A3.98 Several analyses note potential costs for non-ring-fenced banks. Because they would not be able to accept retail deposits, non-ring-fenced banks would not benefit from the diversity or the stability that such funding might otherwise offer. They might therefore incur a cost from reducing their liquidity risk, either by extending the maturity of their liabilities or by holding a larger pool of liquid assets to make them more robust in the event of a funding crisis. Both of these actions would compress the margin between what they earn on their assets and what they pay for their funding, and would therefore reduce their income. At a minimum, non-ring-fenced banks

29 Subject to regulatory limits that may be imposed on wholesale funding as a proportion of total funding.

would be required to meet the Basel III liquidity requirements on a standalone basis. But their own liquidity risk management policies might impose additional constraints.

A3.99 HSBC Global Research (2011) attempt to quantify this cost by assuming that non-ring-fenced banks would face a requirement that at least half of their funding must have a maturity in excess of one year and that the cost of replacing short-term debt with long-term debt to meet such a requirement would be 200 basis points. This would result in an annual pre-tax cost of c.£0.6bn for Barclays, LBG and RBS combined. Figures received from the banks suggest that this is an upper bound.

Quantifying the costs: other costs

A3.100 First, what operational costs might arise from the reforms, and in particular from the ring-fence? The only public analysis reviewed by the Commission since the *Interim Report* that explicitly considers this cost simply assumes that it absorbs 1% of revenues, or c.£1bn-£1.5bn (RBS (2011a)). This does not appear credible and is considerably higher than the costs suggested by banks, which are no more than £0.5bn per annum for the four largest UK banks in aggregate. The Commission has seen limited detail to support these figures but believes that even they may be too high, and perhaps include costs that might arise under a full separation but which need not arise under the ring-fence proposals. These should be considerably lower than the operational costs of full separation because of the scope for continued sharing of operations, subject to safeguards (discussed further in Chapters 3 and 5), and might be limited to those arising from the duplication of board and some management functions.[30] These costs should be significantly lower than £0.5bn per annum.

A3.101 Second, what impact might there be on revenues? Some market participants have suggested that in certain scenarios ring-fencing could make it harder for some banks to compete in some wholesale markets. This risk is noted in various analyses but is typically not costed, on the assumption that management actions taken to minimise the impact on wholesale funding costs – for example, increasing asset diversity and/or equity funding – would be sufficient to maintain an adequate credit rating and therefore retain banks' ability to operate in these markets. The more general question of whether the reforms might lead affected banks' wholesale or investment banking businesses to lose market share to other banks, and what impact this would have, is discussed in Chapter 5.

Summary and interpretation of the costs

A3.102 The range of public estimates for the total annual private costs of the Commission's recommendations to the four largest UK banks is up to c.£10bn, without allowing for mitigating management action on behalf of the affected parties. For the reasons discussed above (and in Chapter 5), the Commission believes that significant costs to

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30 Ensuring operational separability will have some cost, but this will be required in any case as a result of the development of recovery and resolution plans.

banks would arise, mostly outside the ring-fence, and largely reflecting curtailment of the implicit guarantee, but that the upper end of this range is implausibly high.

A3.103 This cost figure does not seek to capture the impact on banks other than Barclays, HSBC, LBG and RBS. While the Commission's proposals would result in costs for other banks, these would be low in the wider context given their relative size,[31] more limited benefit from implicit government support and their involvement in few, if any, activities which could not take place within ring-fenced banks.

The cost to the wider economy

A3.104 Faced with higher private costs as a result of the Commission's recommendations, banks would need to cut other costs (including remuneration), increase revenues, or accept lower profits. The prices of bank inputs – capital, labour and debt funding – and outputs – financial services – are all set in markets in which UK banks must compete, to varying degrees, with other buyers or sellers. A change in UK banks' valuation of these things would lead to some combination of changes in prices charged or paid and quantities bought or sold. This would impact different groups in different ways.

- Bank depositors and other creditors: holders of bank debt might experience gains or losses, relative to a baseline in which they benefit from a guarantee. All existing creditors would gain from an increase in the equity cushion that protects them from asset losses. The FSCS would also gain from depositor preference, although this might be mitigated by a reduction in the levy it charges for insurance, whereas those creditors made junior to insured deposits would lose. Other things equal, the measures to make bank debt more loss-absorbing would reduce the value of some existing debts, depending on how far they are from maturity. And any increase in costs that might result from reduced diversification would be borne, in the first instance, by existing bank creditors. These effects would be mitigated by the length of the transition period. Going forward, banks would have to compete with other issuers of debt to attract funds. New creditors would therefore be appropriately compensated for the increased risks associated with bank debt. In good times, they would enjoy higher returns. But in bad times, they would be more likely to share losses.

- Employees: salaries, bonuses and other staff costs are a major component of bank costs. The staff costs of the four largest UK banks amounted to £40bn in 2010. For the sake of illustration, a cost increase of £5bn would be 12.5% of total staff costs. However, UK banks must compete with alternative employers – foreign banks and non-banks – for their staff. This would limit the extent to which they could pass through any cost increases to them, though clearly not to zero.

- Shareholders: as with creditors, future shareholders' expected returns on their investments will be determined in the capital markets, where banks compete

31 Other banks represent only c.15-20% of UK bank assets.

with other firms for capital. Expected returns will accordingly be set in line with investors' attitudes to risk and the pay-offs they expect from owning bank shares. In particular, if having more equity makes banks' equity returns less risky, banks will be able to attract capital with lower returns. Furthermore, to the extent that financial instability – a major source of macroeconomic volatility – is reduced, investors may require less compensation for risk as the total risk in the economy is reduced (Barro (2006)).

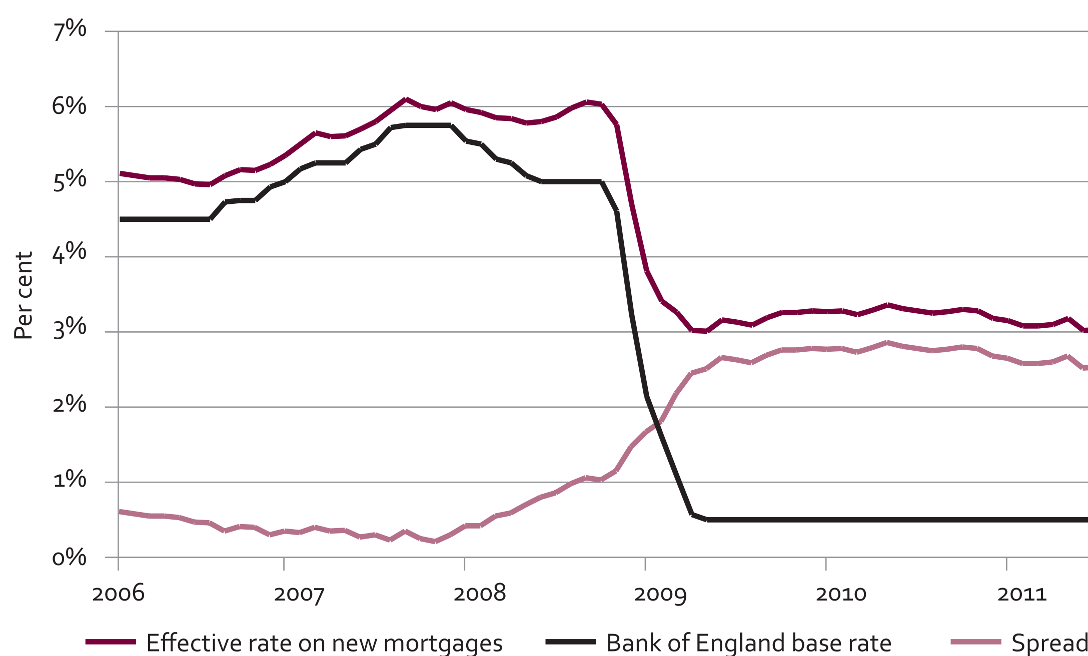
The impact of the recommendations on existing shareholders would depend on the extent to which higher costs could be passed on to employees and customers. An increase in capital requirements would transfer some value to existing debt holders at the expense of existing shareholders, while this measure, and the increased loss-absorbency of bank debt, would reduce the value of the implicit guarantee, part of which accrues to shareholders.

- Borrowers: banks might seek to offset part of the increase in costs by charging higher prices to their borrowers. Where there are ready alternatives to loans and other services provided by UK banks, such as financing from the capital markets or from non-UK banks, the ability of banks to pass higher costs through would be limited. UK banks might react by raising lending spreads, although the effect on the total supply of credit available to customers would be limited as they switch into substitutes.

The increase in costs is likely to be mainly outside the ring-fence. But to the extent that costs do rise within the ring-fence, where borrowers have few alternatives to UK banks, loans may get more expensive. However, the effect on the interest rates charged by banks to borrowers would likely be small both in absolute terms – perhaps 0.1 percentage points[32] – and in relation to overall uncertainty about their future level. Such a rise would be small in relation to the recent volatility in spreads (Figure A3.8), and to markets' uncertainty about the future path of interest rates.[33] Any increase in spreads might also be offset by the Bank of England interest rate, set in pursuit of the inflation target, being slightly lower. Furthermore, the improvements in economic stability that would result from the reforms would be positive for investment in the economy generally.

32 For example, a £6bn increase in the four largest UK banks' costs, if entirely recouped through higher yields on these banks' approximately £4.5tn of funded assets, would require yields to rise by 0.13 percentage points. For the reasons outlined above, costs, and hence spreads, would probably rise by rather less in the ring-fence.
33 The standard deviation of swaption-implied Libor one year ahead was around 80 basis points in mid-August 2011.

Figure A3.8: Bank of England base rate, effective interest rates on new mortgages, and the implied spread between them



Source: Bank of England, Commission calculations.

- Government: the effects on the fiscal position would be complex, but should be strongly positive.

  - Tax receipts: the fall in revenues and increases in welfare payments as a result of the recession that followed the crisis is by far the biggest reason for the deterioration in the fiscal position. As explained below, greater financial stability would work in the opposite direction, raising the average level of GDP. Furthermore, the substitution of equity for debt in banks' liabilities would increase their taxable profits, raising the ratio of tax to GDP.[34] The migration of tax-rich financial services activity to or from the UK as a result of the reforms might also affect the tax/GDP ratio, and the Commission's view is that this effect should be broadly neutral (see Chapter 5, and Annex 8 of the *Interim Report*).

  - Debt interest: to the extent that curtailment of contingent fiscal liabilities reduced market concerns about the Government's creditworthiness, gilt yields would be likely to be lower in the long-term. This would tend to reduce the cost of servicing public debt. For the sake of illustration, the removal of a 10 basis point risk premium in gilt yields would, once priced in

34 For the sake of illustration, if the RWAs of the four largest UK banks are approximately £2tn, an increase in equity capital requirements of 1 percentage point of RWAs would require an extra £20bn in equity. If the bank debt this replaced yielded 5% less than the cost of equity, taxable profits would be increased by £1bn, and the tax on these profits, assuming a 25% rate, would be increased by £250mn per annum.

to all liabilities, save the Exchequer £1bn per year in extra interest on its approximately £1tn of debt.

- Bail-out costs: a key aim of the recommendations is to reduce the implicit government guarantee of bank debt. The risk of a large outlay, the net costs of which have been material in many countries, would be reduced. The effect of such an outlay on the sustainability of the public finances can be priced in to interest rates, raising government borrowing costs in advance as illustrated above.

- Shareholdings: the Government is a major shareholder in two of the largest UK banks. So, to the extent that the Commission's proposals result in costs for bank shareholders, the taxpayer will bear some of these. The implications of this, including the extent to which such costs represent transfer payments rather than costs to the economy, is discussed in Chapter 5.

A3.105 Approaches to quantifying the impact on the economy of these various effects are set out in Chapter 5. Two methods are used. One takes the private costs and then reduces them directly to take account of the proportion of them likely to reflect the removal of the implicit government guarantee and tax effects, neither of which represents a social cost. The other involves more steps, including translating private costs into changes in lending spreads, and then translating the lending spread changes into changes in GDP. This latter step draws on the findings of a number of empirical studies,[35] whose results are summarised in Table A3.4.[36] Note that these GDP impacts are on the level of GDP, not the growth rate.

35 These studies consider long-run steady-state costs and benefits. Other studies, such as IIF (2010), look only at short-run costs and do not assess benefits.
36 The sources of the translation rates used in Chapter 5 are as follows: 0.45% is implied from the Barrell et al. (2009) study (0.10% x (100/22)) and 0.83% is implied from the Miles et al. (2011) study (0.05% x (100/6)).

Table A3.4: Summary of external studies of the GDP impact of higher capital requirements on bank lending spreads

Study	Modelled change	Normalised results for a 1% increase in Basel III CET1/RWAs	
		Impact on cost of credit	Annual lost GDP[38]
Barrell et al. (2009)	1pp increase in Total capital/RWAs	22 basis points	0.10%
BCBS (2010a)	1pp increase in Tangible Common Equity/RWAs	0-16 basis points	0.00%-0.11%
Elliott (2009)	4pp increase in Equity/Assets	0-13 basis points	*Not reported*
Hanson et al. (2011)	10pp increase in Equity/Assets	2-3 basis points	*Not reported*
Miles et al. (2011)	8.4pp increase in Tier 1 capital/RWAs	1-6 basis points	0.01%-0.05%

Notes

1. Where ranges are shown, these reflect the different results arising from a variety of modelling assumptions. In general, the top end of the range reflects the impact assuming that all costs are passed through to customers and the bottom end of the range reflects the impact assuming that some or all costs are absorbed elsewhere (e.g. by lower bank operating expenses or a lower cost of debt/equity). The ranges shown here do not incorporate the additional uncertainty about the effect of a given rise in spreads on GDP.

2. The published study results have been normalised to reflect the impact of a 1% increase in the ratio of Basel III CET1 to RWAs. Assets have been converted to RWAs using a Basel II 53.9% risk weight (BCBS (2010a)). Basel II RWAs have been converted to Basel III RWAs by applying a 23% uplift (BCBS (2010b), Table 6). Additional units of CET1 capital are assumed to be common equity/ retained earnings and treated consistently for all studies.

How the recommendations promote UK financial stability and growth

A3.106 This annex concludes by summarising how the Commission's proposals may be expected to promote UK financial stability both effectively and efficiently compared with alternative approaches. The proposals are a package with two main elements that complement each other – the structural reform of ring-fencing (as detailed in Chapter 3) and a set of measures on loss-absorbency (Chapter 4). The package builds on, reinforces, and goes considerably beyond other reform measures in train such as

37 This figure refers only to the gross costs of higher capitalisation – the effect of higher lending spreads on investment, the capital stock, and hence GDP. The gross benefits – an increase in GDP due to a reduced frequency of financial crisis – are not included here.

those being led by the Basel Committee on Banking Supervision and European Commission internationally, and the development of macro-prudential regulation in the UK.

A3.107 More radical options were considered by the Commission, including full separation between retail and wholesale/investment banking, and much higher equity requirements than those proposed in this report. Such options have not been recommended, however, in part because of their prospective costs and risks to competitiveness, but mainly because the proposed reforms are judged to be far-reaching and effective in combination. There is no practical way to remove altogether the possibility of future crises, but much can be done to make the UK banking system, and hence the UK economy, more resilient to financial disturbance and less likely to give rise to it.

A3.108 Box A3.1 considers three simple scenarios with financial shocks that illustrate how the Commission's recommendations, by building on and going beyond other reforms in train, may be expected to increase the stability of the UK financial system in general, and in particular to secure the stable provision of key banking services to the UK economy.

A3.109 The challenge for policy is to strengthen the resilience of the banking system without obstructing the efficient performance of the core functions of the financial system to which banks are central – facilitating payments, intermediating funds between savers and borrowers, and helping to manage financial risks. The Commission's proposals would strengthen resilience in a number of ways.

A3.110 First, the ring-fence would help insulate UK retail banking from external shocks. A channel of financial system interconnectedness – and hence of contagion – would be made safer. This is especially important for the UK because of the presence of major retail banks that also conduct wholesale and investment banking business globally on a large scale.

A3.111 Second, UK retail banking would be made safer by the requirement on the systemically important UK banks to have equity of at least 10% of RWAs and primary loss-absorbing capacity more generally of 17%-20%. Ring-fencing would ensure that these safeguards cannot be eroded by capital transfers within banking groups. As noted above, better-capitalised banks would provide a more stable supply of credit in a crisis.

A3.112 Third, ring-fencing and loss-absorbency would greatly ease the resolution of banks that still got into trouble, whether domestically or in international operations, without the need for taxpayer capital support.

A3.113 Fourth, insured depositors (and hence the FSCS) in the UK would have the further last-resort protection of seniority in insolvency. Those better able to monitor and discipline risk would bear it.

A3.114 Fifth, the public finances would be much better protected from the direct and indirect costs of bank failures, and as a result less likely to be a source of stress to banks. Recent experience shows that while the direct fiscal costs of bank failure (in terms of losses on public funds invested) can be very large, the indirect costs (through macroeconomic contraction) can be vastly greater.

A3.115 Sixth, the implicit government guarantee, from which larger banks benefit especially, would be curtailed.[38] A consequence of shifting downside risk from the taxpayer to bank shareholders and creditors (other than the FSCS, on behalf of insured depositors) would be better incentives towards risk-taking in future. Some bank capital and funding costs are likely to increase as a result, but that is an inevitable part of the process of risk shifting to where it should be. It also creates incentives to reduce risk and manage it better.

A3.116 The Commission's reform package – and the ring-fence in particular – has been designed to promote these benefits of resilience without obstructing the efficient flow of the financial services that banks provide. (Indeed measures that curtail the implicit government guarantee should advance efficiency.) Important benefits of asset and liability diversification should be retained by the relatively broad and flexible ring-fence design – as compared with, for example, full separation or narrower or more rigid ring-fencing. The ring-fence nevertheless needs to be strong, or else its benefits would be at risk of being circumvented.

A3.117 The reform package has also been designed with UK competitiveness in mind. In particular, by safeguarding UK retail banking and greatly enhancing resolvability, the ring-fence improves UK financial stability while allowing wholesale/investment banking operations of UK banks to remain competitive by operating under capital and liquidity standards consistent with their global peers. While there is a strong case for further increases in bank equity requirements internationally, the case in relation to UK banks must be balanced against the costs of transition to higher equity, and the potential beyond some point for regulatory arbitrage that UK super-equivalence could engender. By averting the need for much higher capital standards across-the-board, the ring-fence helps keep down the costs to the international wholesale and investment banking businesses of UK banks, relative to alternative regulatory approaches. When considering quantitative analyses of costs, with which much of this annex has been taken up, this point should be kept in mind.

A3.118 Quantification of the benefits of reform was discussed in Chapter 5 and has not been elaborated upon in this annex. In conclusion it is however important to emphasise how large are the prospective benefits of reform in relation to the likely costs to the economy.

38 It may be noted that, notwithstanding a background of increasing bank equity requirements and moves to make bank debt absorb losses more easily, some market participants have already attached weight to the implications of the policy package outlined in the *Interim Report* – with its combination of loss-absorbency and structural reform by way of ring-fencing – as a means by which the guarantee would be constrained.

A3.119 First and to repeat, the effect of the proposals in curtailing the implicit government guarantee, which is estimated considerably to exceed £10bn currently, entails costs to banks but is a benefit to the economy as a whole quite apart from the reduction in the frequency and cost of financial crises brought about by the reforms.

A3.120 Since financial crises arise largely unpredictably, it is inherently impossible to quantify their frequency and economic cost, and how those might both be reduced by different packages of reform measures. What can be said with certainty is that the economic cost of crises is huge and lasting. Part of the cost is heightened risk of further crises, possibly involving the public finances in some cases. A financial crisis can easily have costs of the order of 60% of a year's national output. Volatility itself has costs on top of that.

A3.121 On this basis it would be worth paying a large insurance premium to reduce the likelihood, scale, and damaging impact of financial crises. On an annualised basis the costs of such crises could well be of the order of 3% of GDP on average. Therefore, even leaving aside the efficiency benefits of removing the incentive to take excessive risks due to the implicit government guarantee and the positive effect of improved financial stability on investment incentives generally, reductions in the probability and costs of financial crises do not have to be large for the reform package to yield net benefits. The Commission's judgement is that, as a result of its proposals, on top of the other reform efforts in train, crises will become rarer than in the absence of reform, and, when they occur, substantially less costly for the UK economy, by a margin comfortably in excess of costs that the package might generate. It is estimated that those costs to the economy are probably of the order of 0.1%-0.2% of GDP on an annualised basis. The net effect is therefore likely to be firmly positive for future GDP, and still more so for economic welfare more generally.

Box A3.1: Scenarios illustrating how the Commission's recommendations would increase financial stability

Box 2.1 outlined how the Commission's recommendations would have addressed some recent bank failures. This box considers, for illustrative purposes only, how the recommendations would address the probability and impact of bank failures under three potential future scenarios.

Scenario 1: A global shock to asset values

This might be similar to the global impact of losses on US sub-prime mortgages, transmitted through banks' holdings of debt securities in their trading books. There would be no direct impact on UK ring-fenced banks as they would not be exposed to these assets. Indirect effects would be limited because counterparty relationships with non-ring-fenced banks would be tightly circumscribed. UK non-ring-fenced banks might suffer losses directly or indirectly through counterparty relationships with affected banks. Any losses incurred could be more readily absorbed, in the first instance, by larger equity cushions, and in the second instance, by greater genuinely loss-absorbent debt. Ring-fenced banks could provide capital support to non-ring-fenced banks elsewhere in the group, but only to the extent that this did not jeopardise their own ability to meet minimum regulatory capital requirements.

Scenario 2: A domestic shock to asset values

Consider a drop in UK house prices, notwithstanding the possibility that macro-prudential regulation will make this less likely. This would affect most ring-fenced banks. Its impact should be constrained by large ring-fenced banks having equity of at least 10% of RWAs. Ring-fenced banks could also benefit from capital support from the rest of the group if surpluses were available. If the equity proved insufficient to absorb losses and the bank was put into resolution, a further cushion of loss-absorbent debt would significantly reduce the likelihood of the government needing to provide extraordinary capital support. Both of these loss-absorbency cushions would help to maintain credit relationships in the face of losses on existing loans.

Scenario 3: Problems in wholesale funding markets

Such problems might arise due to concerns about: (i) the creditworthiness of banks as borrowers of wholesale funds; or, (ii) liquidity constraints on the providers of such funds. UK ring-fenced banks would be less susceptible than universal banks to (i), to the extent that their assets are less risky and more transparent. Both ring-fenced and non-ring-fenced banks would be affected by (ii), but restrictions on wholesale funding for ring-fenced banks would constrain its potential adverse impact on their overall funding position. International liquidity reforms would make all banks more robust in the face of such a scenario, but even if these proved insufficient, the provision of emergency liquidity assistance by the Bank of England to banks, and related tail risk to the public finances, would be made more straightforward by the enhancement of solvency by requirements for more capital and loss-absorbent debt.

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Annex 4: Response to critiques of the competition analysis in the *Interim Report*

Introduction

A4.1 The *Interim Report* provided an analysis of competition in retail banking markets in the UK. Some respondents to the *Interim Report* challenged aspects of this analysis. The two most detailed critiques were received from Lloyds Banking Group (LBG) and Barclays.[1] This annex discusses and responds to the main elements of those critiques. LBG and Barclays raise a number of important points, and in combination with other analysis conducted by the Commission and received from other respondents to the *Interim Report*, this has led to some developments of the Commission's assessment and recommendations as set out in this report.

A4.2 This annex discusses each of the main critiques of the competition analysis in turn. Each section begins with a summary of each critique and the Commission's response. This is followed by a more detailed analysis. Most of the points raised by Barclays and LBG concern the personal current account (PCA) market and so this annex focuses mainly on this market.

1 LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition.* Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf. Barclays, 2011, *Interim Report: Consultation on Reform Options*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Barclays.pdf.

Competition in retail banking

Concentration and market share

Summary of LBG claim: the levels of concentration in retail banking markets are well below any measure of high concentration and LBG's market share is not uniquely high.[2]

Summary of Barclays claim: the assertion that retail banking markets are highly concentrated is based upon historic (stock) numbers rather than current market conditions.[3]

Summary of response: some other markets are indeed just as concentrated as the PCA and SME banking markets. However, the PCA and SME banking markets also have high barriers to entry and problems with consumer choice.

A4.3 The level of the Herfindahl-Hirschman Index (HHI)[4] in the PCA market after the divestiture from LBG will be approximately 1570 if the divestiture does not change, it is sold to a new entrant and no customers revert from it back to LBG.[5] This is between the level of 1000, above which a market may be considered 'concentrated', and the level of 2000 above which a market may be considered 'highly concentrated' by the Office of Fair Trading (OFT) and Competition Commission (CC) for the purposes of merger investigations.[6]

A4.4 LBG provides examples of other markets that are more concentrated than the PCA market but where the competition authorities did not find a problem with competition.[7] LBG also claims that their 25% market share in PCAs (post-divestiture)[8] would not be uniquely high, making the point that in some other industries without competition problems the largest player has a greater market share.[9] That is true, but it may be noted in passing that for the purposes of the Fair Trading Act 1973 – the precursor to the Enterprise Act 2002 as far as mergers and market investigation

2 Pages 13-15, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition.* Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.
3 Page 47, Barclays, 2011, *Interim Report: Consultation on Reform Options.* Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Barclays.pdf.
4 The Herfindahl-Hirschman Index (HHI) is a measure of market concentration that takes account of the differences in the sizes of market participants, as well as their number. The HHI is calculated by adding together the squared values of the percentage market shares of all firms in the market.
5 Page 120, *Interim Report.*
6 OFT and CC, 2010, *Merger Assessment Guidelines.* Available at: http://www.competition-commission.org.uk/our_role/ms_and_fm/pdf/100916_merger_assessment_guidelines.pdf.
7 Pages 14-15, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.
8 As elsewhere, this 25% market share for LBG assumes that the customers divested by LBG do not switch back to it. It is more likely that some customers would switch back and hence LBG's market share will be greater than 25%.
9 Page 5, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition.* Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.

references are concerned – a 'monopoly situation' was said to exist if a firm supplied more than a quarter of services supplied.

A4.5 In line with the standard analysis of competition authorities, the *Interim Report* did not only use concentration to measure competition. Competition authorities may have considered there to be few competition problems in more concentrated markets because the barriers to entry were low, customers could compare and switch suppliers easily and/or there was a great deal of buyer power. Mergers may have been allowed in other markets for similar reasons or because they would have led to significant efficiencies.

A4.6 Turning to Barclays' claim, the concentration of retail banking markets is measured by calculating the HHI using share of customers from 2000 to 2010, set out in Figure 2.4 of the *Interim Report*. This figure did not include data for SME banking in 2010. This has been included in Figure 7.1 of this report, and hence now includes the most recent data available. Market shares are important for understanding the level of competition as they affect the incentives of banks: those with a larger stock of customers will have a reduced incentive to offer customers good products at low prices, compared to smaller producers who may be in a position to expand. The HHI is a standard tool for analysing these dynamics, and it has been used similarly by competition authorities in their inquiries.[10] In any case, although challenger banks have succeeded in winning share from incumbents, share of new business is generally strongly correlated with market share so the use of share of new business rather than market share would have little effect.[11]

A4.7 In Barclays' view, concentration in the UK relative to other European Union (EU) member states remains moderate.[12] However, Barclays rely on data from 2004, and the concentration of the PCA market in the UK has increased since then. The CR5 for the PCA market in the UK had risen to 87% in 2010.[13] Only two countries, Holland and Belgium (both of which are small), had higher levels of CR5 in 2004.[14] Even if other markets were more concentrated than the UK, that would not provide a rationale for not promoting competition in the UK banking market.

10 CC, 2007, *Personal Current Account Banking Services in Northern Ireland*. Available at: http://www.competition-commission.org.uk/rep_pub/reports/2007/fulltext/527.pdf. OFT, 2008, *Personal Current Accounts in the UK*. Available at: http://www.oft.gov.uk/shared_oft/reports/financial_products/OFT1005.pdf. OFT, 2008, *Anticipated Acquisition by Lloyds TSB plc. of HBOS plc*. Available at: http://www.oft.gov.uk/shared_oft/press_release_attachments/LLloydstsb.pdf.

11 The correlation of market share and share of new business for PCAs from 2000 to 2010 is 0.94. Source: GfK NOP Financial Research Survey (FRS), 5 months ending September 2000-2010, main current accounts (sample size 21396-24789), new main current accounts (1061-1487). Calculation includes the following PCA brands: Alliance & Leicester, Abbey National, Barclays, Bank of Scotland, Clydesdale Bank, Co-operative Bank, Halifax, HSBC, Lloyds TSB, NatWest, Royal Bank of Scotland and Yorkshire Bank.

12 Page 52, Barclays, 2011, *Interim Report: Consultation on Reform Options*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Barclays.pdf.

13 The CR5 is the sum of the five largest market shares.

14 The UK CR5 in 2010 was 87% for the PCA market, see Paragraph 2.41 of the *Interim Report*. For the data for other EU countries, see Figure 1, Page 20, EC, 2007, *DG Competition Report on Retail Banking Sector Inquiry*. Available at http://www.europarl.europa.eu/registre/docs_autres_institutions/commission_europeenne/sec/2007/0106/COM_SEC(2007)0106_EN.pdf.

The relationship between concentration, the competitive process and the financial crisis

Summary of LBG claim: new entrants such as Virgin Money, Tesco Bank and Metro Bank show that barriers to entry are low.[15]

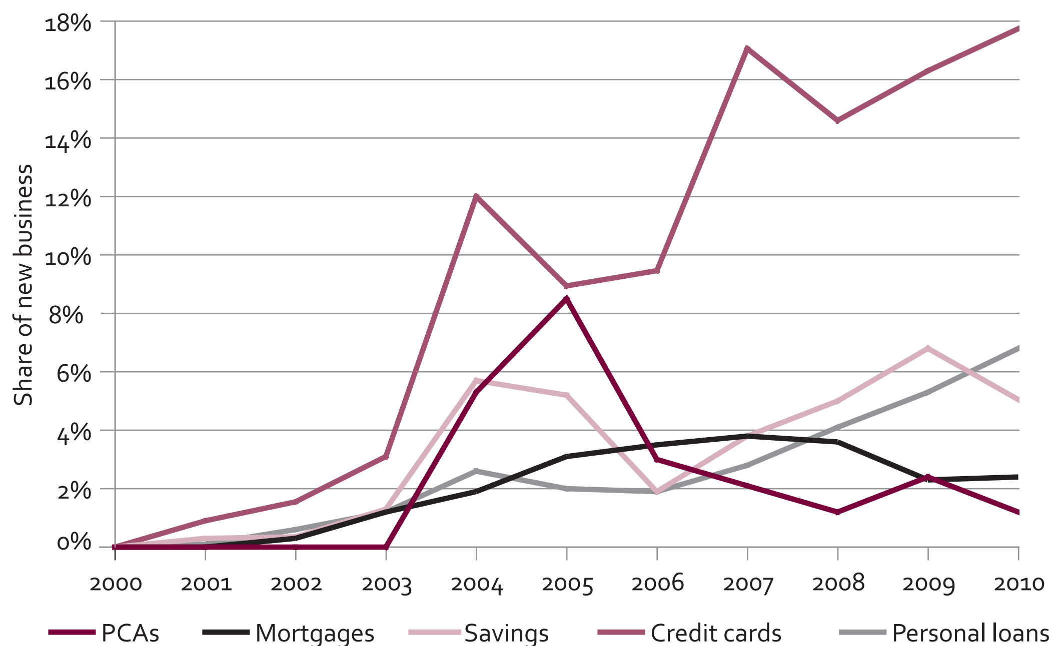
Summary of Barclays claim: evidence of the dynamic state of the UK banking sector is widespread and barriers to entry are not insurmountable.[16]

Summary of response: the OFT found significant barriers to entry in the retail banking sector due to low levels of switching, high levels of brand loyalty and consumers' preference for providers with a branch network. Very few firms entered the PCA and SME banking markets over the last decade, which indicates that barriers to entry are high.

A4.8 Figures A4.1 and A4.2 below show the extent to which new entrants have been able to gain market share in the last decade. Figure A4.1 shows that new entrants since 2000 have never exceeded 8.5% of new PCA business in any given year and for most of the period took only around 2% of new business. In 2004 and 2005, the Post Office had entered and was reasonably successful in gaining new market share, but unlike any other new entrant it already had an extensive network of branches and a large number of benefit claimants and pensioners who were beginning to receive payments electronically – including into accounts offered by the Post Office.[17]

15 Page 15, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.
16 Page 52, Barclays, 2011, *Interim Report: Consultation on Reform Options.* Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Barclays.pdf.
17 Bachelor, L., 2003, Electronic Benefits Have Loose Wiring, *Guardian*, [online] 16 February 2003. Available at: http://www.guardian.co.uk/money/2003/feb/16/pensions.observercashsection.

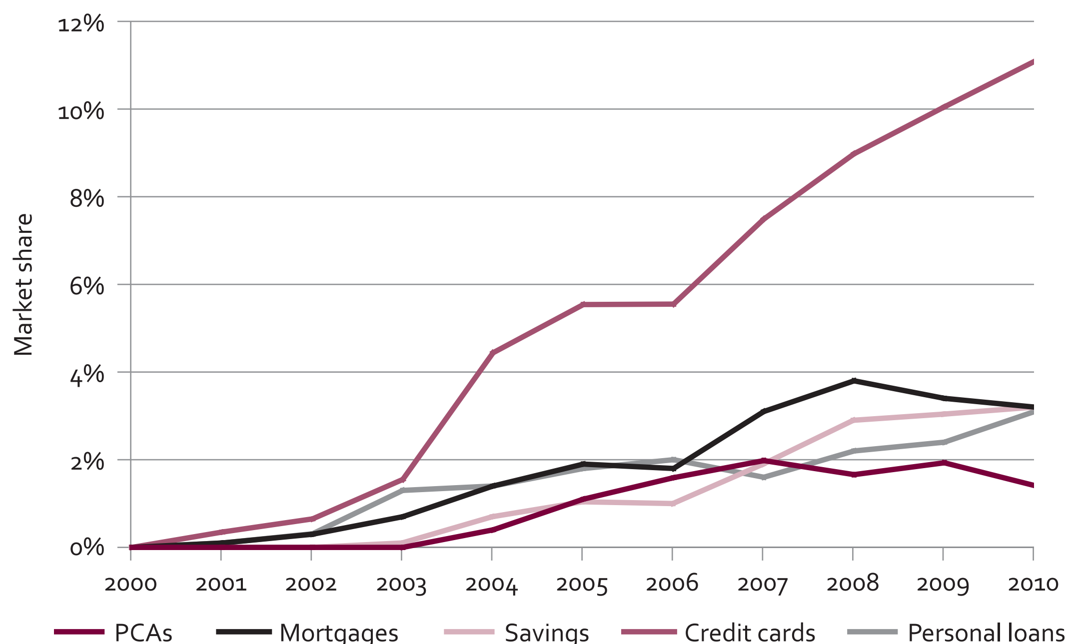
Figure A4.1: Share of new business each year for new entrants



Source: Commission analysis of data provided by GfK FRS.[i] (Roman numerals refer to endnotes at the end of this annex.)

A4.9 Figure A4.2 shows the total market share of all firms who have entered personal banking markets since 2000. Firms have clearly been successful in entering the credit card market, but in other markets there has been very limited growth by new entrants. The PCA market has seen the least success for new entrants out of the five personal banking markets considered here.

Figure A4.2: Market share of firms that have entered since 2000



Source: Commission analysis of data provided by GfK FRS.[ii]

A4.10 Table A4.1 below shows the number of new entrants since 2000 in personal banking markets. From 2001 to 2010 five firms entered the PCA market. There have been more new entrants in other markets.

Table A4.1: Number of new entrants since 2000

	PCAs	Mortgages	Savings accounts	Personal loans	Credit cards
Total number of new entrants	5	16	19	23	34

Source: Commission analysis of data provided by GfK FRS.[iii]

A4.11 The total share of all firms that have entered the business current account (BCA) market since 2005 was less than 1% in 2010.[18] In fact, no firm has entered the BCA market and taken significant market share in the last 13 years. HBOS did begin to provide BCAs in England, but it already had a presence in Scotland through the Bank of Scotland.

18 Here, as elsewhere, an SME's main banking relationship is used a proxy for who provides that SME with a BCA. Source: Commission analysis of data from the Charterhouse Research UK Business Banking Survey 2010, based on more than 16,000 interviews with businesses conducted between January and December 2010 covering businesses with turnover up to £1bn.

A4.12 In sum, there has been substantial entry into the credit card market indicating that the barriers to entry appear to be low, but new entrants have been much less successful in other markets and they have had very little impact in the PCA and SME banking markets, indicating that barriers to entry in these markets are high. Indeed, of the three new entrants LBG cites, only Metro has actually entered the PCA market – the other two have expressed an intention to do so, but have not yet done so.[19]

A4.13 As well as a dearth of new entrants, there is direct evidence of the barriers to entry that new entrants face. The OFT recently found that new entrants face significant challenges in attracting personal and SME customers through a combination of low levels of switching, high levels of brand loyalty and consumers' preference for providers with a branch network.[20] Small banks might also be required to hold relatively more capital than larger banks for a number of reasons.

A4.14 LBG claims that the increase in concentration that has occurred recently is due to the normal competitive process whereby uncompetitive firms exit the market.[21] But a number of the changes to the market recently were clearly influenced by financial stability considerations, for example, the merger of Lloyds TSB and HBOS and the transfer of Bradford & Bingley's retail deposit book to Abbey National under statutory powers. The rescue of banks by the Government prevented the competitive process that occurs in most markets whereby firms fail and the surviving firms compete for the business of the exiting firm. LBG also claim that concentration will naturally fall as the recovery takes hold.[22] This may happen as the remaining challengers grow, but it is likely to happen very slowly, as it did between 2000 and 2008.[23]

19 Page 5, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.

20 OFT, 2010, *Review of Barriers to Entry, Expansion and Exit in Retail Banking*. Available at: http://www.oft.gov.uk/shared_oft/personal-current-accounts/oft1282.

21 Page 5, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.

22 Page 15, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.

23 Figure 7.11 shows the slow growth of challengers from 2000 to 2008.

The relationship between concentration and prices

Summary of LBG claim: the level of concentration is not a cause of higher prices in the PCA market. The *Interim Report* relies on a very limited selection of academic studies to show that concentrated banking markets are less competitive and have higher prices. Finally, the papers do not consider overdraft charges and only establish correlation not causation.

Summary of Barclays claim: the concentration levels and HHIs set out are unlikely to have any validity as evidence of market power.[24]

Summary of response: a thorough review of the available academic research on the relationship between concentration and prices in banking has been conducted. The results from a large body of empirical studies indicate that, holding all else equal, greater concentration leads to worse outcomes for consumers.

A4.15 It can be expected that, holding all else equal, a more concentrated market will have higher prices when barriers to entry are high, and in the absence of efficiencies such as economies of scale.[25] Hence the conclusion in the *Interim Report* that greater concentration leads to worse outcomes for consumers is entirely in line with standard economic analysis. However, concentration is not the only factor that determines the level of competition.

A4.16 LBG considers that Annex 4 of the *Interim Report* does not support the conclusion that more concentrated banking markets have higher prices for three reasons:[26]

- the papers are out of date;
- most papers do not use data from the UK; and
- many of the papers are of low quality as they are working papers or from low quality journals.

A4.17 A wide range of relevant published papers regarding competition and concentration in banking was reviewed and a selection was summarised in Annex 4 of the *Interim Report*. Academic papers take some time to be published and the most up to date data when they are written is usually a couple of years old. Hence, the most recently published academic papers will always use data that is at least a few years old. It is true that there are few papers using UK data but the fundamental relationship

24 Page 47, Barclays, 2011, *Interim Report: Consultation on Reform Options.* Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Barclays.pdf.
25 For example, see Page 234, Motta, M., 2004, *Competition Policy: Theory and Practice*, New York: Cambridge University Press.
26 Pages 3-4, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition Annex*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response-Annex.pdf.

between concentration and competition, holding all else equal, is likely to be the same in different countries – though of course the scale of the effect may vary.

A4.18 LBG claims that the two papers relating to the UK are of limited relevance since they only look at interest rates rather than other charges such as unarranged overdraft charges.[27] This issue is considered in Chapter 7 and Paragraphs A4.27 to A4.30 below. LBG has also provided new analysis examining the correlation between concentration and PCA prices based on a study of nine countries in August 2010.[28] This analysis has a number of limitations:

- it only uses the total cost of a PCA to consumers at one point in time. This total cost varies greatly in the UK over time depending on the base rate;
- it excludes unarranged overdraft fees;
- it uses only nine data points whereas two of the papers on cross-country comparisons in Annex 4 of the *Interim Report* each use thousands;[29]
- the concentration measure it uses is concentration of retail deposits, which is not the same as concentration in the PCA market; and
- it only considers two factors, price and concentration. There are a number of factors other than concentration that affect the price of a PCA, including barriers to entry, regulation, history of the market and interaction with other products. For these reasons, the academic literature on cross-country comparisons often takes other factors into account.

A4.19 Collectively, these limitations caution against putting too much weight on this one analysis, as compared to the much wider set of studies available. Further, cross-country analyses of the kind conducted by LBG face particular analytical challenges and it may therefore be more sensible to place greater weight on studies looking at one particular country over time. Summaries of such studies, including those discussed in Annex 4 of the *Interim Report*, typically demonstrate that greater

27 Unarranged overdraft charges are charges paid by PCA customers for using, or attempting to use, an unarranged overdraft. They are also sometimes called unauthorised or unplanned overdraft charges.

28 Page 16, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.

29 Bikker, J. and Haaf, K., 2002, Competition, concentration and their relationship: An empirical analysis of the banking industry, *Journal of Banking & Finance*, 26 (11), pp.2191-2214 uses 29,000 observations while Bikker, J. and Spierdijk, L., 2008, How banking competition changed over time, *DNB Working Papers* (available at: http://www.dnb.nl/binaries/Working%20Paper%20167-2008_tcm46-170649.pdf) uses 112,343 observations.

concentration does lead to worse outcomes for consumers. This is in line with the reviews of this literature in authoritative publications.[30]

Packaged PCAs

Summary of LBG claim: packaged accounts are a significant and growing part of the PCA market and are not included in the Commission's analysis. Hence, the analysis is incomplete. There is no evidence that challengers are cheaper for packaged accounts.

Summary of response: packaged PCAs are a relatively small part of the market, and examination of them does not appear to affect the PCA analysis much, if at all.

A4.20 It is correct that the analysis in the *Interim Report* did not include packaged PCAs. That is because:

- they are only a small part of the PCA market (around 17% according to LBG);[31]
- they are hard to compare with each other; and
- there is no obvious reason why competition for them would vary much from standard PCAs due to different behaviour of firms or consumers.[32]

A4.21 LBG presents prices for packaged PCAs from June 2011 in addition to a list of services that each account offers. It is very difficult to compare the packaged accounts of the larger banks with those of the smaller ones since each element of the package can have many different components and because it is hard to know what the value to a consumer is of something that they may not use. Hence, such comparisons may be of limited value.

30 For example, Degryse and Ongena find that: "Market definition is key, but studies continue to find that average market concentration, compared to a situation with a zero HHI, results in significant spreads in both deposit and loan markets of up to 50 basis points. Decreases in bank market concentration could lower spreads." See Pages 540-541, Degryse, H. and Ongena, S., 2008, Competition and Regulation in the Banking Sector: A Review of the Empirical Evidence on the Sources of Bank Rents, in Thakor, A. V. and Boot, A., eds., *Handbook of Financial Intermediation and Banking*, Amsterdam: Elsevier. Similarly, F.M. Scherer in summarising the literature on concentration in banking concludes that: "This compressed review of the literature on structure – performance relationships in banking reveals that structure clearly does matter. In particular, higher levels of local market bank concentration lead to lower interest rates for depositors and, with some complex exceptions, higher interest rates for borrowers." See Page 16, Scherer, F. M., 2010, A perplexed economist confronts 'Too big to fail', *HKS Faculty Research Working Paper Series, RWP10-007*, John F. Kennedy School of Government, Harvard University.
31 Page 6, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.
32 For instance, some of the transparency problems around standard PCAs may also be present for packaged ones. Consumer groups and the Financial Services Authority (FSA) have raised concerns about whether consumers are being sold packaged PCAs that are appropriate for them. See Which?, 2010, *Regulator Criticises Packaged Bank Accounts*, [online] 11 March (available at http://www.which.co.uk/news/2010/03/regulator-criticises-packaged-bank-accounts-205900/) and Moore, E., 2011, FSA Examine Packaged Accounts, *Financial Times*, [online] 8 April (available at: http://www.ft.com/cms/s/2/98567f9c-6201-11e0-8ee4-00144feab49a.html).

Challenger pricing for standard PCAs

Summary of LBG claim: PCA pricing analysis shows that the four biggest banks are cheaper than challengers.

Summary of response: the evidence indicates that challenger banks compete harder for PCAs. However, the competition problems associated with this product – including high and opaque charging structures for unarranged overdrafts – are not limited to the incumbent banks.

A4.22 LBG makes a number of comments regarding how pricing analysis should be undertaken:[33]

- introductory rates should not be included;
- prices across the four biggest banks should not be averaged as the banks do not follow the same strategies;
- overdraft fees and charges should be included when considering PCA prices; and
- the OFT's intervention on overdraft fees should be taken into account.

A4.23 The lower introductory rates offered by challengers are relevant because customers benefit from these rates, albeit for a limited time. Anyway, as LBG show,[34] the finding in the *Interim Report* that the best deposit interest rate offered by challengers is, on average, better than the four biggest banks is not changed if introductory rates are excluded.

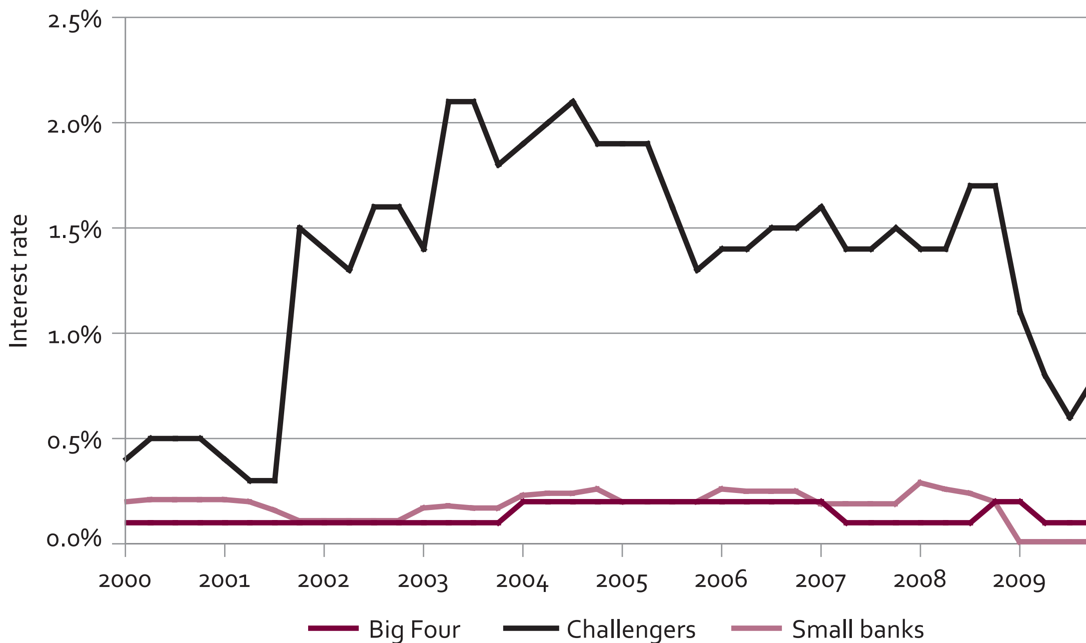
A4.24 LBG offered a standard PCA with an interest rate that rivalled the challengers from 2003 onwards. However, Figure A4.3 shows that the average interest rate on deposits offered by the four biggest banks has been very low for the past decade both in absolute terms and relative to average rates offered by challengers.[35] A similar picture was given by the OFT in its market study in 2008,[36] and authorised overdraft rates offered by challengers were also lower in the last decade than those offered by the four biggest banks.[37] The argument outlined in the *Interim Report* regarding the behaviour of challengers and the four biggest banks is not that all banks of one group

33 Page 6, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.
34 Figure 4, Page 19, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.
35 The average interest rate on deposits for smaller banks not defined as challengers was also much lower than that of the challenger banks.
36 Chart 3.11, Page 39, OFT, 2008, *Personal Current Accounts in the UK*. Available at: http://www.oft.gov.uk/shared_oft/reports/financial_products/OFT1005.pdf.
37 For the average authorised overdraft interest rates see Figure 7.9.

will act in the same way in relation to all their customers at all times: clearly there will be some variation across banks and time. Rather, it is a way of explaining banks' general strategies over time.

A4.25 LBG states that the four biggest banks offered higher interest rates on deposits during 2009 and 2010.[38] It is difficult, however, to draw firm conclusions from the prices set during the financial crisis, and the eight previous years in which challengers offered better rates are likely to provide a better insight into the competitive dynamics at play.

Figure A4.3: Estimated average interest rates on deposits for standard PCAs



Source: Commission analysis of data provided by banks, GfK FRS and Defaqto.[iv]

A4.26 LBG also submitted evidence that while challengers offered better rates on the visible charging structure of deposit and authorised overdraft interest, they imposed higher charges for unarranged borrowing. Further analysis has shown that this was not significantly the case until 2005, but was true for three years after. It hardly follows, however, that all was well with competition. For one thing, the large incumbents did not advertise their lower unarranged overdraft charges to attract new business. On the contrary, another respondent submitted evidence that unarranged overdraft charges were identified as an area where banks could generate greater profits specifically because they are less visible to consumers.[39]

38 Figure 4, Page 19, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.

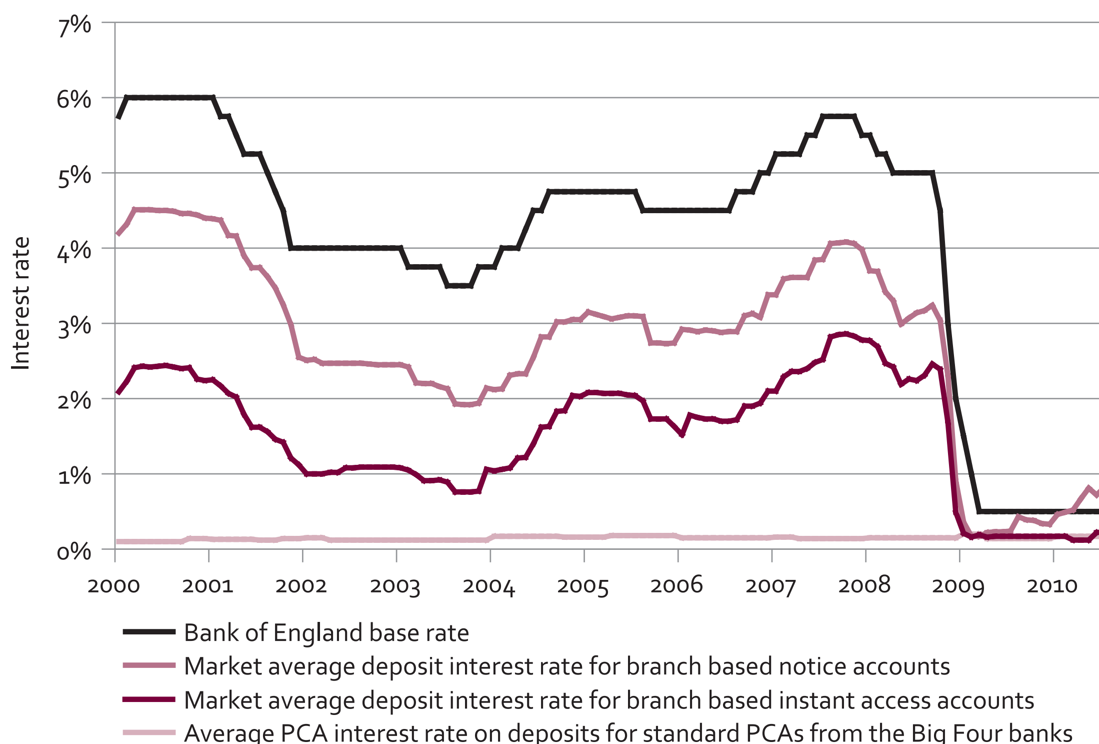
39 Which?, 2011, *Which? Response to the ICB Interim Report*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Which.pdf.

A4.27 Banks earn a significant proportion of their PCA revenue from net credit interest (the difference between the funding benefit earned on the funds held, less any interest paid out to the depositor). The OFT found that 50% of PCA revenue from banks in 2006 was net credit interest income[40] and more up to date confidential information provided by the banks to the Commission shows this source of revenue is still very significant. As the base rate rises, it would be expected that the funding benefit earned on the funds held would also increase, as for example, the interest rates on loans and mortgages increase. Hence, as the base rate increases/decreases the revenue from net credit interest increases/decreases if the interest paid to depositors does not change.

A4.28 In a competitive market, it would be expected that as this revenue increased (base rate rises) the price of PCAs would fall, either through interest rates on deposits rising, or other fees falling. The average interest rate on deposits for most deposit products changed roughly in line with the base rate over the last decade, suggesting there may be some level of competition for these products (see Figure A4.4). Under the free-if-in-credit pricing model for PCAs, the biggest four banks have typically not passed through these changes in the same way. Rather, total costs for PCAs increased for consumers during the period from 2003 to 2008 when the base rate was rising (see Figures A4.11 to A4.14). This increase in revenues may indicate how the features of the PCA market impede effective competition. This will not result in bad deals for all consumers at all times, although banks have a strong incentive to make up revenue shortfalls in other ways when the base rate is low, while not doing the opposite when the base rate is high.

40 Page 18, OFT, 2008, *Personal Current Accounts in the UK*. Available at: http://www.oft.gov.uk/shared_oft/reports/financial_products/OFT1005.pdf.

Figure A4.4: Average interest rates for deposit products



Source: Bank of England and Commission analysis of data provided by banks, GfK FRS and Defaqto.[v]

A4.29 The total cost of using a PCA (including interest foregone) varies depending on the usage of the account. For example, the amount of time a customer is overdrawn or how often a customer uses an unarranged overdraft affects the total cost of using the PCA. Therefore, it is necessary to define different types of consumer usage in order to compare the total cost of using PCAs across providers. Banks provided the Commission with their own definitions of customer types, and related profile information. The approaches taken by different banks were broadly consistent with one another. The profiles provided by one bank have been used as they were based on the most robust evidence base, but some small adjustments have been made to reflect the types of consumer proposed by other banks. The types of customer, referred to as types A to D, are described below.[41]

A4.30 The first three types rarely use unarranged borrowing. Type A customers represent around a quarter of active accounts.[42] They have fairly high deposits and rarely use arranged overdrafts. Type B customers account for around half of all active accounts. They use arranged overdrafts around a quarter of the time and have fairly low deposits and arranged overdrafts. Type C customers account for around a fifth of consumers and have fairly high level of deposits and very rarely use arranged overdrafts. Type D customers use unarranged borrowing fairly frequently and have

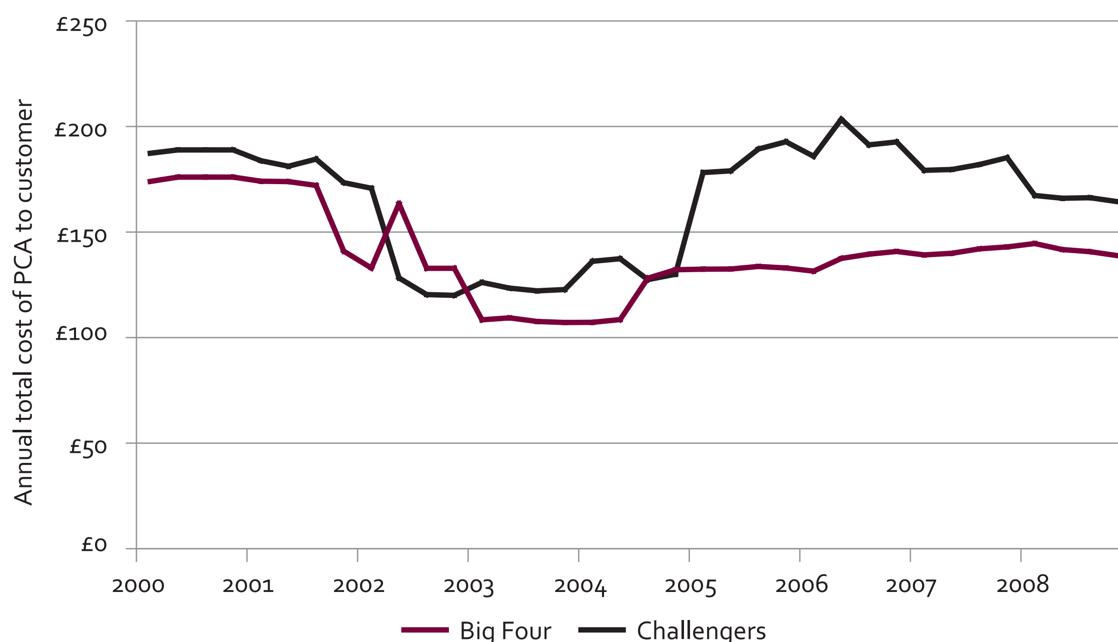
41 Greater detail cannot be provided here for reasons of commercial confidentiality.

42 The proportions referred to here are from estimates provided by one bank, based on its own customer base. This customer base is large and diverse enough to give a reasonable guide to the wider market.

low deposits. They account for around 5% of active PCA accounts. Internet-only brands were not included in this analysis and only standard PCAs were used to ensure that similar products were compared.

A4.31 Figure A4.5 below confirms LBG's finding that customers who use unarranged borrowing fairly frequently would have paid more on average using challengers rather than the four biggest banks over the latter half of the last decade.[43] From 2000 to 2009, a customer with this usage profile would have paid on average £20 more per year for a PCA from an average challenger as compared to the four biggest banks. However, this group represents only around 5% of all active PCA users and there is great variation in the total cost, possibly indicating that there is little competition on unarranged borrowing fees (see Figure A4.14).

Figure A4.5: Average cost of a standard PCA to someone who uses an arranged and unarranged overdraft more frequently than average (Type D customer)[44]

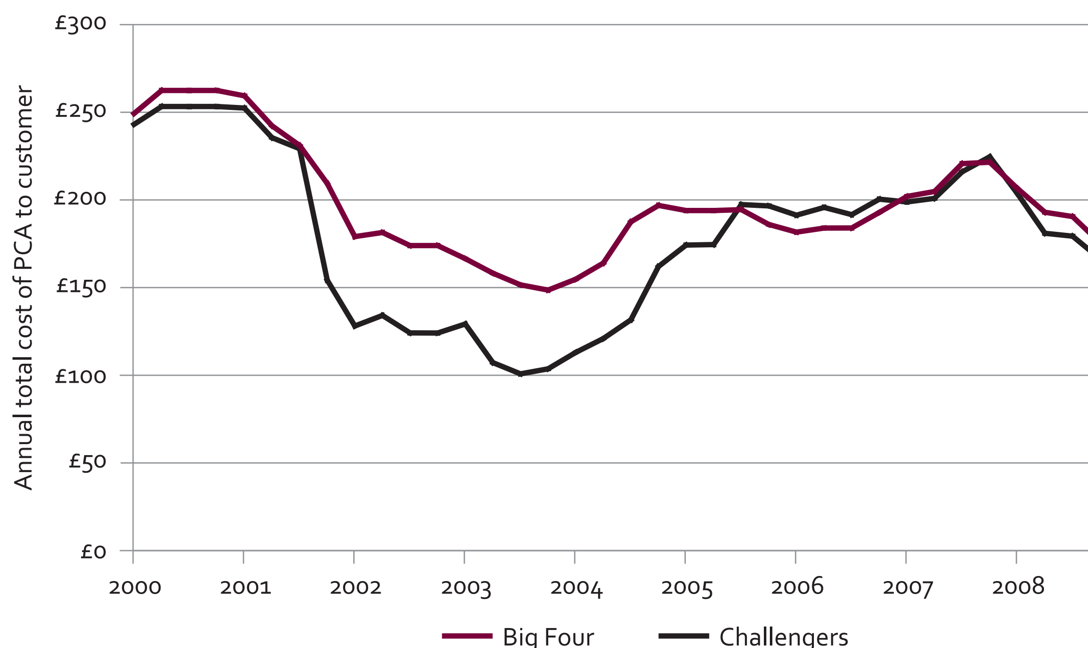


Source: Commission analysis of data provided by banks, GfK FRS and Defaqto.[vi]

A4.32 The large majority of customers rarely use unarranged borrowing.[45] Figures A4.6, A4.7 and A4.8 below provide the total average cost of using a standard PCA for these customers, using three different profiles. For Type C customers, who make up around 20% of active PCA users, the average annual total cost of a PCA from a challenger bank from 2000 to 2009 was around £20 less than from the four biggest banks.

43 Figure 5, Page 20, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.
44 Figures A4.5, A4.6, A4.7 and A4.8 only provide results up to 2008 due to later data being confidential.
45 The OFT found that in 2006, 26% of accounts had an unarranged overdraft. Page 71, OFT, 2008, *Personal Current Accounts in the UK*. Available at: http://www.oft.gov.uk/shared_oft/reports/financial_products/OFT1005.pdf. More recent data provided by banks to the Commission supports this finding.

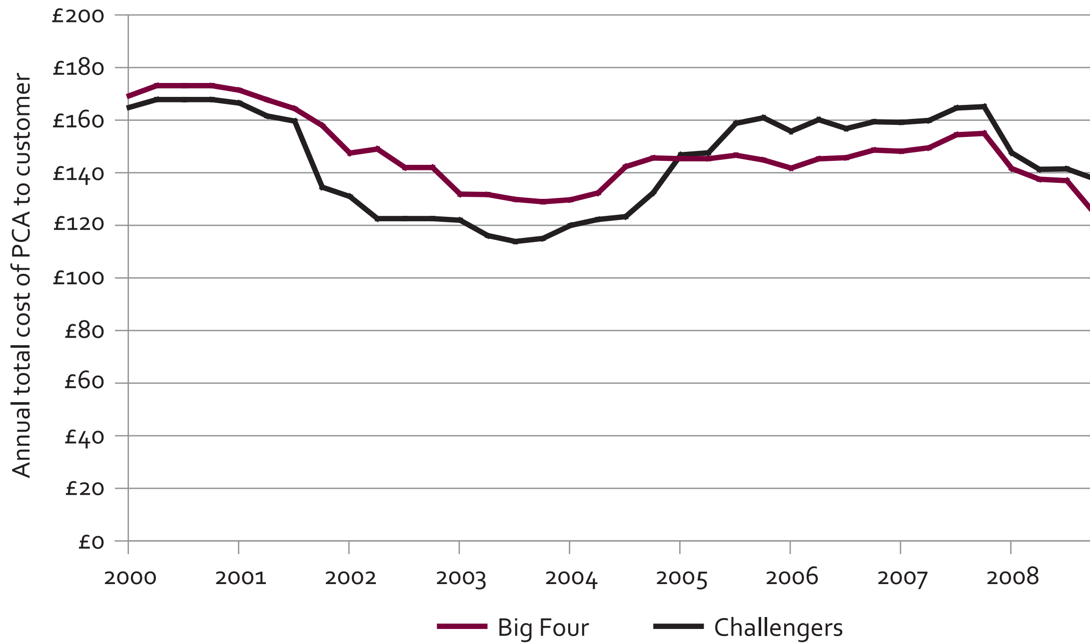
Figure A4.6: Average cost of a standard PCA to Type C customer



Source: Commission analysis of data provided by banks, GfK FRS and Defaqto.[vii]

A4.33 For Type B customers, who make up around 50% of active PCA users, the average total cost of a PCA from 2000 to 2009 was slightly higher for the four biggest banks than for challengers. The PCA provider with the lowest average total cost for consumers was a challenger 72% of the time, indicating that most of the time it was one of the challengers that offered their customers the best deal despite the fact that challengers made up only a small part of the total market.

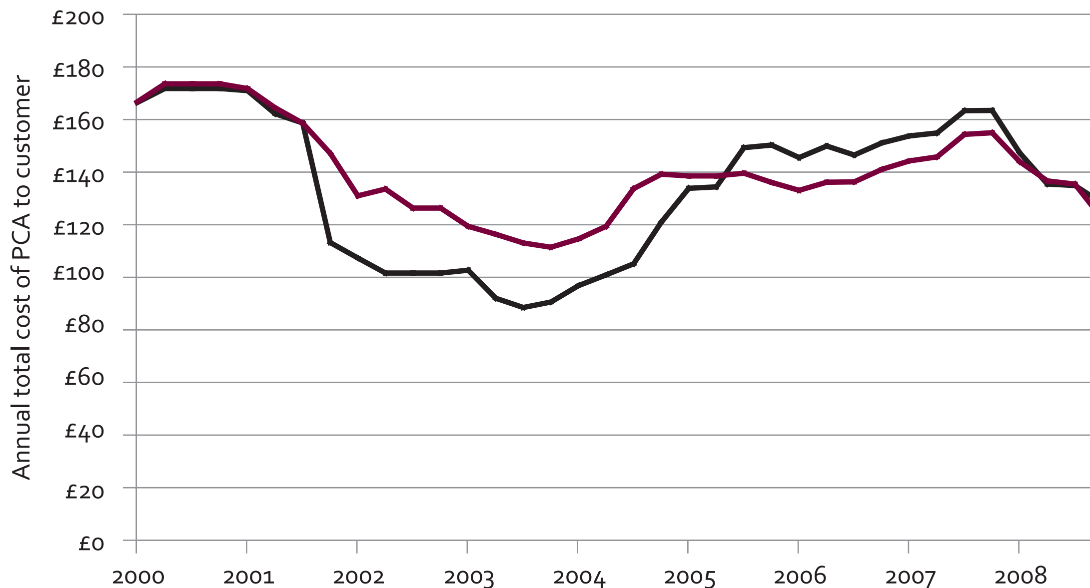
Figure A4.7: Average cost of a standard PCA to Type B customer



Source: Commission analysis of data provided by banks, GfK FRS and Defaqto.[viii]

A4.34 For Type A customers, who make up around a quarter of active PCA users, the average total cost of a PCA from a challenger bank from 2000 to 2009 was around £5 per year lower than the four biggest banks. The PCA provider with the lowest average total cost for consumers was a challenger 78% of the time.

Figure A4.8: Average cost of a standard PCA to Type A customer



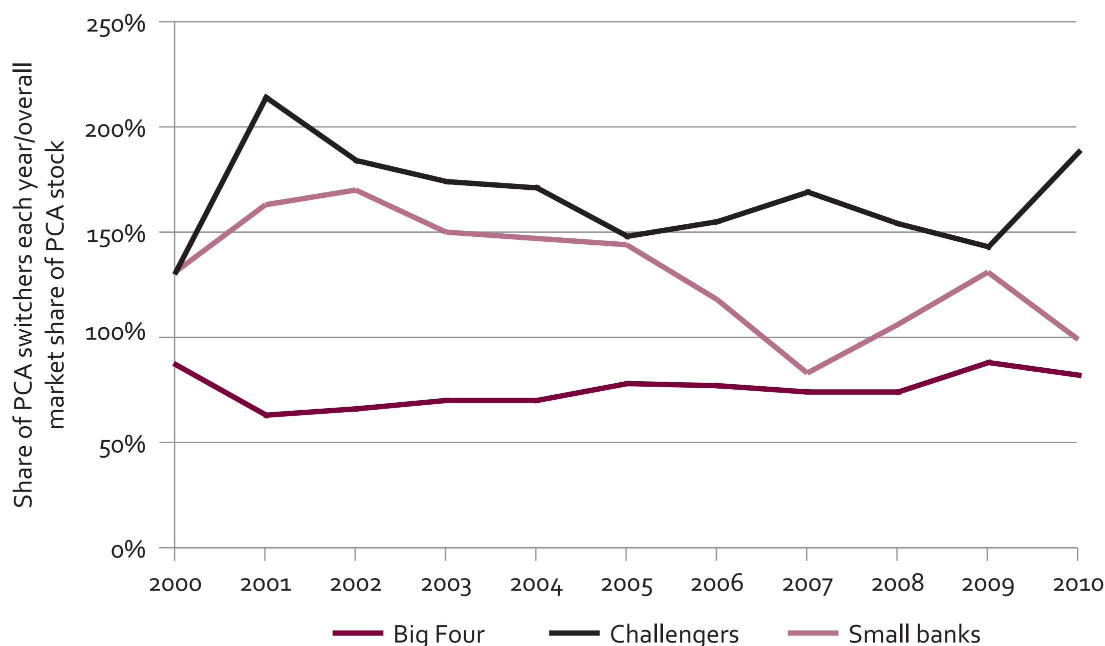
Source: Commission analysis of data provided by banks, GfK FRS and Defaqto.[ix]

A4.35 A further point to consider is about the nature of competition, and what these data might indicate. It does not appear that incumbents were competing on overall cost, while challengers competed only on headline rates. In particular, the large incumbents did not advertise their lower unarranged overdraft charges to attract new business. Because unarranged overdraft fees are less visible to customers, the main changes in these charges appear to have been driven by regulation. In 2007, the OFT began an investigation into the fairness of unarranged overdraft fees on PCAs. Following the OFT's intervention, unarranged overdraft fees have fallen in recent years. In addition, large and small banks alike have introduced new products and charging structures in response to widespread concern about excessive unarranged borrowing charges.

A4.36 Another way to look at the nature of competition is to look at changes in market shares over time. LBG point out that the challenger argument predicts that very small providers will have a low ratio of new customers to market share.[46] LBG states that in April 2011, LBG gained more customers than some of the challengers relative to their stock of market share, which would disprove the challenger argument.[47] It is difficult to draw any conclusions based on LBG's strategy since 2010, as discussed further below, and it is more informative to look at a number of banks over several years. Figure A4.9 below shows that over the last decade challengers as a group have consistently gained more switchers than the four biggest banks and smaller providers.[48]

46 Page 22, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.
47 Page 23, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.
48 Figure 2.9 from the *Interim Report*.

Figure A4.9: Rates of switcher share to market share for PCAs

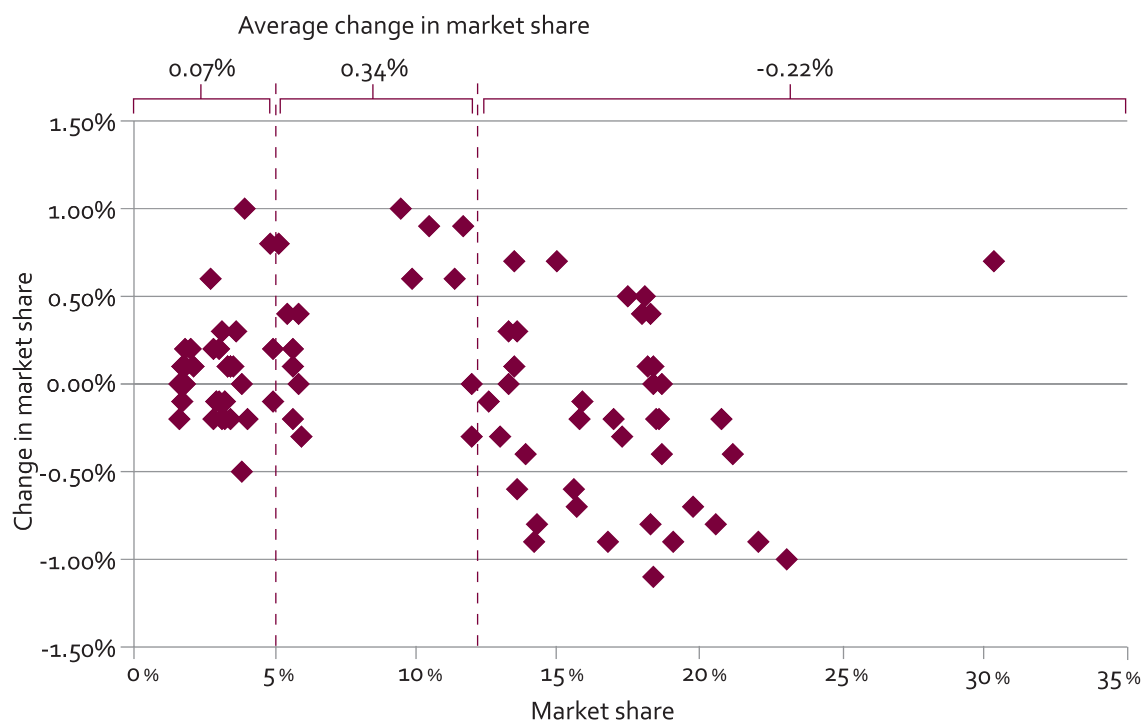


Source: Figure 2.9 from the Interim Report.

A4.37 The change in banks' market shares can show the extent to which banks were a competitive threat to other banks, and the extent to which banks were offering good products. Figure A4.10 below shows the change in market share per year for banks over the last decade and how this varies with existing market share. This figure shows that the four largest banks have been slowly losing share over the last ten years, indicating that customers preferred the products from other, smaller banks. But, on average, the smallest firms with a market share of below 5% have hardly grown at all over the last decade while the larger challenger banks with a market share of between 5% and 12% have grown the most, putting the greatest competitive pressure on other PCA providers. Therefore, it is reasonable to conclude that the larger a challenger bank is, the more likely it is to attract customers and exert such pressure.

A4.38 It is not possible to state with complete certainty that a bank of a particular size, funding or other characteristics will challenge, while other banks will not. It is a question of probabilities. This is discussed in more detail in relation to LBG's planned divestiture ('Project Verde') in Chapter 8.

Figure A4.10: Annual changes in PCA market share, 2000-2010



Source: Commission analysis of data provided by GfK FRS.[x]

A4.39 Taking into account all this evidence, the Commission's conclusion is that challengers do compete harder for PCAs, but that the competition problems associated with this product – including high and opaque charging structures for unarranged overdrafts – are not limited to incumbents.

LBG's current PCA offers

Summary of LBG claim: LBG currently has some of the best PCA deals on the market.[49]

Summary of response: it is hard to draw any conclusion from LBG's current pricing in the PCA market.

A4.40 LBG claims that it currently has some of the most competitive offers in the PCA market.[50] It is hard to draw firm conclusions from this for a number of reasons including: LBG's large funding gap, which gives it a particularly strong current incentive to attract deposits; the atypical conditions in funding markets more

49 Page 21, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.
50 Page 21, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.

generally; and the high level of current interest in banking issues including competition. It is more reliable to look at the situation in the years before the financial crisis to understand how competition normally works in retail banking.

Price dispersion

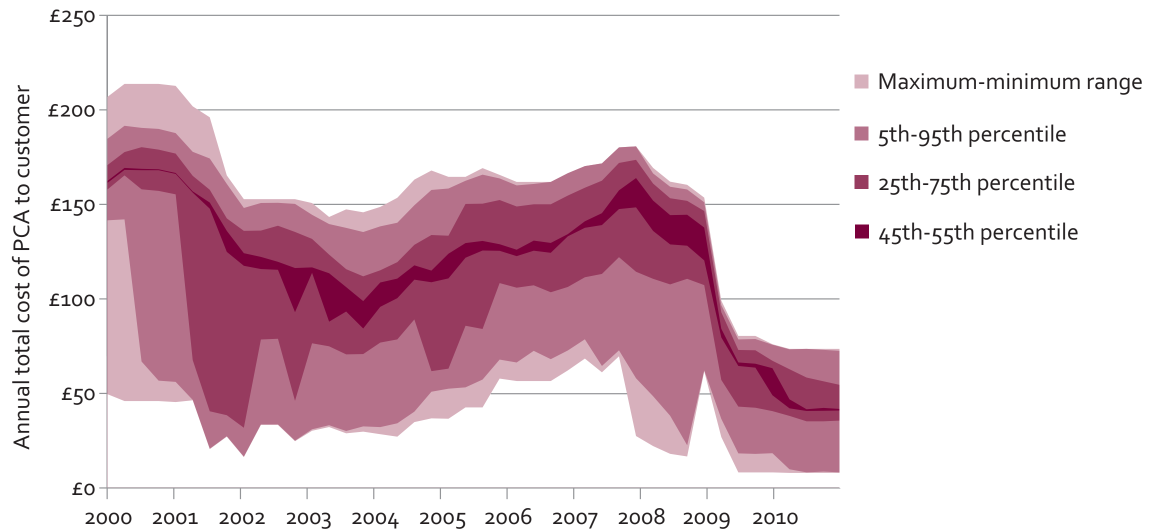
Summary of LBG claim: price dispersion is consistent with effective competition.[51]

Summary of response: price dispersion alone may not show a lack of competition. However, in combination with other factors, it may do so.

A4.41 LBG claims that differences between products can account for dispersion in PCA deposit interest rates,[52] and argues that price dispersion must take into account all aspects of price, not just interest rates.[53] The dispersion of total costs for four types of PCA consumer is provided in Figures A4.11 to A4.14 below. In order to compare PCAs that are very similar, only standard PCAs have been included in this analysis.[54] In addition, only products without an introductory rate of deposit interest are included. There may be small differences between the remaining products which could account for some of the dispersion at the extremes, but on the whole most of the price dispersion does not appear to be caused by differences in products.

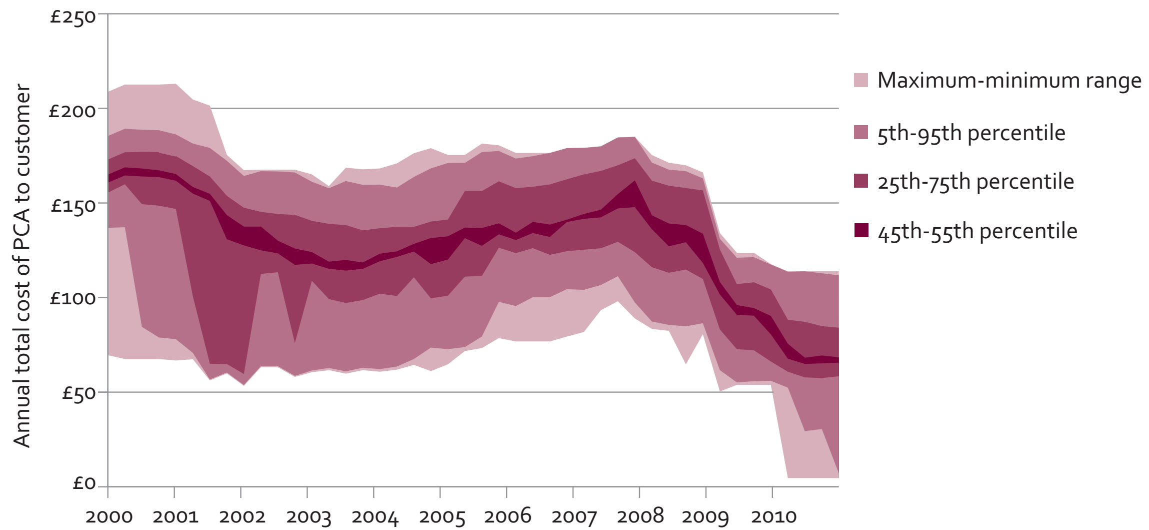
51 Page 24, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.
52 Page 24, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.
53 Page 25, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.
54 Only PCAs with the following characteristics are included: free banking, no monthly charge, no maximum age, no area restrictions, no minimum income, overdraft offered, no withdrawal restrictions, no introductory credit interest rate and minimum investment of no more than £300. Interest rates that apply to deposits of £1000 have been used to prevent the tiering of rates from having an effect.

Figure A4.11: Dispersion of total annual cost of a standard PCA for Type A consumers



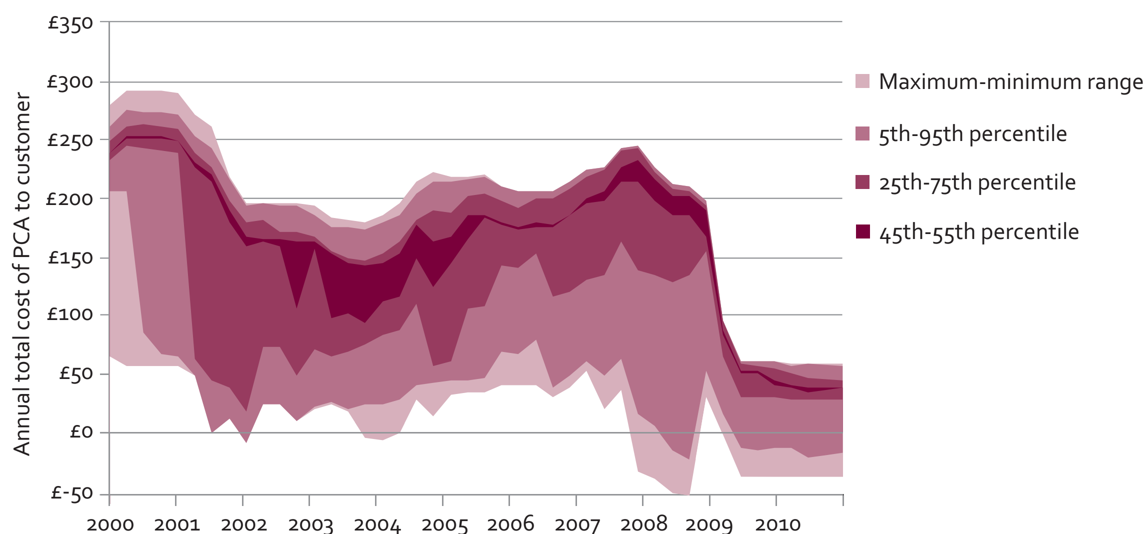
Source: Commission analysis of data provided by Defaqto.[xi]

Figure A4.12: Dispersion of total annual cost of a standard PCA for Type B consumers



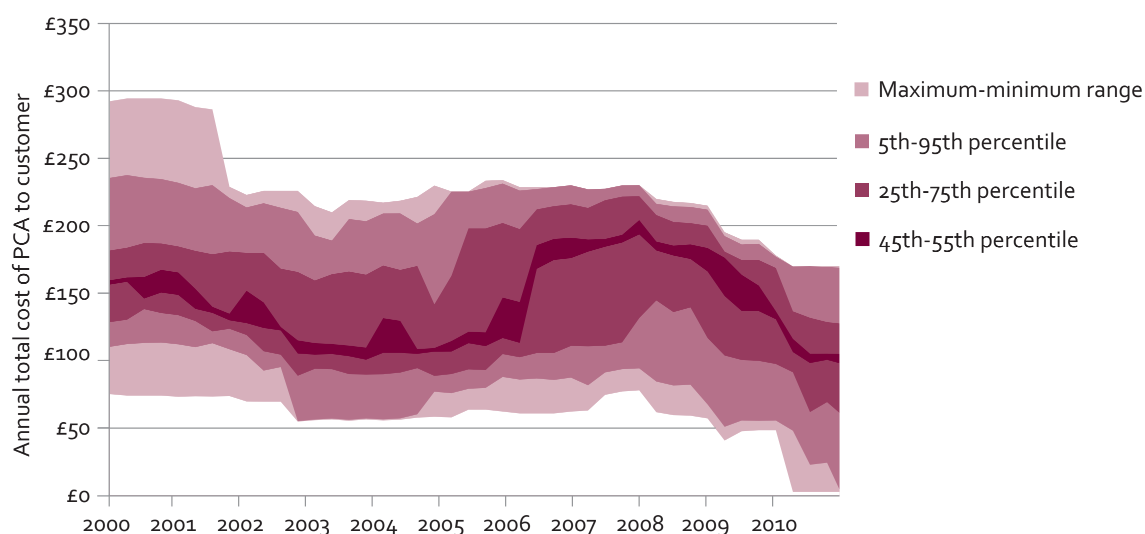
Source: Commission analysis of data provided by Defaqto.[xii]

Figure A4.13: Dispersion of total annual cost of a standard PCA for Type C consumers



Source: Commission analysis of data provided by Defaqto.[xiii]

Figure A4.14: Dispersion of total annual cost of a standard PCA for Type D consumers[55]



Source: Commission analysis of data provided by Defaqto.[xiv]

55 For each PCA product included in this analysis, the total cost was calculated by summing the cost of using arranged overdrafts, the interest foregone and unarranged overdraft fees.

A4.42 LBG states that competitive markets can have some degree of price dispersion. That is true to an extent, though it is worth noting that the level of dispersion shown above is material, with an inter-quartile range usually of around £50 for a product costing around £150.

A4.43 Finally, LBG believes that the academic literature shows that price dispersion is caused by a lack of transparency and switching, and therefore that any remedies should focus on problems in those areas.[56] Improvements in switching and transparency are clearly needed: whether or not these alone would be sufficient to secure effective competition is discussed in Chapters 7 and 8.

Switching and transparency

Summary of LBG claim: the competition authorities have consistently recognised that competition in banking should be addressed by improving switching and transparency, and effective switching solutions can be implemented to increase competitive intensity significantly, as has occurred in other markets.

Summary of response: this is agreed. The question is whether such moves alone would be sufficient to secure effective competition. This is discussed in Chapters 7 and 8.

A4.44 Chapter 8 set out the anticipated benefits of the redirection service. It notes that the switching recommendation would greatly reduce the cost and risk to consumers who switch their PCA. However, for effective consumer choice, transparency needs to be greatly improved in the PCA market. LBG argued that the redirection service would transform the PCA market into a market like insurance or utilities where switching is common, and therefore structural solutions would no longer be needed to promote competition. Chapter 7 pointed out that concentration in PCAs is a particular problem because of high switching costs and barriers to entry. This raises the question: will the redirection service lower switching costs enough that PCAs would become a market where the current level of concentration is not a problem, because switching costs are very low, products are easily comparable, and barriers to entry are low?

A4.45 The Commission's conclusion is that this is not the case. The switching and transparency recommendations in this report should lower switching costs, which would be a significant improvement. However, given the complex nature of PCAs, transparency would remain a concern although the Commission's recommendations should improve it over time. In addition, others barrier to entry would remain, such as the importance of branch networks. Therefore, the most reasonable conclusion is that PCAs will continue to be a product for which switching costs are at least moderate, and where barriers to entry remain. The conclusion is therefore that concentration will continue to be relevant in this market. A lack of challengers, HHI of over 1500 and one

56 Page 26, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.

firm with a share of around 25% or more in the PCA market will continue to impede competition. Therefore, creating a new challenger is vital to promoting competition, in addition to the introduction of a redirection service.

Summary of LBG claim: the Commission has taken a narrow definition of customer activity. Hence the switching rates in the *Interim Report* are too low.[57]

Summary of Barclays claim: the *Interim Report* ignores the importance of potential switching.

Summary of response: the switching rates in the *Interim Report* include those people who said they have switched and those who have opened an additional account with a new brand. This seems the most reasonable measure of switching, and the estimates of the switching rates in the *Interim Report* are in line with previous estimates. Potential switching is important, but the evidence does not suggest that this is very high.

A4.46 LBG claims that the switching rates given in Figure 2.5 of the *Interim Report* only considered the situation in which customers move their main banking relationship from one bank to another by opening a new account, transferring their regular payments and credits and closing the old account. This is not completely accurate, because the definition used in the *Interim Report* includes:

- people switching their PCA from one brand to another; and
- people taking up an additional PCA with a new brand.

A4.47 The definition used in the *Interim Report* does not include:

- people who have not had a bank account before; and
- people taking a new PCA with their existing brand.

A4.48 The measure of switching used in the *Interim Report* appears to be the most appropriate measure of the extent to which customers move between brands. It could be argued that this measure over-estimates switching since it includes switching between brands of the same group – for example from NatWest to RBS. The measure is also consistent with that used by others such as Ofcom and Ofgem.[59]

57 Pages 26-29, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.
58 Page 47, Barclays, 2011, *Interim Report: Consultation on Reform Options*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/Barclays.pdf.
59 See Ipsos MORI, 2011, *Customer Engagement with the Energy Market – Tracking Survey* (available at: http://www.Ofgem.gov.uk/Markets/RetMkts/rmr/Documents1/IpsosMori_switching_omnibus_2011.pdf) and the questionnaire used by Ofcom (available at: http://stakeholders.ofcom.org.uk/binaries/consultations/consumer-switching/annexes/questionnaire.pdf).

A4.49 There is clearly a distinction between 'churn', including for instance all new account openers, and switching. LBG are correct to point out that account activity as measured by churn will be higher, offering a figure of 11.4% for the rate of PCA opening in 2010. Other data suggest that the total may be lower than this (see Table A4.2), though the difference may arise because some customers are not aware of transferring their account within the same brand, or because some customers have moved more than once in one year.

Table A4.2: All new business in the PCA market (2010)

Reason for opening a new PCA	Percentage of survey respondents who gave each reason for opening a new PCA in the previous 12 months
Switched accounts	2.1%
Opened an additional account with a different brand	1.8%
Subtotal: switcher definition used in this report	**3.8%**
Transferred internally between accounts	1.4%
Opened an additional account with the same brand	1.0%
Re-entered PCA market	0.3%
Opened first ever account	1.2%
Total new accounts opened	**7.7%**

Source: Commission analysis of data provided by GFK FRS.[xv]

A4.50 The difference between the switching rate used in this report and total new accounts opened is the four categories below the switching definition used in this report, described in Table A4.2 above. There is considerable doubt over the extent to which there is competition for customers who transfer internally or who open an additional account with the same brand. These customers may not have searched the market at all. In contrast, there is likely to be some competition for customers who re-enter or open their first account ever but the competitive dynamics are different to those faced by switchers. However, these customers are clearly not switching accounts and so are not included in the measure of switching used in this report.

A4.51 Turning to the level of switching itself, the estimate of the PCA switching rate given in this report and in the *Interim Report* (3.8% for 2010, based on a sample of over 20,000 people) compares to the following estimates made by others:

- consumer research undertaken by Bacs[60] in 2010 found that 8% of people had switched or attempted to switch current accounts in the last 5 years, while 3% had switched or attempted to switch in the last 12 months;[61]
- the European Commission (EC) found that the PCA switching rate in the UK was 9% cumulatively over two years to July 2008;[62]
- the OFT found, in its market study published in 2008, that the annual rate of switching PCAs was 6%;[63]
- Ofcom found that the annual switching rate for bank accounts in 2008 and 2009 was 5%;[64]
- Consumer Focus found that 7% of consumers had switched over a two-year period to 2010;[65]
- switching rates amongst Which? members average 6% per year (measured over a five year period);[66] and
- the National Consumer Council found that in 2000, 6% of people switched and 15% of people considered switching. In 2005, 7% switched and 15% considered switching.[67]

A4.52 Barclays correctly identifies that, provided there is a high willingness and ability to switch (potential switching), low levels of actual switching would not be a cause for concern. It is possible for switching rates to be low in a competitive market if a large number of consumers would switch if one bank offers a slightly worse deal than

60 Bacs (originally known as Bankers' Automated Clearing Services) is an industry body responsible for the schemes behind the clearing and settlement of automated payments in the UK.
61 Page 19, British Bankers' Association, 2010, *Letter to Independent Commission on Banking*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/01/British-Bankers-Association-Issues-Paper-Response.pdf.
62 Page 33, EC, 2009, *Consumers' Views on Switching Service Providers*. Available at: http://ec.europa.eu/public_opinion/flash/fl_243_en.pdf.
63 OFT, 2008, *Personal Current Accounts in the UK*. Available at: http://www.oft.gov.uk/shared_oft/reports/financial_products/OFT1005.pdf.
64 Ofcom, 2009, *The Consumer Experience 2009*. Available at: http://stakeholders.ofcom.org.uk/binaries/research/consumer-experience/research09.pdf.
65 Consumer Focus, 2010, *Stick or Twist*. Available at: http://www.consumerfocus.org.uk/files/2010/10/Stick-or-twist-for-web1.pdf.
66 Paragraph 56, Which?, 2010, *Written evidence submitted by Which?*. Available at: http://www.publications.parliament.uk/pa/cm201011/cmselect/cmtreasy/612/612we06.htm.
67 National Consumer Council, 2005, *Switched on to Switching?*. Available at: http://www.oecd.org/dataoecd/13/17/40080443.pdf.

others.[68] However, there are strong reasons – as set out in Chapters 7 and 8 – to believe that switching rates are low due to other factors including a lack of transparency and high switching costs, rather than due to the market being competitive. Further, it is not clear that levels of potential switching are very high: a recent survey found that 28% of respondents had thought about switching but had not done anything about it.[69]

Innovation

Summary of LBG claim: innovation both by challengers and the four biggest banks demonstrates the effectiveness of competition.

Summary of response: it is accepted that both challengers and the biggest four banks have innovated over the past decade, despite challengers' lower market shares.

A4.53 Analysing this issue is difficult since it is hard to measure levels of innovation. The following method was used to measure innovation by PCA providers. Firstly, data from PCA providers was used to show when innovations were introduced by a number of PCA providers. For innovations that became widely adopted, the PCA providers that introduced them first or second were considered to have innovated. These data suggest that challengers and the four biggest banks have both innovated while challengers have had a lower market share.

68 The number of customers who would have to be willing to switch must be large enough such that a small price rise by one firm is not profitable.
69 Page 13, Quadrangle, 2011, *PCA Consumer Research Findings*. Available at: http://www.quadrangle.com/PCA_switching_consumer_research.pdf.

Impact of the internet and new technology on the supply of PCAs

Summary of LBG claim: increased use of the internet will reduce the reliance on branches, lowering barriers to entry. Comparison websites may be transformed making it quick and easy for customers to compare products.

Summary of response: PCA customers are using the internet more to manage their PCA. However, the evidence shows that branches are still very important for customers' *choice* of bank – branches and the internet are complements, not substitutes. New technology could allow new players in, but it may also be an additional barrier to entry.

A4.54 PCA customers are increasingly using the internet to manage their PCA, and to a limited extent to open accounts. It also appears that consumers are using branches less. However, when customers choose a PCA provider they continue to see branches, and their location, as important.

A4.55 The *Interim Report* provided the results from a survey on what customers who had switched said were the important factors in their choice of bank.[70] LBG argues that the *Interim Report* was incorrect to include 'opening hours' and 'ATM machines' within the category of 'branch'.[71] However, the opening hours are clearly important features of the branch, and ATM machines probably so. LBG claims that the product was the most important factor for switchers in choosing their account. However, this includes the category of whether the account was on a price comparison website which is not an aspect of the product. Whether that is included or not, branches were the most important factor in customers' choice of PCA in every year from 2000 to 2010.[72]

A4.56 LBG claims that the internet is becoming more important, diminishing the value of branches. This does not fit with the view of other banks that have pointed out that branches are key to forming customer relationships. It also does not fit well with the data. For the last three years, the importance of branches as a reason for consumers' choosing their bank has remained relatively constant.[73] While it is true that more people are using internet banking, and may even open their account online, this does not mean that the importance of branches is diminishing as a reason for *choosing* a bank. The OFT concluded that: "[o]ur research suggests that personal and SME consumers continue to place value on the ability to engage with their retail banking provider in person through visits to a local branch. While internet and mobile banking

70 Figure 2.6, *Interim Report*.
71 Page 30, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.
72 Source: GfK NOP Financial Research Survey (FRS), 5 months ending September 2000-2010, reason of choice (1410-2662).
73 Source: GfK NOP Financial Research Survey (FRS), 5 months ending September 2008-2010, reason of choice (2202-2662).

are growing in importance they largely remain, especially for PCAs and BCAs, complements to, rather than substitutes for, branches."[74]

A4.57 This conclusion was based in part on surveys by the OFT that found that only 30% of those surveyed said that branch location was not important in their choice of bank.[75] And only 15% of consumers surveyed said they would consider using a PCA provider with only telephone and internet service. This is not surprising given the limited market share of brands without branches. Even if First Direct (whose customers have some access to HSBC branches) is included into that group, brands without branches had a market share of 2.2% of the PCA market in 2003, and 2.4% in 2010.[76]

A4.58 For many years, banks have made the claim that new technology will reduce barriers to entry. Lloyds TSB said regarding its proposed merger with Abbey National in 2001 that the internet was going to have a significant effect on the structure of the market and allow new entrants to enter without branches.[77] Since then, the internet-only brands have not had great success, and there has been very little entry. In part this might be because when new technologies do arise, the large banks are best placed and financed to adopt them – particularly if the new technologies are largely complementary to the existing ones. So while new technology such as mobile banking might make it easier for new entrants to win market share, it is not clear that this will be the case.

A4.59 LBG states that advances in price comparison websites may make it quick and simple to compare PCAs. For this to happen, customers would need to be able to make quick and accurate comparisons between products from different banks. This would rely either on them being able to download their PCA usage data in an easily comparable format, or on them being able accurately to select an adequately detailed customer profile against which to test different products. Such changes may occur, and price comparison sites may start to play an important role in competition for PCAs. But it seems unlikely that this will occur for some years at least. The evidence from surveys shows that price comparison websites are currently not playing a big role in consumer choice for PCAs – in 2010, 2.4% of customers surveyed said that a comparison website was important in their choice of PCA.[78] Price comparison websites have indicated to the Commission that they have little incentive to invest in major improvements.

A4.60 LBG also states that other new technologies, such as the use of smart phones to allow payments, could increase competition in the PCA market. While this is possible, it seems likely that the existing banks will themselves be well placed to use this

74 Page 160, OFT, 2010, *Review of Barriers to Entry, Expansion and Exit in Retail Banking.* Available at: http://www.oft.gov.uk/shared_oft/personal-current-accounts/oft1282.
75 Page 187, OFT, 2010, *Review of Barriers to Entry, Expansion and Exit in Retail Banking*. Available at: http://www.oft.gov.uk/shared_oft/personal-current-accounts/oft1282.
76 Source: GfK NOP Financial Research Survey (FRS), 5 months ending September 2000-2010, main current accounts (21396-24789).
77 Paragraph 5.8, CC, 2001, *Lloyds TSB Group plc/Abbey National plc.* Available at: http://www.competition-commission.org.uk/rep_pub/reports/2001/fulltext/458c5.pdf.
78 Source: GfK NOP Financial Research Survey (FRS), 5 months ending September 2010, reason of choice (2662).

technology. Further, the limited impact, to date, of the internet on customers' choice of bank (despite expectations on the part of some banks to the contrary) suggests some caution should be applied with regard to the potential impact on competition of future technological shifts.

Competition in mortgages

Summary of LBG claim: the mortgage market remains competitive since prices are low, price dispersion has not increased and the number of products has increased.

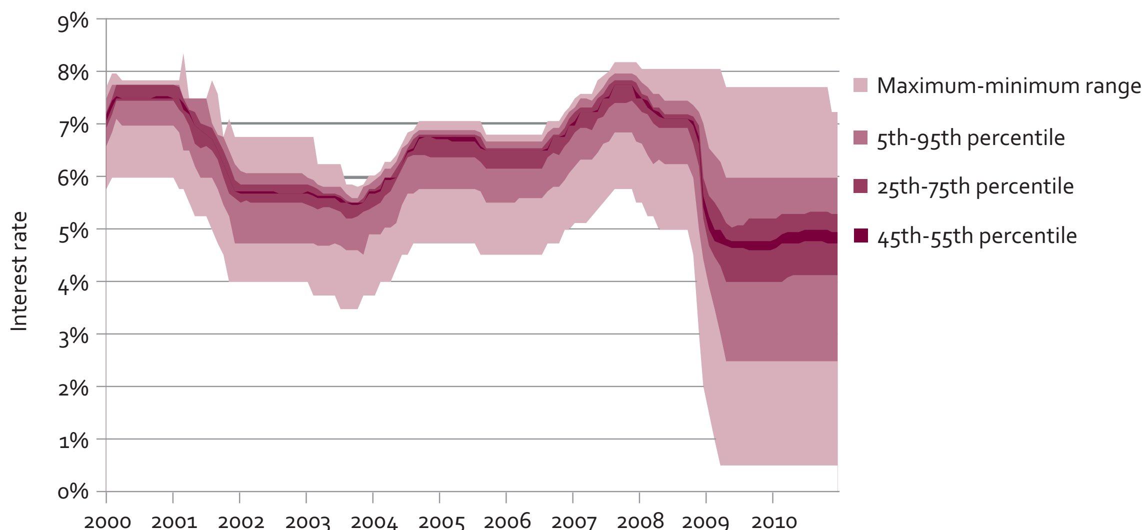
Summary of response: competition in the mortgage market has been more effective than in the PCA and SME banking markets in the past, but the financial crisis may have given rise to new problems.

A4.61 As explained in the *Interim Report*, a number of new firms entered the mortgage market over the past decade, though many have since exited. The mortgage market was more concentrated in 2010 than pre-crisis.[80] The market share of the smaller providers has fallen significantly from 38% in 2007 to 28% in 2010 and the share of small providers' new business has fallen from around 40% in 2007 to just over 20% in 2009 and 2010.[81] This exit and retrenchment of the smaller providers reduces choice in the mortgage market and could be expected to affect competition.[82]

A4.62 LBG claims that price dispersion has increased due to some firms being contractually obliged to price their Standard Variable Rate (SVR) mortgages at base rate plus a low, fixed margin. This is true for some firms, but it is not clear that this alone explains all of the increase in price dispersion.[83] Figure A4.15 below provides the dispersion in mortgage SVR rates from 2000 to 2010. Some of the very low SVRs that were offered in 2010 are probably due to the contractual issues LBG mentions. But the dispersion is also greater around the median which may suggest that fewer customers are comparing mortgages and switching than before the crisis.

79 Page 9, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.
80 Figure 2.4, *Interim Report*.
81 Small providers are those that are not the biggest four retail banks and are not defined as challengers. Sources: GfK NOP Financial Research Survey (FRS), 5 months ending September 2000-2010, all mortgages (7586-8518) and GfK NOP Financial Research Survey (FRS), 5 months ending September 2000-2010, new mortgages (943-1833).
82 In this context, it is worth noting that in relation to the Lloyds TSB/HBOS merger the OFT found that the test for reference to the CC on competition grounds was met in respect of PCAs, banking services to SMEs and mortgages. See, OFT, 2008, *OFT Report to the Secretary of State on Lloyds/HBOS merger*. Available at: http://oft.gov.uk/OFTwork/mergers/decisions/2008/LloydsTSB.
83 A number of lenders raised their SVR ceiling in response to the low base rate – e.g. Halifax and Skipton Building Society.

Figure A4.15: Dispersion of mortgage SVR rates



Source: Commission analysis of data provided by Defaqto.

A4.63 The barriers to entry in the mortgage market have probably increased since before the crisis, as it is now more difficult for banks to raise funds.

A4.64 LBG claims that mortgage prices are low. The interest rate on many mortgages has fallen since 2008, for example Figure A4.15 shows that this is the case for SVR mortgages. But the spread between mortgage market rates and the base rate has increased.[84] To an extent this may be due to higher costs for the mortgage providers, but there is some evidence that mortgage rates have increased by more than the increase in costs.[85]

A4.65 LBG states that the number of mortgage products has increased. This may or may not improve the effectiveness of competition if the number of providers has decreased: the presence of more products of itself does not indicate an improvement in competition.

A4.66 Finally, LBG argues that the level of switching in mortgages has fallen because of the fall in base rates. While this will be a factor, it remains a concern that switching is low while considerable gains remain to be made from switching mortgage provider (see Figure A4.15 above).

84 See for example, Chart B, Bank of England, 2011, *Inflation Report, August 2011*. Available at: http://www.bankofengland.co.uk/publications/inflationreport/ir11aug.pdf.
85 Bank of England, 2010, *Understanding the Price of New Lending to Households*. Available at: http://www.bankofengland.co.uk/publications/quarterlybulletin/qb100301.pdf.

Competition in SME banking

Summary of LBG claim: the *Interim Report* uses the wrong market definition; concentration levels will be the same as pre-crisis once the divestitures have taken place; switching rates are under-estimated in the *Interim Report*; and the *Interim Report* does not take account of other features of the SME market which demonstrate effective competition.[86]

Summary of response: the *Interim Report* focused on the main banking relationship for SMEs as this is the focus of competition for a number of core SME banking services. Concentration levels have been high for at least the last decade and will remain high post-divestitures. Switching is low, and other measures do not indicate that competition is working well.

A4.67 LBG argues that the *Interim Report* does not adequately reflect the fact that there are separate markets for the supply of different kinds of banking products to SMEs, and that it generally refers instead to an 'SME market' as a whole. The approach taken to assessing market shares for SME banking in the *Interim Report* was to use the share of the main banking relationship that SMEs reported having. This is a good proxy for the BCA market as 96% of those with a BCA have a BCA from their main bank and there is little multi-banking.[87] The main banking relationship is also a good proxy for competition in other SME products such as corporate credit cards, deposit accounts, business loans and commercial mortgages, because at least 80% of SMEs that hold these products take them from their main bank.[88]

A4.68 LBG claims that after its planned divestiture, its market share will be reduced to 19% in BCAs and that concentration levels after the EC-mandated divestitures will be the same as they were prior to the financial crisis. This is accepted. However, this still leaves SME banking markets fairly concentrated with five firms having 88% of the market between them, which is similar to the concentration over the last decade.[89] Further, markets may be less competitive locally, particularly where concentration levels are much higher as in Scotland (see Chapter 7 for more on this).

86 Page 9, LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition.* Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.
87 Source: Commission analysis of data from the Charterhouse Research UK Business Banking Survey 2010, based on more than 16,000 interviews with businesses conducted between January and December 2010 covering businesses with turnover up to £1bn. Data from SMEs with a turnover of up to £1mn has been used for this calculation.
88 Source: Commission analysis of data from the Charterhouse Research UK Business Banking Survey 2010, based on more than 16,000 interviews with businesses conducted between January and December 2010 covering businesses with turnover up to £1bn. Data from SMEs with a turnover of up to £1mn has been used for this calculation.
89 The source for post-divestiture market shares is Commission analysis of 2010 data from the Charterhouse Research UK Business Banking Survey 2010, based on more than 16,000 interviews with businesses conducted between January and December 2010 covering businesses with turnover up to £1bn. Data from SMEs with a turnover of up to £1mn has been used for this calculation.

A4.69 As in the PCA market, differences in price levels between challengers and incumbents are visible in the BCA market. These differences were found using the following analysis: six different types of SME were defined, based on profile data provided to the Commission by banks.[90] The cost to SMEs of using each different type of account was calculated. This includes the cost of interest foregone but does not include the cost of overdrafts which are often set by negotiation. Only accounts that could be used by SMEs of the six types were included and only accounts that allowed branch access were compared. The minimum price across all accounts offered by each bank was taken. An average of those prices across the four biggest banks and challenger banks was calculated where market shares were used to weight each banks' prices within both groups of banks. This analysis is based on published prices and so it does not take account of negotiated prices or different levels of service between banks. However, it does not appear that the larger banks have higher levels of customer satisfaction.

A4.70 For 2005 to 2010, on average, challengers were 17%-27% cheaper for five out of the six types of customers reviewed.[91] For the sixth customer type, where most of the transactions were manual, rather than automated, the four biggest banks were 12% cheaper than challengers when cost was averaged out across the five years. But despite offering better rates on the whole, challengers grew very little over the five years reviewed, indicating that competition may not be working well in this market.

A4.71 LBG claims that the extent of switching in BCAs is under-estimated and that it increased to 6% in 2010, representing a doubling of the switching rate in five years. LBG add that there is considerable churn in SMEs. The most recent data for SME switching does show a slight increase to 6% in 2010.[92] This is an increase from the rate of around 4% that the OFT found in its 2007 study.[93] The OFT's study recommended that the CC lift price controls on the four main business banks in England and Wales. However, the OFT remained concerned by some aspects of SME banking markets.

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90 A similar approach to constructing the profiles has been taken as to PCA customer profiles discussed above. Type A SME customer is one that has a turnover of c.£900k, deposit balances of just under £70k, high levels of automated and manual transactions, and has medium levels of cash usage. Type B SME customer is one that has a turnover of £100k, deposit balances of between £5k-£10k, low levels of automated and manual transactions, and high levels of cash usage. Type C SME customer is one that has a turnover of £250k, deposit balances of just over £10k and some use of automated and manual transactions (no cash usage). Type D SME customer is one that has a turnover of £100k, low levels of automated transactions, medium cash usage, high levels of manual transactions and deposit balances of c.£5k. Type E SME customer has a turnover of £250k, with high levels of automated transactions and cash usage, some manual transactions, and deposit balances of £10k-£15k. Type F customer also has a £250k turnover, with a similar deposit balance, but low levels of automated transactions and cash usage, and high levels of manual transactions.

91 Source: Commission analysis of Moneyfacts price data and market shares from TNS RI Small Business Banking Survey in Great Britain for SME with a turnover of less than £1mn and the Charterhouse Research UK Business Banking Survey 2010 (using the data from SMEs with a turnover of less than £1mn) based on more than 16,000 interviews with businesses conducted between January and December 2010 covering businesses with turnover up to £1bn. Averages were taken from the first half of 2005 to the first half of 2010.

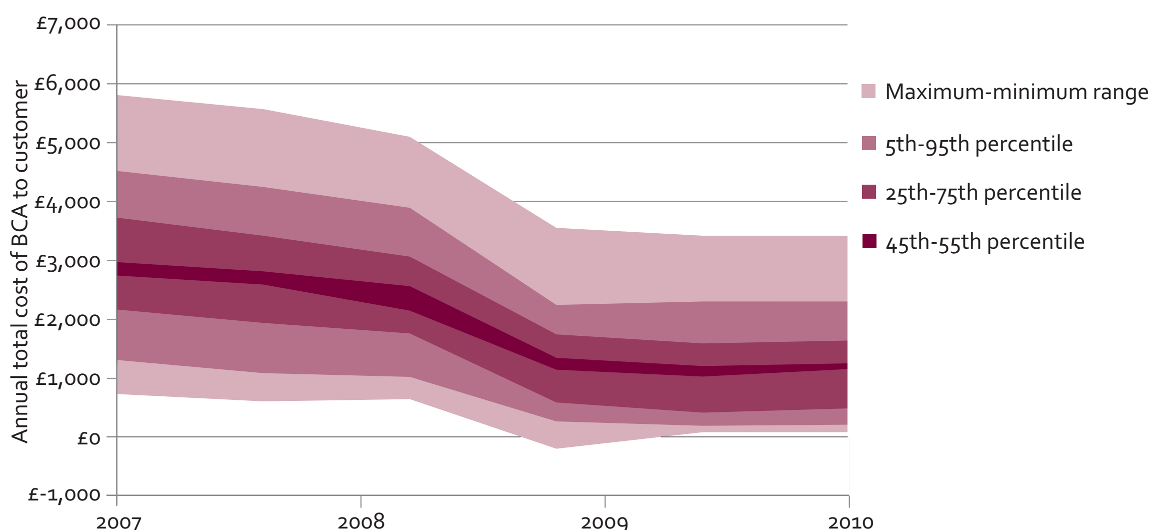
92 Source: Charterhouse Research UK Business Banking Survey 2010, based on more than 16,000 interviews with businesses conducted between January and December 2010 covering businesses with turnover up to £1bn. Data from SMEs with a turnover of up to £1mn has been used for this calculation.

93 OFT, 2007, *SME Banking Review of the Undertakings Given by Banks Following the 2002 Competition Commission Report.* Available at: http://www.oft.gov.uk/shared_oft/reports/financial_products/oft937.pdf.

In particular, there had not been a significant increase in switching since 2002, customers appeared not always to be aware of their banking costs and they lacked confidence in the switching process.

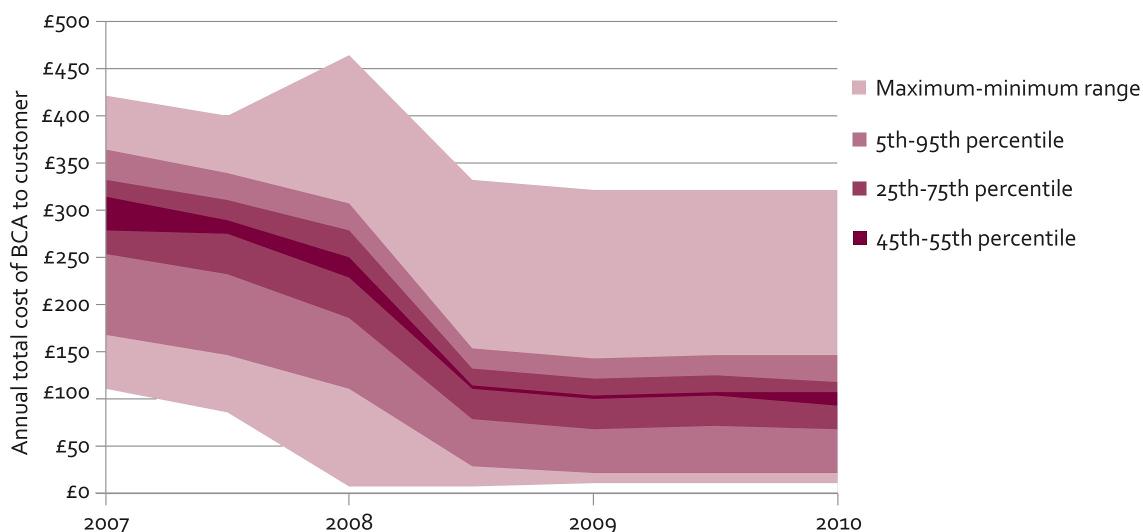
A4.72 The level of price dispersion in the BCA market is high as demonstrated by Figures A4.16, A4.17 and A4.18 below.[94] This indicates that there may be a problem with transparency and/or switching between BCA providers, though it is possible that some dispersion is explained by differences in quality between products.

Figure A4.16: Price dispersion for BCAs – SME Type A



Source: Commission analysis of Moneyfacts data.[xvi]

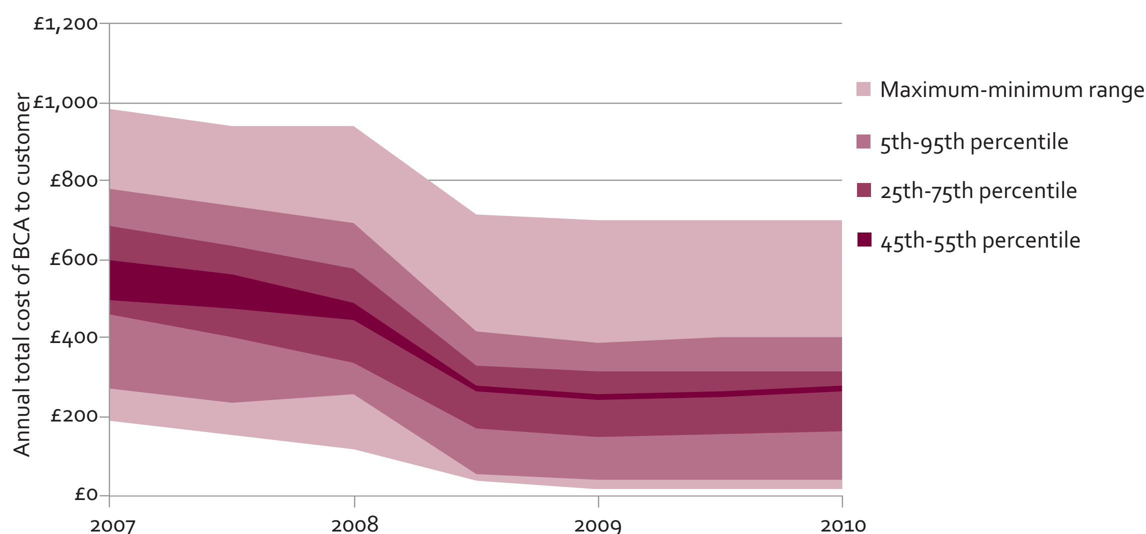
Figure A4.17: Price dispersion for BCAs – SME Type B



Source: Commission analysis of Moneyfacts data.[xvii]

94 Dispersion for the three types not given here are similar to Figures A4.16, A4.17 and A4.18.

Figure A4.18: Price dispersion for BCAs – SME Type C



Source: Commission analysis of Moneyfacts data.[xviii]

A4.73 LBG argues that in relation to SMEs, the *Interim Report* did not take sufficient account of the role of intermediaries, the impact of the internet, multi-banking and high levels of customer satisfaction. Taking these points in turn:

- intermediaries such as accountants and lawyers do sometimes give advice to SMEs on banks, but from discussions with banks and small business groups, it does not appear that intermediaries have a very significant impact. Evidence provided by one bank also indicates that the use of price comparison sites for BCAs is very low;

- more SMEs are using the internet to manage their banking, but there are a significant number of firms that will not be able to do so for all their regular banking needs, in particular the need to handle cash. As for individuals, branches are still an important factor in SMEs' choice of bank, as are relationship managers who are often attached to branches; and

- multi-banking is not common amongst SMEs. A recent survey found that 95% of firms with a turnover of up to £1mn have one bank.[95] Hence, multi-banking is unlikely to have a significant effect on choice of banks for SMEs.

A4.74 Finally, customer satisfaction with SME banking services is not obviously high. Across the industry, in 2010, 51% of SMEs rated their main bank as excellent or very good for

95 This is based on a survey of SMEs with a turnover of less than £1mn. Source: Charterhouse Research UK Business Banking Survey 2010, based on more than 16,000 interviews with businesses conducted between January and December 2010 covering businesses with turnover up to £1bn.

the previous year, and 77% rated their main bank as good, very good or excellent.[96] Satisfaction is a relative measure so it is difficult to say whether the average satisfaction indicates a good level of competition or not.

Structural remedy

Whether the Commission's structural remedy is disproportionate and discriminatory

Summary of LBG claim: a substantial enhancement of the LBG divestiture is unnecessary, and would be disproportionate and discriminatory.

Summary of response: see Chapters 7 and 8 for more discussion of the market structure, importance of challengers and options to ensure the emergence of a strong challenger. The process of divesting the Verde business is ongoing, so an enhanced divestiture would be less costly than the type of structural remedy that might normally be required following a CC market investigation. On balance, the current divestiture does not give confidence that a strong challenger will emerge. The Commission's recommendation is reasonable and targeted.

A4.75 In a market investigation by the OFT or the CC, there would not normally be a divestiture already under way. Hence, there would normally be high costs involved in a structural remedy. The two largest costs would be the operational costs of splitting up an existing company, and the cost of reducing the incentive for firms to grow organically for fear of a structural remedy. An enhancement to an existing divestiture has much lower operational costs than splitting up an existing company. In addition, LBG did not acquire its market share by growing organically. It did so through a merger that raised serious competition concerns, but was cleared on financial stability grounds. LBG notes that it currently has the third largest share of SME banking services in the UK, so a remedy that requires it to divest SME market share is discriminatory. However, the two banks with a larger share of the SME market are not also at the same stage of a divestiture, did not acquire their market share in the same way and do not have the largest share of the PCA market.

A4.76 Ensuring the LBG divestiture results in a strong challenger is the most cost-effective method of achieving greater competition because:

- additional divestitures from other firms would have very high costs, whether that involved divesting standalone challengers, or divesting books of assets and liabilities from a number of banks and combining them. It is more proportionate to enhance an existing divestiture;

96 This is based on a survey of SMEs with a turnover of less than £1mn. Source: Charterhouse Research UK Business Banking Survey 2010, based on more than 16,000 interviews with businesses conducted between January and December 2010 covering businesses with turnover up to £1bn.

- a divestiture from other firms with large shares of the SME market would have to be quite large to create a challenger – in the order of 6% of the PCA market, which would be more costly than any incremental change to LBG's divestiture that might be necessary;

- additional divestitures from other firms may reduce the incentive to grow organically whereas a divestiture of LBG does not;

- the enhancement could be achieved in a number of ways. It is not clear that any of these must involve additional cost for LBG: some clearly would not, and some could bring benefits to LBG; and

- a divestiture of other firms would not improve competition in the PCA market as much as enhancing the LBG divestiture since LBG has the highest market share in the PCA market.

A4.77 Apart from enhancing the Verde business, a challenger bank could be created by breaking up a large bank to create a challenger or by taking a smaller market share from a number of banks to create a challenger. The latter option would be very difficult and costly since there would be many different systems to integrate. The former would be more costly than ensuring the LBG divestiture results in an effective challenger since a larger book of assets and liabilities would have to be removed to create a challenger.

A4.78 LBG submitted that the Verde divestiture will benefit from a number of key strengths, such as quality of staff, management and branch network, untarnished strong brands and capital and liquidity management unavailable to new brands.[97] If Verde's balance sheet is unencumbered, its mortgages can be securitised to raise finance. Even so, a large funding gap would blunt the incentive of the divested entity to compete effectively as a credit provider, and would raise its cost base, thereby weakening its ability to compete generally.

A4.79 It is difficult to judge the value of the brands being divested, and other factors such as its capital treatment will depend to a great extent on the identity of the eventual purchaser.[98] As recognised by the EC, the Cheltenham & Gloucester network could provide an opportunity to grow PCA share, but this would require some initial investment, since it does not currently offer PCAs. Verde's product offering (under the terms set out in the state aid document) does not include wider products, particularly the capability to offer corporate banking services, which would allow it to diversify and compete harder across different markets.

97 LBG, 2011, *Response to the Interim Report of the Independent Commission on Banking – Competition*. Available at: http://bankingcommission.independent.gov.uk/wp-content/uploads/2011/07/LBG-ICB-Comp-Response.pdf.
98 See, for example: Goff, S., 2011, Lloyds Looks to Ease Branch Disposal, *Financial Times*, [online] 21 August. Available at: http://www.ft.com/cms/s/0/3c7710c0-c821-11e0-9852-00144feabdc0.html.

A4.80 LBG submitted that the divestiture can be a viable business and can be profitable for its eventual purchaser even if it is a standalone business and is not enhanced. Consideration should also be given to the fact that an enhancement might price some potential bidders out of the transaction. These are important arguments to consider, but the balance of probabilities based on previous experience and Verde's current attributes does not give confidence that it will result in the creation of a strong challenger, especially on a standalone basis.

A4.81 There has been significant consolidation over the previous few years. Prior to the crisis, the challengers identified by the OFT in the PCA market were HBOS, Santander/Abbey National, Alliance & Leicester and Nationwide. Two of these challengers were taken over during the crisis. As a result, challengers account for 17.8% of the PCA market if Verde is not considered a challenger.[99] If it is assumed that Verde will be a challenger, and it does not lose any PCA customers, then the total market share of challenger brands post-divestitures will be 22.4%.[100] This would still be significantly below the market share that challenger brands held in 2008.

A4.82 LBG claims that the total market share of challenger banks in the PCA market will be higher than in 2006. However, this conclusion is reached by the addition of Co-operative Financial Services which has never been considered a prime challenger by the competition authorities in the past, due to its small size and slow rate of growth. Significant dynamic institutions have been lost and there are now only two challengers remaining of the firms previously identified by the competition authorities. After its recent acquisitions, Santander is also approaching the size in some markets (e.g. the PCA market) of banks that have historically been considered 'incumbents' by the competition authorities, so it is questionable to what extent it will continue to act as a challenger.

A4.83 The competition investigations that are most relevant to the markets being considered by the Commission are the Lloyds TSB/HBOS merger and the proposed Lloyds TSB/Abbey National merger. The analysis in these investigations recognised the importance of losing a challenger in the PCA market – the Lloyds TSB/Abbey National merger was prohibited following a CC recommendation, and the OFT found that the competition test for a referral to the CC was met in the case of the Lloyds TSB/HBOS merger but the Government cleared it on other grounds.[101]

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99 Source: GfK NOP Financial Research Survey (FRS), 5 months ending September 2000-2010, main current accounts (21396-24789).

100 Source: GfK NOP Financial Research Survey (FRS), 5 months ending September 2000-2010, main current accounts (21396-24789).

101 OFT, 2001, *Proposed Acquisition of Abbey National plc by Lloyds TSB Bank plc*. Available at: http://oft.gov.uk/OFTwork/mergers/mergers_fta/mergers_fta_advice/abbey-national2. OFT, 2008, *OFT Report to the Secretary of State on Lloyds/HBOS merger.* Available at: http://oft.gov.uk/OFTwork/mergers/decisions/2008/LloydsTSB.

Whether an enhanced Verde constitutes an improper reversal of the Lloyds TSB/HBOS merger

Summary of claim: some respondents claimed that adding branches to Project Verde is arguably an improper reversal of the merger clearance given to Lloyds TSB/HBOS. This would undermine the credibility of commitments made by the Government and could damage the reputation of the UK Government in the investment community.

Summary of response: the Commission is not seeking to reverse the Lloyds TSB/HBOS merger.

A4.84 The recommendation in this *Final Report* – that the entity resulting from Project Verde should have at least 6% PCA market share – would not reverse the Lloyds TSB/HBOS merger. Even if the 6% is reached by transferring PCA market share from LBG, this would not reach the level of HBOS' market share in 2008. The Commission's recommendation does not amount to an unpicking of the Lloyds TSB/HBOS merger, since significant synergies would remain. It would not amount to reversing the transfer of HBOS's assets and liabilities into LBG. As stated in the *Interim Report,* the costs of reversing the merger would be high and the benefits not clear-cut.

A4.85 Ensuring that the entity emerging from Project Verde is a strong, effective challenger is not inconsistent with the state aid agreements entered into by the UK Government, for a number of reasons including:

- when it assessed the scale of the divestiture required by LBG, the EC had a number of objectives, the primary one of which was to address the distortions to competition brought about by state aid to LBG. The Commission's locus is to promote competition across the UK banking sector; and
- as outlined in Chapter 8, there are a number of ways in which Verde can be enhanced. The Commission believes these are consistent with the state aid terms and should not, of themselves, disrupt the timeline of the divestiture.

A4.86 LBG's submission cited evidence to the Treasury Select Committee from John Fingleton (Chief Executive of the OFT), who said that it could be very costly to restructure the banking sector. This answer was given in response to a question about restructuring the entire banking sector, which the Commission agrees would be very costly. In his evidence John Fingleton did not address the specific question of whether the Verde divestiture should be enhanced.[102]

102 See questions 768 and 793, House of Commons Treasury Committee, 2011, *Oral Evidence on Competition and Choice in Retail Banking*. Available at: http://www.publications.parliament.uk/pa/cm201011/cmselect/cmtreasy/uc612-viii/uc61201.htm.

Endnotes

i In each year, a new entrant is defined in Figure A4.1 as one that did not have any market share, or share of new business in 2000, and had at least 0.05% of new business in the given year. If a new entrant is merged with another firm, the brands of the new entrant remain defined as new entrants. Source: Commission analysis of GfK NOP Financial Research Survey (FRS), 5 months ending September 2000-2010, new main current accounts (1061-1487), new mortgages (943-1833), new savings accounts/cash ISA/national savings (1799-4519), all new credit cards (1761-2623), all new loans (GfK definition) (501-1160).

ii In each year, a new entrant is defined in Figure A4.2 as one that did not have any market share, or share of new business in 2000, and had at least 0.05% of market share in the given year. If a new entrant is merged with another firm, the brands of the new entrant remain defined as new entrants. Source: Commission analysis of GfK NOP FRS, 5 months ending September 2000-2010, main current accounts (21396-24789), all mortgages (7586-8518), all savings/cash ISA/national savings (26315-33759), all credit cards (15701-20081), all loans (GfK definition) (2556-3545).

iii A new entrant in Table A4.1 has been defined as a firm with no market share in 2000 that subsequently gained any market share or share of new business. There is some uncertainty in the exact figures as the number of survey respondents with an account from a very small provider can be very low. The *Interim Report* reported that there were six rather than five new entrants into the PCA market from 2000 to 2010. Source: Commission analysis of GfK NOP FRS, 5 months ending September 2000-2010, main current accounts (21396-24789), all mortgages (7586-8518), all savings/cash ISA/national savings (26315-33759), all credit cards (15701-20081), all loans (GfK definition) (2556-3545), new main current accounts (1061-1487), new mortgages (943-1833), new savings accounts/cash ISA/national savings (1799-4519), all new credit cards (1761-2623), all new loans (GfK definition) (501-1160).

iv Standard PCAs in Figure A4.3 are those that have no monthly charge, no restrictions on where they are offered, are not youth or student accounts and are not private bank accounts. The deposit interest rate used is the rate paid on balances of £1000. Source: Commission analysis of data provided by banks, GfK NOP FRS and Defaqto. GfK NOP FRS data used for brand weighting only. All assumptions and analysis conducted by the Commission.

v Standard PCAs in Figure A4.4 are those that have no monthly charge, no restrictions on where they are offered, are not youth or student accounts and are not private bank accounts. The deposit interest rate used is the rate paid on balances of £1000. The interest rates for branch based instant access accounts and branch based notice accounts are estimates of the market average rates. Source: the Bank of England base rate, branch based instant access accounts and branch based notice accounts are from the Bank of England and the PCA interest rate on deposits for the four biggest banks is based upon Commission analysis of data provided by banks, GfK NOP FRS and Defaqto. GfK NOP FRS data used for brand weighting only. All assumptions and analysis conducted by the Commission.

vi Based upon Commission analysis of Defaqto data, and GfK NOP FRS, which was used for brand weighting only. The deposit interest rate used is the rate paid on balances of £1000. All the assumptions have been made by the Commission rather than data providers. Internet-only brands were not included in the analysis. Standard PCAs in Figure A4.5 are ones that offer free banking, no monthly charges, have no age restriction, no minimum income, no area restriction, an overdraft facility, at least 20 free withdrawals per month, no introductory credit interest rate and a minimum investment of no more than £300. Total cost includes the cost of arranged overdrafts, unarranged overdrafts and interest foregone. Figures are deflated by the GDP deflator and expressed in 2005 prices.

vii Based upon Commission analysis of Defaqto data, and GfK NOP FRS, which was used for brand weighting only. The deposit interest rate used is the rate paid on balances of £1000. All the assumptions have been made by the Commission rather than data providers. Internet-only brands were not included in the analysis. Standard PCAs in Figure A4.6 are ones that offer free banking, no monthly charges, have no age restriction, no minimum income, no area restriction, an overdraft facility, at least 20 free withdrawals per month, no introductory credit interest rate and a minimum investment of no more than £300. Total cost includes the cost of arranged overdrafts, unarranged overdrafts and interest foregone. Figures are deflated by the GDP deflator and expressed in 2005 prices.

viii Based upon Commission analysis of Defaqto data, and GfK NOP FRS, which was used for brand weighting only. The deposit interest rate used is the rate paid on balances of £1000. All the assumptions have been made by the Commission rather than data providers. Internet-only brands were not included in the analysis. Standard PCAs in Figure A4.7 are ones that offer free banking, no monthly charges, have no age restriction, no minimum income, no area restriction, an overdraft facility, at least 20 free withdrawals per month, no introductory credit interest rate and a minimum investment of no more than £300. Total cost includes the cost of arranged overdrafts, unarranged overdrafts and interest foregone. Figures are deflated by the GDP deflator and expressed in 2005 prices.

ix Based upon Commission analysis of Defaqto data, and GfK NOP FRS, which was used for brand weighting only. The deposit interest rate used is the rate paid on balances of £1000. All the assumptions have been made by the Commission rather than data providers. Internet-only brands were not included in the analysis. Standard PCAs in Figure A4.8 are ones that offer free banking, no monthly charges, have no age restriction, no minimum income, no

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

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

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

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

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

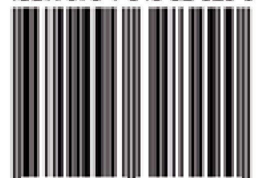
xiv Standard PCAs in Figure A4.14 are ones that offer free banking, no monthly charges, have no age restriction, no minimum income, no area restriction, an overdraft facility, at least 20 free withdrawals per month, no introductory credit interest rate and a minimum investment of no more than £300. Total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

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

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

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

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


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