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Interim Report Feedback
Independent Commission on Banking
Victoria House
Southampton Row
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4 July 2011

Dear Sirs

We thank the Commission for the opportunity to comment on these important proposals. Our response reflects our views on how to ensure that the proposed measures achieve their intended objectives and the practical steps needed to make them workable. Our comments draw on our experience in the banking sector and our work with regulators, as well as discussions with a range of business and government clients.

The social and economic costs of the financial crisis continue to weigh heavily on the UK. The Independent Commission on Banking review will be judged on its ability to bolster the stability of the financial services sector as well as promoting competition. It will also need to reconcile the financial services sector's importance to the UK economy with the need to limit support from, and risk to, the taxpayer. We welcome the overall direction of the interim proposals as representing an important step towards these aims. However, we believe that further consideration and modifications are likely to be required to make sure the measures are effective and workable.

Solving the right problems

It is critical that the Commission has a clear view of the problems it is seeking to resolve, as this will guide the assessment of reform options. While the financial crisis had a number of complex and interlinked contributing factors, the key problems that need addressing are the potential build-up of excess risk and the inability of the overall system to maintain liquidity and individual institutions to bear losses in a crisis. Asset price volatility and maturity transformation are fundamental aspects of banking, so risks within the sector will always need to be managed rather than eliminated in their entirety. Therefore, the ability to withstand and deal with crisis events when they occur – and they undoubtedly will – is the appropriate lens through which to view this challenge.

Ring-fencing is potentially valuable to the taxpayer, but is not a panacea

Placing barriers between investment and retail banking does not eliminate risk. We are therefore unsure about the primary purpose of the proposed ring-fence. Is it to allow separation of banking activities following an event in a crisis, or is it designed to reduce the risk on either side of the ring-fence on an on-going basis? The former relates to reducing the impact of a crisis, the latter relates to reducing the probability of a crisis. Both are laudable aims, though being clearer about the primary objective will help to determine the appropriate specifications of the ring-fence and help judge how the ring-fence operates alongside other reforms. As numerous reforms have been designed to reduce the probability of bank failure and systemic crisis (e.g. higher capital and liquidity requirements), we believe the focus of the Commission should be on how it can assist successful resolution in the event of bank failure and that the ring-fencing proposal should be seen in that light.

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There appears to be an implicit assumption in the report and more widely that retail banking is inherently less risky than investment banking. This is far from the case. The Northern Rock example demonstrates that retail banking is exposed to both asset price volatility and unstable deposit funding. Therefore, risk management is of equal importance to retail banks as it is to their wholesale counterparts. Risk management is vital in allowing retail banks to uphold the quality of their loan book, avoid concentration of exposures and ensure a sustainable funding mix.[1] While ring-fencing can help to isolate and limit risks, it is not a sufficient safeguard on its own.

Need for clear definition of boundaries

The Commission should carefully consider how ring-fencing will work in practice to ensure the right balance between the benefits and potential costs. The major benefit of ring-fencing is that it allows governments and supervisors to compartmentalise risks and the potential subsequent losses of a bank. It therefore gives taxpayers the potentially valuable option of choosing not to recapitalise the non-retail activities of a bank; they can focus primarily on the retail depositors, and support the non-retail elements only when absolutely necessary for market stability. However, it is not clear how ring-fencing will achieve stability in any significantly better way than the current work being undertaken on 'Recovery and Resolution'.

The ring-fencing needs to be fully considered in terms of costs, benefits and potentially negative consequences. For example, restrictions on the transferability of funds and distribution of profits between the retail and investment bank could heighten the risk of instability, particularly if it discourages banks from carrying out a range of businesses. As an example of the benefits of carrying out a range of businesses, we observe that many universal banks have benefited from strong investment banking performance over the past two years and have been able to use these returns to support the group as a whole. Ring-fencing may also have a knock-on impact on the pricing and availability of products for bank customers. The consequences will vary according to the business mix of the bank.

The governance implications for the new bank formed in any proposed split is a critical issue that calls for further consideration. Reconciling group and entity governance has been a challenging area for many years and ring fencing will add a new dimension. Clearly the new bank's board will need to have the experience and capacity to manage the bank's affairs prudently, as a separate legal entity, in accordance with regulatory standards (and of course in accordance with the individuals' legal duties as directors). This has the potential to raise challenges for the board members of complex groups and for their regulators, particularly in times of stress.

It is also important to ensure that the boundaries of separation are clear in relation to the infrastructure of the bank. This includes the demarcation in key operational areas such as treasury, payments and centralised services. The extent of separation will affect the time it will take to enact the operational separation and hence implementation of the proposals. Greater operational separation will enable the retail operation to stand on its own if a crisis takes hold, but will give rise to higher implementation and ongoing running costs.

Creating a separate company to provide arm's length services to both arms of the bank in areas such as payments could provide a viable solution. However, it will be important to consider whether such a

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[1] In the case of Northern Rock it was also the tapping of capital markets through mortgage book securitisations which accelerated its growth and increased exposure to both asset price falls and closure of funding sources. In this case, better risk management rather than a ring-fence could have reduced the risk of and impact in the event of a bank failure.

company might be so reliant on business from the investment bank side that it would be difficult to sustain its obligations to the retail side if the investment bank ceased operations. The arrangements should therefore take account of the balance of business within the group.

Expanding the armoury beyond capital requirements

The proposals put forward capital requirements as a key foundation of financial stability and protection for taxpayers. While the need for higher levels of capital than were in place before the financial crisis is recognised, the rationale for the interim proposals on capital is insufficiently explained. UK banks have taken strong steps to recapitalise. Using Basel II definitions of regulatory capital, we estimate six major UK banks will converge – over time – on a 16% Tier 1 capital ratio as the Basel III reforms are implemented. This is already close to the figures suggested by the Bank of England in their optimal bank capital analysis.[2]

It is also essential that capital is supplemented by other mechanisms for promoting the safety and stability of retail banks. A sudden withdrawal of deposits, inability to access wholesale funding markets or over-exposure to a collapse in asset values such as property prices could lead to a failure however well-capitalised the bank.

We therefore agree with the Commission that the most effective approach is to draw on a range of regulatory and management mechanisms to protect against bank failure, rather than over-reliance on capital requirements. These mechanisms should include an appropriate focus on loss-bearing debt instruments and the management of individual product risks, along with the need to avoid a potentially dangerous concentration of exposures (for example to the property sector). Effective stress testing, scenario evaluation and recovery and resolution planning are also of course critical elements in the frontline management of the bank.

Managing the economic impact

As many commentators have noted, further banking sector reforms should help to strengthen financial stability, but are likely to incur economic costs. These costs can arise from higher capital and liquidity requirements, operational requirements or funding constraints being translated into higher prices for credit and lower deposit rates, along with restrictions in the availability of credit and commensurate impact on economic growth. It is therefore vital that the economic impact of these proposals, for example in a tight ring-fencing regime, is fully assessed.

There has been considerable research about the overall cost of financial crises (and hence the benefit of avoiding crises), but little work on how individual reforms (both enacted and still under consideration) reduce the likelihood and impact of financial crises. It will be important to make sure that the way that the costs and benefits are analysed does not overstate the benefits ascribed to individual reforms.

In considering the economic effects it is also important to recognise that bringing the concept of Systemically Important Financial Institutions (SIFIs) into prudential regulation could lead to the market viewing a limited number of large banks as having implicit state backing. As a result, they may gain more favourable credit terms than smaller competitors (though it is also arguable that such backing was already assumed). The competition implications of this state-supported 'too big to fail' benefit should be fully thought through at least as carefully as those for prudential regulation.

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[2] External MPC Unit Discussion Paper No. 31, Optimal bank capital by David Miles, Jing Yang and Gilberto Marcheggiano, January 2011, revised and expanded April 2011.

Need for further assessment of the impact on the competitiveness of the UK as a leading financial centre

National competitiveness (as represented by decisions to carry out high value added banking functions in the UK) is a key element in GDP growth. Banking is an important employer in its own right, as well as a major contributor to tax receipts and a positive trade balance.[3] While we recognise the steps taken by the Commission to assess the impact of its proposals on competitiveness, it is important to consider the cumulative effect of new regulation on the choice of whether to invest and headquarter in the UK. It is notable that the CBI/PwC Financial Services 'Industry Sentiment' survey (April 2011) found that 87% of financial services respondents thought that new rules have made the UK less competitive (95% for banks, building societies, investment managers and life insurers). [4]

Limited impact on customer choice

As they stand, in our view, the proposals on promoting competition are unlikely to encourage new entrants or increase choice for customers, which are key aims of the review. This is a complex issue and we therefore believe there should be a broader debate about how to promote competition and choice that goes beyond the proposals outlined by the Commission.

The Commission rightly notes that competitive pressures differ across segments of the banking industry. For example, concentration is far greater for SME banking services than retail mortgage markets. Many of the current proposals are directed towards consumer markets, whereas measures to strengthen competition in SME business banking markets appear to have been overlooked.

While we support easier switching of bank accounts as a step towards a more efficient banking market, at present the economic rationale for bank account switching is not high, or at least not readily evident, for example when compared to utility and telecommunications markets. There is little pattern of switching in the sector and there needs to be more evidence about whether this is for positive reasons (e.g. consumers are happy with their bank) or detrimental reasons (e.g. the switching process is difficult). So even if switching were to be made easier through such measures as portable bank accounts, we do not believe there would be significant take-up under the current proposals.

Account switching is one possible barrier to market entry or expansion, but there are many others that need to be brought into the debate. For example, the high fixed costs of running a bank (capital, funding and infrastructure) are a potentially critical impediment to market entry, especially as these cannot be offset by the economies of scale and cross-selling opportunities enjoyed by more established banks. So even if there are profitable opportunities for new entrants, the incentives for start-ups and non-bank entrants may be limited. This is why more radical options need to be considered if the Commission wants to have a meaningful impact on competition in the banking industry.

There is a possibility that continued technological advances (e.g. contactless payment, electronic banking, peer-to-peer lending, etc.) mean that new business models and competitors could emerge throughout the banking value chain. The Commission should consider measures which promote and protect these emerging business models, as this is where future competitive pressure is likely to come from.

Finally, targeted support for start-ups and non-bank entrants could create a more even playing field and provide greater financial incentives for the creation of new and more differentiated retail banks.

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[3] Trends in UK financial and professional services, TheCityUK, June 2011.
[4] CBI/PwC Financial Services Survey, April 2011.

Such support should be industry-provided, rather than government-funded. Possible measures for further consideration might include access for smaller/new entrant banks to a cross-sector payment and clearing infrastructure or the ability to offer services through an easily accessible distribution network such as existing bank branches. The debate might also consider mechanisms for providing liquidity support for mortgage lending, access to a higher threshold for depositor protection, greater assistance to obtain FSA/PRA authorisation and temporary capital relief or exemption from the bank levy. Some of the measures to promote competition may have a potential impact on institutional stability, but if they are targeted at the smaller end of the banking industry, then any systemic risk is minimised.

Making decisions alongside a sea-change in regulation

A key challenge for the Commission is making policy recommendations while many other regulatory proposals are still being developed and implemented. We are concerned that no supervisory authority is assessing the cumulative impact of these changes, which risks overlapping, inefficient and costly reforms. The Commission needs to be mindful of these other regulatory developments in the context of (i) making choices between different reform proposals (where some reforms may be better than others and not all may be required); (ii) assessment of benefits (where only incremental benefit of individual reforms should be captured); (iii) overall impact on consumers and wider economy; and (iv) implementation timescales (where banks may struggle to implement all reforms simultaneously).

In conclusion, although the interim report outlines a number of useful proposals, several major issues remain and further work is needed to clarify and hone the measures. How these practical issues are resolved will have a crucial impact on whether the objectives of protecting taxpayers and bolstering competition are met. The overall impact of proposed reforms must then be thoroughly assessed. It will also be crucial to look at the bigger regulatory picture to ensure that a balanced and effective armoury of safeguards is in place and that the UK remains a leading global financial centre.

We would be pleased to discuss these issues further with you. If you would like to do so, please contact me on 020 7804 3431 or via e-mail at agray@uk.pwc.com.

Yours sincerely

Andrew Gray
UK Banking Leader

Comments on specific consultation questions

1.1: Do you agree with the general position set out in this Interim Report?

We fully support the need to protect taxpayers against the risk of a breakdown in the banking system and the need to fund the bail out of failing banks.

We recognise the progress made by the Commission and generally welcome the overall direction of the report's proposals, though we raise points in relation to the specific consultation questions.

2.1: Do you agree with the analysis set out in Chapter 2?

As 1.1

2.2: Do you agree with the analytical framework?

As 1.1

3.1: Are there other reform initiatives, beyond those set out in Chapter 3 and Annex 5, which you consider it essential for the Commission to examine further?

Assessing the interrelated impact of other regulatory reviews and developments is essential, particularly as they are evolving at pace. In addition to the reform initiatives cited in Chapter 3, we believe the Commission should consider parallel product level reviews being undertaken by the Financial Services Authority. Such reviews affect both the risk profile of the industry and the financial performance of banks (and therefore their ability to absorb regulatory changes).

The proposals should interact appropriately with the EU passporting regime, particularly in relation to any requirement for subsidiarisation. While large cross-border retail banks are relatively unusual, there needs to be a level playing field between UK and other EU banks if UK banks are not to be at a competitive disadvantage.

The ICB's work must also be developed in the context of the difference between the tax and regulatory treatment of debt and equity capital and the consequent incentives for the development of bank capital structures.

4.1: Should systemically important banks be required to hold more equity than Basel III requirements? If so, how much?

In general, we agree that systemically important banks should be supervised more closely and adhere to tougher regulatory requirements. However, the regulatory regime should also respond to other risk characteristics, the prevailing level of capitalisation and the impact of capital requirements on the economy. Any additional capital requirement for systemically important banks should be considered and implemented on a globally consistent basis and we support the on-going work of the Financial Stability Board in reviewing the capital requirements of systemically important banks on both a global and a national level.

Any assessment of additional capital requirements should take account of the progress made by UK banks in recapitalising their institutions since the financial crisis. In December 2010, five of the six leading UK banks held Core Tier 1 capital ratios (on a current definitional basis) in excess of 10%, a level that is emerging as a consensus benchmark. This is a 4% increase on pre-crisis levels and it is expected that as Basel III reforms are implemented, the amount of truly loss-absorbing capital in the system will further increase. This is because rules will tighten what qualifies as regulatory common equity capital and will further increase the equity capital that banks must hold to support their risk-weighted assets. Using Basel II definitions of regulatory capital, Table 1 sets out this capital improvement.

Table 1: Change in UK bank equity and Core Tier 1 ratios

	Equity[1] 2007 £billion	**Core Tier 1 2007 %**	**Equity[1] 2010 £billion**	**Core Tier 1 2010 %**
Barclays	23.3	5.6%	50.9	10.8%
HSBC	69.6	7.5%	94.6	10.5%
Lloyds Banking Group[2]	12.1	7.4%	46.1	10.2%
RBS	53.0	4.5%	75.1	10.7%
Banco Santander[2]	40.5	6.2%	64.4	8.8%
Standard Chartered	10.7	6.6%	24.5	11.8%
Total / weighted average	**209.3**	**6.2%**	**355.5**	**10.3%**

[1] Bank equity is calculated as total equity as recorded on the balance sheet less minority interest equity. This includes goodwill, preference shares and certain intangible assets which do not form part of Core Tier 1 regulatory capital.

[2] Includes acquisitions (e.g. LBG/HBOS and Santander's purchase of B&B)

Note: Figures are for banking groups.

Source: Bank statutory accounts, Capital IQ

In assessing the appropriate level of capital to be imposed by regulation in the UK, the work of the Bank of England is instructive.[5] This work built on earlier evaluations of appropriate equity capital ratios at the Bank of England, FSA and the Basel Committee on Banking Supervision by considering the impact of reduced debt funding costs as a consequence of a higher proportion of equity in the capital structure (the 'Modigliani-Miller' effect). This study concluded that a capital ratio in the high teens could be deemed optimal – considerably above the earlier studies.

[5] External MPC Unit Discussion Paper No. 31, Optimal bank capital by David Miles, Jing Yang and Gilberto Marcheggiano, January 2011, revised and expanded April 2011.

We think there are two observations required when informing conclusions from this work:

I. The study is based on empirical data of capital ratios over the past few decades. It is therefore based on Tier 1 as a measure of capital and consequently we think it important to consider how capital ratios on this Basel II Tier 1 definition are likely to evolve over the coming years. Our analysis suggests that the six large UK banks will converge on a 16% Tier I capital ratio as they strengthen their capital position in response to Basel III and other reforms. This is close to the figure suggested by the Bank of England and therefore questions the need for additional capital beyond what has been set out in the current proposals.

II. The Bank of England and others' assessment of benefits (i.e. cost of crises averted) is drawn from the empirical records of financial crises over the past 180 years. This evaluation is strongly influenced by some extreme geo-political crises – e.g. the world wars. It is therefore important to assess whether capital requirements are the best regulatory tool to use in such extreme events. We suggest that at any capital level, there is always the remote possibility that a crisis is sufficiently large to consume all available equity capital: the role of capital requirements should be to support stability in all but the most extreme events. Capital requirements for banks should be sufficient to support the sector through the magnitude of crisis we have just experienced, but not extreme geopolitical risks where individual bank capital has to be seen in the context of the broader national situation.

The first observation above suggests that bank capital ratios are already on the way to reaching an appropriate level; the second suggests that the ratio to adopt for regulatory purposes should be somewhat lower than suggested from empirical pieces of analysis.

The calibration of appropriate capital requirements also needs to be influenced by the perceived deliverability of successful resolution and recovery mechanisms. If resolution and recovery plans (especially if linked with some form of ring-fencing) can deliver successful resolution without tax payer support, then additional capital may simply incur unnecessary economic costs.

We strongly agree with the Commission that it is important to have a range and blend of tools and resolution mechanisms to sustain financial stability, rather than being over- reliant on any single mechanism. As such, while we recognise the need for higher levels of capital than before the financial crisis, relying on additional capital increases may not always be the surest way to strengthen financial stability.

Furthermore, it is important to recognise that increased capital and liquidity requirements are a potentially costly way of increasing financial stability and should be used carefully. In particular, the Commission should consider the potential for higher banking and borrowing costs and the impact this would have on investment and growth within the economy. Recent evidence of this can be seen in the rise in interest rates (APR) for unsecured personal loans.

4.2: Should UK retail banks be required to hold more equity than Basel III requirements? If so, how much?

We believe it is right that the Commission acknowledges the difference between international standards for all banks (whether they are systemically important or not) and the potential for a different capital target for UK retail banking activities. Such a distinction reduces the potential adverse impact on the competitiveness of the UK economy, but needs to be considered in the context of home regulation of foreign-owned UK bank branches by EU member state regulators.

Retail bank capital requirements should reflect the fact that retail banking is – like all forms of banking – inherently risky and that additional equity will not always provide desired total protection for taxpayers. We would certainly challenge any implicit assumption that retail banking is less risky than its investment counterpart.

Key risk considerations within retail banking include:

- The relative quality of the loan book, especially where a bank has concentrations of lending to particular subsectors such as real estate development.
- The mix of retail versus wholesale funding.
- The security of the bank's funding arrangements.
- The size and complexity of the bank.
- Customers' access to the Financial Services Compensation Scheme for resolution of issues, the structure and funding of the Scheme and the number of depositors above the compensation limit.

In our view, rather than being required to hold more capital, this range of risks requires a blend of enhanced regulatory and management tools and should include an appropriate focus on product risks and the need to avoid potentially dangerous concentrations of exposures. Effective stress and scenario testing and response mechanisms should also be integrated into the frontline management of the bank.

Additional equity is unlikely to cover risks such as the mass withdrawal of retail deposits, a substantial drop in house prices, or mass loan impairments from the combination of higher unemployment and rising interest rates. It is therefore more important to establish a regime that sets out who bears losses once existing shareholdings have been highly diluted. This would require bondholders to bear loss, and for the position to be clear at an early stage to allow effective and prompt resolution. We would favour measures built around convertible contingent bonds (CoCos) and 'bail-in' mechanisms, as these would provide natural incentives for shareholders to supply additional equity capital prior to bail-in events in all but the most extreme events. In the context of establishing a ring-fence between retail and investment banking activities, investors will need clarity on which side of the bank they are funding, as the risk of such bail-in/CoCo debt capital will differ.

4.3: Do you agree that bank debt should be made more loss-absorbing using some or all of contingent capital, bail-in-able debt and/or depositor preference? If so, which of these tools do you support and how should they be designed?

Change is needed. Both in the lead up to and during the financial crisis, existing capital instruments did not work due to the misalignment between the holders/investors, banks and regulators. While the market focus is currently on equity (core Tier 1 ratios) as the foundation of going concern stability (and therefore rightly the ongoing focus of regulators), going forward non-equity is a major backstop as a 'gone concern' resolution mechanism (that is, as a last tool to rebuild Tier 1 capital on near failure, rather than a substitution for Tier 1 capital in normal times).

In general, we would therefore favour more loss-absorbing debt capital and consider the successful introduction of such a regime as important to reducing the risk of requiring future taxpayer bailouts. In Denmark, 10 banks have failed since the onset of the financial crisis. Two institutions (Amagerbanken and Fjordbank Mors) were recently allowed to fail, with substantial losses borne by debt holders. This shows that taxpayers do not necessarily have to intervene. While these banks do not pose the same degree of systemic risk as larger UK banks, such a regime would help to minimise taxpayer support and restore funding costs towards an unsupported market level. CoCos and bail-in bonds, if properly designed and used, potentially could have a valuable role to play in this.

However, we caution that the success of the market for CoCo/hybrid capital instruments is dependent on the fair and transparent treatment of investors and appropriate risk management. Considerations include:

- Banks and regulators need to address a range of practical and operational issues, including what metrics to use for triggers, the level of triggers, assurance of key financial data and trigger metrics
- The 'death spiral', where a trigger event causes further loss of confidence and concerns over liquidity and solvency, is a problem that needs to be explored. This will require calibration of the amount of such capital and the conversion trigger points.
- The impact of CoCo triggers underlines the vital importance of the provision of regular and reliable information to investors and potential investors. Further work is needed here.
- The regulatory treatment of CoCo/bail-in holdings should consider who would be the likely holders of these instruments and the potential for destabilising concentrations of exposure on systemically important investors such as pension funds. With the holders likely to include insurers and asset managers, the Commission should bear in mind the potential impact of new regulations within these sectors (e.g. based on Solvency II and the AIFMD) to ensure that the macro-economic implications of such holdings are considered and any potential for market destabilisation is addressed.

The creation of liquid CoCo/hybrid capital markets is dependent upon global backing. In this regard, the Commission should closely follow developments of the Basel Committee's recommendations to the Financial Stability Board (FSB).

Finally in this area, for completeness the regulators should also reassess the appropriate role in bank funding of secured debt (e.g. covered bonds), which allocates specific assets to support specific creditors and potentially weakens support for general creditors.

4.4: In relation to structural reforms to promote stability, do you agree that the Commission should focus its work on a UK retail ring-fence?

We recognise that ring-fencing can provide a useful pre-defined fire-break for taxpayers in the event of a crisis. However, as outlined in our responses to earlier questions, it is also important to focus on other structural reforms including effective resolution mechanisms to ensure that the burden on taxpayers is curtailed.

A retail ring-fence gives the taxpayer the option of supporting or not supporting a non-retail business. The Lehman experience highlights this. If there had been a retail banking business on the Lehman Brothers International (Europe) (LBIE) balance sheet, UK taxpayers may have had to bail out Lehman investment bank clients and counterparties around the world with or without the support of international supervisors. The alternative, of course, is to let the compensation scheme support those depositors below the limit. This is a valuable tool, but in extremis when a bank is under very public pressure, a simple carve out of a separately capitalised retail bank combined with well-publicised state support (say over a weekend) is probably more likely to contain the risk of a run on a bank than a promise of future repayment via a compensation scheme..

However, as outlined earlier, retail banks have inherent risks. Ring-fencing retail activities may have the perverse effect of actually increasing the perception of the likelihood of a taxpayer-funded bail-out by signalling which part of the bank would be saved. It may thus deflect from addressing the more important need for effective risk management and strengthened supervision in the first place and mechanisms for resolution as a last resort.

The work on developing the ring-fence should prioritise the product sets which reside on either side of it, as this will allows banks to think through the operational considerations, implementation requirements and any potential unintended consequences. We consider this in more detail under 4.6 below.

4.5: What are the costs and/or benefits of a UK retail ring-fence, and what approaches could be taken to analysing them (noting Annex 3)?

Assessing the economic costs and benefits of proposed reforms is a fundamental requirement. Careful articulation and comparison of different reform options are needed, along with an assessment of what would happen in the absence of such measures. This requires careful specification of the current regulatory situation, or 'base case' and the situation with such reform proposals (often termed the 'but-for' or counter-factual case). Without this, there is a danger that there may be misspecification in the cost-benefit analysis.

There are a number of crisis situations which could be envisaged, involving either the retail activities or the investment activities of banks. History tells us there will be future crises, but that the source and transmission mechanism is usually different – no two crises are the same.

To illustrate this we might consider one crisis involving the activities inside the retail ring-fence, and another crisis involving activities outside the retail ring-fence.

First we need to define the current situation of how the regulatory and supervisory environment would respond to a crisis in the retail part of the bank. Here it is critical to set out the reform landscape which already exists. The Banking Act has made speedier resolution of failing institutions possible, but precedents have shown that governments will ultimately support large deposit-taking institutions. As banking reforms are implemented (e.g. improved ability for debt holders to bear losses through CoCos or bail-in capital), options for less costly taxpayer intervention may emerge (compared to what was available prior to the crisis). So defining the basis for the current situation is not simple, but the presumption is that the retail activities (inside the ring-fence) would ultimately be publicly supported.

Turning to the reform case, or counter-factual, in this example the ring-fence does not substantially change the nature of intervention. If the existing reforms are insufficient to save the failing institution, public support would still be required to prevent systemic risks.

In the case of a crisis in the investment bank part (outside the ring-fence) which was too large for the bank's shareholders to support, the current regulatory situation could involve a number of options including administration, a public recapitalisation, or in future may involve a bail-in type scenario. The decision on whether to proceed with a public recapitalisation is dependent on whether the benefits exceed the costs. In the case of substantial investment banking activities with a multitude of counterparties, the impact of allowing the investment banking activities to fail could be considerable, so there could be substantial benefits in averting such a failure. In this situation the ring-fence does not contribute, but may help move the retail banking activities onto a more stable basis more quickly.[6] If the benefits of public recapitalisation do not exceed the cost, then the ring-fence gives the government and supervisors the option of allowing the investment banking activities to fail, but for the crisis not to impair the retail banking and broader economic activity.

This construct is set out below:

Table 2: Possible construction of cost-benefit framework

	Without ring-fence	**With ring-fence**
Probability of retail failure	Systemic risks reduced through capital requirements (including CoCos, bail-in bonds) and other regulatory changes.	Systemic risks reduced through capital requirements (including CoCos, bail-in bonds) and other regulatory changes. Design of ring-fence further reduces probability of failure, but allows separate governance and/or higher capital requirements. Some risk-taking incentives may be counterproductive, because protection is assured.
Impact of retail failure	If retail failure poses a systemic risk, then the government would seek to provide public support.	If retail failure poses a systemic risk, then the government would seek to provide public support.
Probability of investment bank failure	Basel '2.5'/III reforms and RWA treatment mean investment bank failure risk should reduce.	Basel '2.5'/III reforms and RWA treatment mean investment bank failure risk should reduce. Ring-fence may force lower risk activities because investment banking activities will be forced to operate on a more stand-alone basis.
Impact of investment bank failure	Government would provide support if the cost was lower than the potential economic impact of a failure.	Government would provide support if the cost was lower than the potential economic impact of a failure. Government would not provide public support if the economic impact was lower (due to lower impact on retail activities in the ring-fence).

[6] Resolving retail banking activities quickly may help to restore credit flows to the rest of the economy – a source of concern frequently cited by small businesses and politicians following the recent financial crisis.

This construct demonstrates a number of key points:

- The impact of the ring-fence should not be assessed on the basis of saving a retail bank from potentially disastrous economic consequences, as it is assumed that the retail part would be saved if it had insufficient capital.
- The impact on the economy of financial crises plays a small role in the cost-benefit analysis; rather it is the costs of different resolution options in specific crisis scenarios which drive the assessment of benefits. This means that much of the general academic/empirical literature on the economic cost of financial crises is at best a start point.
- The benefit of the ring-fence is that it gives the governments and supervisors the option of not having to bail out the investment banking activities and knowing that the systemic risks of failing retail institutions can be averted. The value of this option will depend on the probability of exercising the option (which of course is difficult to assess given the unusual nature of possible circumstance), and how much the ring-fence reduces detrimental economic impact.
- The impact of the existing reforms (both enacted and planned) has gone a long way towards reducing the probability and impact of a crisis. This needs to be considered in setting the reference point for the cost-benefit analysis.

Using the construct described above, Table 3 below describes the elements required in the analysis of costs and benefits.

Table 3: Quantification of benefits of a UK ring-fence

Key components of benefits assessment
Assessment of the probability of a crisis event, where a ring-fence may have an impact in reducing the impact of a crisis. This can be carried out through a review of crises in the historical record, but would need careful consideration of relevant crisis events.
Assessment of the likelihood of utilising the ring-fence. This requires setting out the criteria for when the ring-fence would be used (as opposed to supporting the investment bank). This could be determined by size criteria).
Assessment of saved expenditure arising from not bailing out the investment arm of a failing bank. This could be assessed out by modelling the likely recapitalisation expenditure of a range of investment banking arms across banks in a range of crisis scenarios.
Any overall reduction in the probability of requiring recapitalisation in the retail bank arm. This effect could go in a number of directions. The ring-fence could result in tighter managed businesses and reduce the probability of failure, but the ring-fence may constrain the ability of banks to move capital and/or funding to where it is needed and may therefore increase failure risk on either side of the ring-fence. The ring-fence alone does little to affect these probabilities, but the way it interacts with other reforms and governance arrangements is how a benefit could be achieved.
Assessment of the cost of recapitalising the retail activities (within the ring-fence), across a range of crisis scenarios.
Reduction in value of the government guarantee, which may offset increased funding costs (see below).

Key components of cost assessment
Costs of setting up and running new infrastructure, reporting systems and separate governance requirements across the whole industry. This requires detailed quantification.
Increased funding costs, based on the funding of the different parts of the bank being carried out separately to a greater or lesser degree depending on regulatory policy decisions on the maximum extent of intra-group exposures and hedging. While this could have a bigger direct impact on the investment bank (which would lose its support rating, it could in turn impact the cost credit for larger corporates and the cost of banking products which require investment bank contribution (e.g. fixed rate mortgages).
Other inefficiencies arising from less integrated structure. This could relate to customer management (e.g. customer relationship) and any additional complexity from providing retail products which require wholesale bank components.
Direct losses due to the reduced activities of the failed investment bank activities across the probabilities of bank failure scenarios.
Indirect losses through banking supply chains and employee expenditure in the economy.
Broader economic costs comparing the failure in the investment banking activities where the retail activities are ring-fenced and where they are not. This would need to capture the impact of an investment bank failure on financial markets, liquidity and confidence.

Other effects that would need to be taken into account, but may be harder to quantify include:

- If there are increased tax costs, these normally constitute a transfer from one part of the economy to another and hence do not typically play a large role in cost-benefit analysis. However, the higher tax costs (e.g. due to a less efficient capital structure) will impact banks' post-tax returns and could result in upward pressure on product pricing and therefore affect certain economic segments more than others.
- Other benefits to regulators and banks from being able to identify and assess more accurate funding and operational costs across different business lines, in particular non-deposit borrowers.

On its own, the risk-fence may deliver few net benefits. However, the benefit of the ring-fence may be increased considerably if there are mechanisms for resolution for both retail and non-retail parts of the bank. It is therefore the combination of reforms which can lead to a more stable financial system, but in this case cost-benefit analysis should also be carried out on the combination of reforms, with clear articulation of how individual reforms contribute to the collective benefit.

We have observed a number of publicly-available estimates of the impact of a ring-fence, but would caution that a fuller design (e.g. which products are included within the ring-fence) and approach would need to be specified before undertaking detailed cost-benefit analysis.

4.6: How should a UK retail ring-fence be designed (noting Annex 7)?

It is important that the boundary is carefully and clearly defined. A wide range of questions arise. For example, what is the definition of SME banking for inclusion on the retail side, especially as even small SMEs can demand complex products (e.g. trade finance)? How would foreign exchange desks be treated, as they are likely to serve both retail and investment customers? How will retail products requiring capital market access be provided? To what extent would boards need to be separated to guarantee the required level of funding and risk management separation? What provisions would need to be built into recovery and resolution plans?

The principal product and client types required to be in any proposed ring-fenced bank need careful definition. We assume the intention would be for the new bank to be able to offer a full range of services appropriate to retail customers and relatively small businesses: these customers could need access to, for example, foreign exchange, commodity and interest rate management products as well as loans and deposits. The bank would also need to be able to access a range of asset types if it is to be able to manage its liquidity efficiently while carrying out the key maturity transformation function and thus generate income, growth and financial stability.

The proposed product range for clients will, we assume, need to be provided as principal by the retail bank in order for the client to benefit from the ring-fence on all the products – hence the new bank will do much more than just act as an agent for the provision of products from other group companies. Various options exist for the execution of these trades, and particularly for the extent to which one-to-one matching of such trades against back-to-back trades, for example against matching trades with the non-segregated arm or a third party bank. Alternatively, the bank could be given scope to risk manage its own positions rather than adopt one-to-one hedging, though this could give rise to the bank operating a 'trading book' in reality (as against the banking operations that we would assume are envisaged).

Taking this further, the management of the resulting intra-group balance via regular clearing, netting and collateral will need careful attention if the new bank's exposure to the rest of the group is to be controlled.

A number of practical considerations need to be taken into account in the design of these boundaries:

- The Commission should consider how to ensure appropriately delineated and accountable governance arrangements. In particular, is it enough to create a legal vehicle, or should a degree of management separation be in place to defend the integrity of the retail bank? Clearly the new bank's board will need to have the experience and capacity to manage the bank's affairs prudently, as a separate legal entity, in accordance with regulatory standards (and of course in accordance with the individuals' legal duties as directors). This has the potential to raise challenges for the board members of complex groups and for their regulators, particularly in times of stress.
- The commission should consider public and counterparty perceptions, for example the use of common branding by the ring-fenced and non-ring-fenced banks and requirements around disclosure of the contracted entity, particularly as regards depositor protection and SIFI status.
- The Commission should consider how to ensure suitable and robust risk management frameworks for both sides of the ring-fence.
- The Commission should consider how to ensure clear and appropriate levels of limitation intra-group lending, funding and complex risk transfers.
- The Commission should consider what happens when an operation begins on one side at the inception of the regulations, but would eventually be more appropriate on the other as it evolves. Is the delineation locked in at inception or can it adapt to reflect changing circumstances?
- The Commission should consider the impact on bank employee pension schemes, in particular whether and if so how funds and control should be separated.
- The Commission should consider how to make the ring-fence sufficiently flexible to adapt to changing market conditions, and prevent circumvention.

- The Commission should consider whether to allow a carve-out for particularly small institutions (e.g. small private banks or retail functions serving employees of international banks).
- The Commission should consider the impact on remuneration levels on both sides of the ring-fence. This is clearly an area of potentially added cost.

In assessing the rules of the separation, it is also important to consider the infrastructure of the bank. Some services are common to both retail and investment arms. The Commission should consider how these should be separated (e.g. full separation or service agreements)? Payment services is a particular case in point, as this is an area that would have to be maintained even if it fell within the investment arm. Payment and administration of salaries are also crucial, as without them the bank would quickly cease to function.

In general, a service company that provides services at arm's length to both the retail and the investment arms of the group is likely to provide the most viable solution. However, groups differ in the balance of retail and investment business and this will need to be considered as part of the solution. Indeed, there may be instances where the service company is so reliant on business from the investment side of the group that it would be commercially unviable if it were left with only the retail business. It will therefore be important to set principles for separation that protect the taxpayer, but can be adapted to the specific nature of the bank.

Finally, as a new regulatory intervention, the design of the ring-fence needs to consider carefully the unintended consequences. These include the impact on the provision of certain services on the retail side which depend upon capital market products provided on the wholesale side (e.g. fixed rate mortgages, and certain business credit products, like trade finance) and creating conditions which result in the exit by certain institutions from segments of the market. This is particularly the case for lending to large corporates, which could move away from using ring-fenced banks to international banks that are not required to follow such rules. Without clear guidance, the ring-fence will also provide incentives for the location of capital, funding and activities in order to maximise returns across the group. However, this could result in adverse risk profiles compared to a more integrated group.

4.7: Should the Commission pursue any other structural reforms to promote stability?

The Commission could consider ad hoc guarantees for deposits over the FSCS limit, for example when retail customers move large values on house sale/purchase.

4.8: Do you agree with the Commission's assessment of the impact on the competitiveness of the City and the UK economy of the reforms it is considering? Can you provide further data and analysis in this area?

National competitiveness (as represented by decisions to carry out high value added banking functions in the UK) is a key element in GDP growth. Banking is an vital employer in its own right, as well as a major contributor to tax receipts and a positive trade balance.[7] While we recognise the steps taken by the Commission to assess the impact of its proposals on competitiveness, it is important to consider the cumulative effect of new regulation on the choice of whether to invest and headquarter in the UK. It is notable that the latest CBI/PwC Financial Services 'Industry Sentiment' survey (April 2011) found

[7] Trends in UK financial and professional services, TheCityUK, June 2011

that 87% of financial services respondents thought that new rules have made the UK less competitive (95% for banks, building societies, investment managers and life insurers). [8]

The Commission's considerations should take account of the international nature of the financial services sector in the UK and the regulatory environment that facilitates this. In particular, a valuable amount of international business is booked in the UK because its regulatory environment understands and appropriately reflects the particular and often complex nature of this business.

4.9: Do you agree with the Commission's intention to consider a package of measures, and do you think that some elements could be relaxed if others were strengthened?

We broadly support the proposals, though there needs to be a balance between capital, liquidity, structural and resolution solutions.

As set out in 4.5 above, it is critical that the cost-benefit analysis is also carried out considering the package of reforms and the contribution of individual reforms to the overall financial stability benefits.

4.10: Over what timeframe should any reforms be implemented?

The timeline should be driven by the complexity of the ring-fence requirements. Only once the ring-fence has been fully defined and the operational consequences fully considered can an appropriate timeframe be considered. One key consideration is how to migrate long-term capital market funding to new entities on either side of the ring-fence.

As a broad guide, the timeframe of implementation could run in parallel with Basel III, as the capacity of banks to implement change effectively needs to be considered. In general, banks should be given sufficient time to respond to avoid the risk of over-hasty and potentially detrimental consequences.

Once the reforms are finalised banks will naturally seek to comply as soon as is commercially practical, as this reduces regulatory compliance risk. It is notable that banks have made strong steps to comply with the Basel III reforms despite the elongated reform timetable. This progress has been strongly signalled to the investor community, which increasingly considers readiness for Basel III a key risk.

5.1: Do you agree with the three broad measures proposed in this chapter (structural change, improvements to switching and barriers to entry, and pro-competitive financial regulation)?

Before considering the measures, it is not clear from the Commission's analysis the extent of the competitive problem. It is clear that concentration in the industry has increased across a number of market segments, but it is not clear that this has lessened competition detrimentally. It is also clear that switching levels are low (in comparison to some other industries), but a lack of actual switching does not necessarily demonstrate a lack of competitiveness. The Commission's analysis suggests that business banking segments are more concentrated, but most of the measures suggested appear to be targeted at consumer retail markets.

[8] CBI/PwC Financial Services Survey, April 2011

It is also far from clear whether the proposed measures would lead to improvements in competition and choice for consumers. First, in relation to structural reforms (additional branch disposals), in this situation, we suggest that in the longer term it is the competitive dynamics of the sector which tend to be of greater importance. Such suggested short-term structural reforms are unlikely to have substantial impact.

Looking at switching banks accounts, measures to make switching easier are generally welcome (this has been a consistent requirement following numerous competition reviews, and the industry has made significant progress over recent years). However, the possibility that few consumers will take up the option to switch needs to be considered in the cost-benefit analysis of such a move.

At present, the economic rationale for switching is not high, or at least not readily evident, especially when compared to the utility and telecommunications markets. We estimate that the annual cost of a current account for an average user in the UK is around £77,[9] compared to some claimed annual savings from switching energy suppliers of up to £300.[10] Therefore, even if switching were to be made easier through such measures as portable bank accounts, there is unlikely to be significant take-up under the current proposals.

We believe that greater transparency of costs and charges would have a more positive effect on competition and encourage account mobility by making it easier for consumers to compare value and make more informed decisions about their choice of bank. Making charges and services more visible is also consistent with the direction of the Retail Distribution Review, which provides a model that could be followed by retail banks for current accounts.

There are significant barriers to entry as a result of high fixed costs (capital, funding and infrastructure), especially as these cannot be offset by the economies of scale and cross-selling opportunities enjoyed by more established banks. So even if profitable retail bank opportunities do exist, the incentives for start-ups and non-bank entrants may be limited. There are clear trade-offs between encouraging entry and the risk of institutional failure. However, competition and encouraging new entry should be promoted, especially as the systemic risks surrounding smaller banks are small.

5.2: Should the Commission pursue any other measures to promote competition?

We believe that there should be a broader debate about how to promote competition and choice that goes beyond the proposals outlined by the Commission. Such a debate should focus on where there are demonstrable weaknesses in competition.

There is a possibility that continued technological advances (e.g. contactless payment, electronic banking, peer-to-peer lending, etc.) mean that new business models and competitors could emerge throughout the banking value chain. The Commission should consider measures which promote and protect these emerging business models, as this is where future competitive pressure is likely to come from.

[9] Calculated from: OFT, *"Personal Current Accounts in the UK"*, October 2009. The cost of £77 per active current account excludes any net credit interest earned by banks.
[10] http://www.moneymaxim.co.uk/articles-section/why-wait-for-ofgem%E2%80%99s-review-energymonitor-save-customers-nearly-300-a-year.htm and www.which.co.uk/switch/energy-advice/guide-to-switching-supplier

One reason why retail account switching is low is the current structure of account charges, where charges are typically levied on specific services and not the basic current account service. This naturally creates and hides the forgone interest cost to the consumer. Greater transparency of costs may require an end to this charging structure, which could result in itemised charging for individual components of the current account service.

While this could potentially put an end to the 'free' banking enjoyed by a large part of the market, it would be a more transparent approach. Comparable models exist in much of Continental Europe and North America. The competitive pressure on banks would in turn pave the way for more differentiation of accounts, designed around particular patterns of customer demand.

However, the first mover disadvantages of eliminating 'free' banking mean that no bank is likely to make this step at present. The only way that this more open and competitive market would develop would be through some form of regulatory intervention.

5.3: What factors make smaller banks more likely to exert competitive pressure on larger incumbents?

Support for start-ups and non-bank entrants would create a more even playing field and provide greater financial incentives for the creation of new and more differentiated retail banks. The support should be temporary and proportionate to the benefits – a hand-up not a hand-out. Such a hand-up should be industry-provided, rather than government- supported (where state aid considerations and public resistance limit the amount of support possible).

Possible measures for consideration by the Commission might include:

- Ability to offer a broader range of services through an easily accessible distribution network, preferably through branches of a larger banking incumbent (rather than a non-bank retail network).
- Reduced regulatory requirements (which could relate to capital, liquidity or reporting) or support in making the process for becoming FSA/PRA authorised easier.
- Liquidity support for mortgage lending, so that growth is not constrained by a smaller bank's own balance sheets. Provided the small bank's lending is of sufficient quality, then incumbent banks could provide access to funding, with possible recourse to the underlying mortgages.
- A higher FSCS threshold, as depositors will be wary about depositing amounts above the FSCS limit in smaller banks. This would help to neutralise the advantage of large ring-fenced banks.
- Tax breaks or temporary capital relief or exemption from the bank levy (which, unlike the above, would be a public cost).

As the retail side of any ring-fenced bank will still be implicitly supported by taxpayers, there is an argument for these ring-fenced retail activities bearing the cost of such initiatives designed to promote entry and expansion by smaller banks.

5.4: Where are the limitations on customers' abilities to understand banking costs, compare different accounts, and switch between them?

At present there is no comparison of forgone interest on credit balances. Charges are sometimes for unexpected items (e.g. unauthorised overdrafts), so are generally not considered when making account choices. There is also a perception that changing bank accounts is difficult (or leads to complications), though evidence suggests switching is normally routine. The underlying issue is the level of financial literacy, though improved transparency would encourage greater scrutiny and awareness.

5.5: What costs might an improved switching process impose on banks and direct debit originators?

Easier switching processes for the customer will exert substantial operational costs on banks. There may also be further costs if customers maintain multiple accounts and do not close old accounts. However, we believe that the current proposals are unlikely to lead to a significant increase in switching, so the potential for additional net benefits will be marginal.
Easier switching within a mandated timescale could also have an effect on banks' modelling of extreme liquidity events as required by FSA, by making it easier for a loss of confidence to be followed by a liquidity outflow.

5.6: How could the costs of meeting prudential requirements be mitigated for small banks and new entrants, while ensuring safe practices in all banks?

Such costs arise from managing compliance and from the cost of capital required. A reduction in the costs of meeting prudential regulation could come via simplification, or lowering of levels of capital/liquidity required, or both:

- The volume and complexity of prudential regulation has grown very significantly in recent years and even large banks (SIFIs) struggle to maintain a corps of expert staff and processes to meet the requirements. For smaller and start-up banks this is doubly difficult.
- Regulations that may be appropriate for systemically critical groups may not be appropriate for their smaller and less systemically risky counterparts and may reduce the ability of smaller banks to compete.

If, as is generally accepted, SIFIs should hold more capital as a result of the systemic risk they bring, non-systemically important institutions should by the same argument hold less. Failures at such banks arguably create few systemic issues and alternative tools can be used, not necessarily the high levels of capital required of SIFIs. Provided that any lessening of prudential requirements can be constrained to smaller banks (as defined by market share, turnover or other metrics), then it should be possible to construct a mechanism of support that would provide liquidity or capital or additional protection (beyond current FSCS limits). The key to making this work is that FSCS should be seen by policymakers as more than an arrangement to allocate a minimal amount of losses. Instead, the scheme should be seen as a structured and funded part of the regulatory system in normal times as well as crises.

5.7: How could small banks' ability to offer a national network of cash handling services be improved?

Precedents for such contractual arrangements already exist for smaller institutions offering cash handling services through larger high street counterparts. It is also possible to provide cash handling through an intermediary such as the Post Office.

There are a number of ways of introducing regulatory requirements to open up the provision of wholesale banking services further:

- A formal regulatory requirement to provide wholesale services for smaller/new entrant banks. If this is adopted, it will be important to establish a framework governing the pricing and terms of access.
- A 'reference offer' approach, as used in other industries, where large banks would publish a standard offer of the price and terms of access to cash handling services. This could be reviewed for reasonableness by a regulator, but different commercial arrangements could be agreed.

Regulators need to ensure that opening up the wholesale provision of cash handling and other payment services does not lessen competition on the high street. Banks view their branch networks as a source of competitive advantage, and so such wholesale services should only be available to smaller banks. In other words, regulators should avoid promoting the commercial incentives for a large bank to reduce its branch network by securing wholesale services from another large bank.

5.8: How should the Financial Conduct Authority discharge its duty to promote competition?

The primary function of the FCA should be to promote better conduct across the financial services industry, where there is a clear need to restore the industry's reputation following the mis-selling cases.

The FCA can discharge its competition duty both indirectly and directly. Indirectly, through its conduct work, it should not seek to place undue compliance costs which can deter competition and market entry. More directly it can:

- promote choice through transparency of both product attributes and charges and service providers
- seek to influence product design prior to launch
- encourage pro-competitive best practice from international markets
- support the work of the Competition and Market Authority (CMA) – the proposed successor organisation to the Office of Fair Trading and Competition Commission.