HM TREASURY

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Department for Business Innovation & Skills

The Government response to the Independent Commission on Banking

Cm 8252

December 2011

The Government response to the Independent Commission on Banking

Presented to Parliament by
the Chancellor of the Exchequer
by Command of Her Majesty

December 2011

Cm 8252 £20.50

Any queries regarding this publication should be sent to us at: public.enquiries@hm-treasury.gov.uk.

This publication is also available on http://www.official-documents.gov.uk/

ISBN: 9780101825221
PU1240

Printed in the UK by The Stationery Office Limited on behalf of the Controller of Her Majesty's Stationery Office

Printed on paper containing 75% recycled fibre content minimum

ID P002470109 12/11 19585 17527

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Foreword

This Government is proposing the most far-reaching reform of British banking in our modern history. That is because we recognise that banks play a vital role in any modern economy. They support lending to families and businesses. They allow individuals to save and invest for their future. And they oil the wheels of the economy, making possible the millions of transactions that we all make every day – from the cash machine to the checkout. And as one of the world's leading financial centres, Britain's banking sector creates hundreds of thousands of jobs, and contributes significant tax revenues to the Exchequer. But when banks failed, the whole economy suffered, jobs were lost and many billions of pounds of taxpayers' money were put at risk.

In the years leading up to the financial crisis, a failure of government regulation meant that banks borrowed too much, and took on risks they did not understand. By 2007, the UK financial system had become the most highly leveraged of any major economy. When the bubble burst, huge global banks proved 'too big to fail', and the UK taxpayer was called upon for billions of pounds to prevent widespread collapse of the financial sector. The part nationalisation of the Royal Bank of Scotland alone constituted the biggest bail-out in the world. In addition, competitive forces have not operated effectively in certain parts of the banking sector, in part due to mergers in the sector. This has led to consumers, including small businesses, not getting the products they need.

Over the last eighteen months, the UK has been at the forefront of the reform of financial sector regulation. Tougher standards for bank regulation have been agreed globally, and we are now seeking faithful implementation of them within Europe.

While the international regulatory response is important, the size of Britain's banking sector means we cannot rely on this alone to make our banking system safe. The legacy of the financial crisis therefore confronts us with what has been described as the 'British Dilemma'. How Britain can be the home of some of the world's leading banks, without exposing the British taxpayers to the unacceptable costs of those banks failing.

We both asked the Independent Commission on Banking (ICB), chaired by Sir John Vickers, to answer this question, and the ICB published its final report in September. It set out recommendations about how we ensure that British banks are better able to withstand losses, and that if a bank gets into trouble it can fail in a way that protects vital banking services without the use of taxpayers' money. The ICB also set out recommendations to improve competition, ensuring consumers can switch accounts easily, and that customers benefit from more competitive financial markets.

The Coalition Government warmly welcomes the ICB's recommendations. We believe the ICB has provided a compelling answer to the British Dilemma. We would like to thank Sir John Vickers and the other Commissioners for their impressive report.

Reform of the UK banking system is urgently needed. The ongoing financial instability in the eurozone does not undermine the case for reform. Far from it. The case for ensuring that banks no longer pose a risk to the stability and prosperity of the wider economy is stronger than ever, alongside driving competition to ensure that banks provide consumers and businesses with the best possible service and a diverse range of financial products.

The implementation of these reforms begins today. We will bring forward a White Paper in Spring next year, which will set out our detailed proposals, and all the legislation required to implement the recommendations will be enacted by the end of this Parliament.

George Osborne

Chancellor of the Exchequer

Chair of Cabinet Committee on Banking Reform

Vince Cable

Secretary of State, Department for Business, Innovation and Skills

Deputy Chair of Cabinet Committee on Banking Reform

Executive summary

In its final report the Independent Commission on Banking (ICB) made recommendations to promote financial stability and competition in UK banking. It recommended that its reforms be implemented no later than the start of 2019.

Financial stability

On financial stability, the ICB identified three key objectives:

- 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.

The ICB recommended a package of measures, consisting of ring-fencing vital banking services and increasing banks' loss-absorbency, to achieve these objectives. **The Government strongly supports these objectives and this dual approach.**

Ring-fencing

On structural reform, the ICB recommended ring-fencing vital banking services on which households and SMEs depend, keeping them separate from wholesale and investment banking activities. This would more effectively insulate them from problems elsewhere in the (global) financial system and make banks easier to resolve without taxpayer support. It would also curtail implicit government guarantees, reducing the risk to the public finances and making it less likely that banks will run excessive risks in the first place.

Improving resolvability of banks through structural reform is in keeping with international initiatives to make it easier to deal with failing banks. Structural complexity has been identified by the Financial Stability Board (FSB) as one of the most important barriers to successful bank resolution.[1] And a consultation document on a possible EU framework for bank recovery and resolution, published by the European Commission earlier this year,[2] contemplated changes being required to the structure of financial institutions, so as to reduce complexity in order to allow critical functions to be separated off in resolution.

The Government agrees with the ICB's recommendation that vital banking services – in particular, the taking of retail deposits – should only be provided by 'ring-fenced banks', and that these banks should be prohibited from undertaking certain investment banking activities. The Government agrees that structural reform of the banking sector is needed and supports the proposal for the creation of a ring-fence around vital banking services.

The ICB set out a number of principles on which the ring-fence should be based. For example the fence should be flexible in location but of sufficient height to ensure effective legal,

[1] *Effective Resolution of Systemically Important Financial Institutions,* Financial Stability Board, July 2011. Available at: http://www.financialstabilityboard.org/publications/r_110719.pdf.
[2] *Technical Details of a Possible EU Framework for Bank Recovery and Resolution,* European Commission, January 2011. Available at: http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf.

operational and economic separation between entities. The Government supports all these principles. Specifically, the Government intends that:

- there be a set of mandated services within ring-fenced banks consisting of retail and SME deposits and overdrafts;
- a set of wholesale and investment banking services should be prohibited from the ring-fenced bank in order to meet the objectives of the policy;
- the ring-fenced bank should be allowed to conduct ancillary activities to support the provision of its core functions;
- the ring-fenced bank should be legally and operationally independent from the rest of its corporate group; and
- economically the ring-fenced bank should not be dependent for its liquidity and solvency on the financial health of the rest of its group.

The ICB set out some further details to support these principles. For example ring-fenced banks should be regulated for capital and liquidity purposes on a solo basis, should not be over-reliant on the rest of the corporate group for funding and should undertake transactions with the rest of the group on a third party basis. There is further detailed work to be done to translate the principles into practice. More details on the ICB's recommendations on structural reform, and the Government's plans for taking them forward, are set out in Chapter 2. The ICB recognised that the case for *de minimis* exemptions to the ring-fence restrictions was finely balanced, but was not persuaded at the time. The Government's view is that there is a case for reviewing whether a *de minimis* exemption should apply.

Loss-absorbency

On increased loss-absorbency, the ICB recommended higher equity requirements for large ring-fenced banks, a minimum leverage ratio, loss-absorbing debt, insured depositor preference and higher levels of loss-absorbing capacity for banks that are difficult to resolve.

Many of these recommendations also fall within the range of measures contemplated by internationally agreed reforms. The Basel III rules clearly set minimum, not maximum, standards for equity and leverage ratios. The FSB's standards on resolution regimes require national jurisdictions to make debt loss-absorbing in resolution ('bail-in'). And the European Commission's consultation document on a framework for bank recovery and resolution contemplates both bail-in and requiring institutions that are hard to resolve to hold more loss-absorbing debt.

The Government supports the ICB's recommendations on loss-absorbency and sees these non-structural reforms as an important complement to ring-fencing in making banks better able to absorb losses, easier to resolve if they do fail, and in curbing excessive risk-taking. In particular:

- the Government intends to introduce higher equity requirements for large ring-fenced banks, and will seek sufficient flexibility in forthcoming European legislation to do so in the interests of UK and European financial stability;
- the Government strongly supports a mandatory, minimum leverage ratio for all banks, as recommended by the ICB, and believes there may be a case for applying a higher minimum leverage ratio to some larger banks;

- the Government agrees that the resolution authorities should have a statutory bail-in power to assist in bank resolution. The Government will seek to ensure agreement on including a robust bail-in power in the European crisis management framework;
- the Government supports the principle that systemically important banks hold a minimum amount of loss-absorbing capacity on a group-wide basis. However, if a bank can show that its non-UK operations do not pose a risk to UK financial stability and thus to the UK taxpayer, this requirement should not apply to those operations;
- on balance, the Government supports depositor preference, but believes that further analysis and consultation is needed on the scope of its application; and
- the Government is of the view that supervisors should be able to require firms that are difficult to resolve to have additional loss-absorbing capacity.

More details on the ICB's recommendations on loss-absorbency, and the Government's response, are set out in Chapter 3 below.

The ICB's financial stability recommendations have a clear focus on preserving the continuous provision of vital banking services located in the ring-fenced banks. However, it is important to draw a distinction between protecting the *provision of critical services* by ring-fenced banks, and protecting *investors.* Requiring ring-fenced banks to have more loss-absorbing capacity will ensure that the continuous provision of banking activities can be maintained, if necessary by imposing losses on investors – including creditors – not by guaranteeing them. **The Government's view is that all banks should be subject to normal competitive market forces, which means they must be able to fail safely without relying on a government guarantee and without putting the provision of critical services at risk.**

The ICB's proposals – by curbing incentives for excessive risk-taking, reducing the exposure of ring-fenced banks to the financial system and requiring non-ring-fenced banks to hold higher levels of loss-absorbing capacity – will also increase the resilience, and resolvability, of non-ring-fenced banks. This is crucial. But in order to be effective, this will require the introduction of a resolution regime for all non-ring-fenced banks, including any that may not be covered by the Special Resolution Regime. **The Government believes that all banks – including non-ring-fenced banks – need to be resolvable without the use of state resources, and believes the ICB's proposals are an important step forward. But they should be complemented by the introduction of a resolution regime that covers investment firms and financial holding companies.** This is discussed in Box 1.A.

Competition

On competition, the ICB made recommendations:

- to improve prospects for a strong and effective challenger to come out of the Lloyds divestiture;
- to mitigate barriers to entry and anti-competitive prudential requirements;
- to improve switching;
- to enhance transparency;

- to secure pro-competitive financial regulation; and
- on a possible future market investigation reference to the competition authorities.

The Government strongly supports all these objectives. A competitive banking sector is vital to ensure that the UK economy can benefit from banking products and services at efficient prices. Effective competition is also a spur to innovation and economic growth, and can lead to better quality and service for consumers. The emergence of a strong and effective challenger bank from the Lloyds divestiture – that would exert real, competitive pressure on the big banks – would be good for competition. A regulatory focus on improving competition is also consistent with strengthening the European single market – indeed the European Banking Authority and other European supervisory authorities are required to contribute to promoting "equal conditions of competition".[3]

The ICB's recommendations on financial stability will also help to address competition concerns in financial services, and complement the competition recommendations. As the ICB noted in its final report, financial stability recommendations that eliminate the implicit government guarantee are themselves pro-competitive. Where banks are regarded as 'too big to fail', market participants – in particular debt investors – will contract with them on more favourable terms than with smaller banks, distorting competition. Therefore measures to tackle the implicit government guarantee will help to remove distortions in the European single market.

Going beyond the ICB's recommendations, the Treasury Select Committee has called for the Payments Council, a private sector body responsible for setting the strategy for retail payment systems in the UK, to be brought within the scope of regulation. **The Government supports this, and will consult in the New Year on options for enhancing the regulatory framework for payment systems.**

More details on the ICB's recommendations on competition, and the Government's response, are set out in Chapter 4 below.

Economic impact and competitiveness

The ICB estimated that its package of recommendations would cost the banks £4bn-£7bn a year. The ICB said this could have a knock-on *cost* to GDP of around £1bn-£3bn a year, but this should be set against the *benefits* of reducing the annualised cost of financial crises of up to £40bn a year.

The ICB noted that the impact on the Government's fiscal position of the reform package would be complex but should be strongly positive. However, the ICB did not attempt to quantify this. On competitiveness, the ICB noted that its recommendations would only affect around 15% of the banking institutions in the City and would not affect insurance companies, fund management firms etc. By improving financial stability the recommendations would in fact be likely to increase the attractiveness of the UK as a place to do both financial and non-financial business.

The Government has conducted its own economic impact analysis, informed by modelling exercises carried out by the major UK banks. On the basis of this work, the Government has

[3] Regulation (EU) No. 1093/2010 of the European Parliament and of the Council of 24 November 2010. Available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:331:0012:0047:EN:PDF.

concluded that while the ICB's estimates do not capture the full range of costs, the measures that the ICB recommended will deliver net benefits to the UK economy and the taxpayer.

The Government estimates the **aggregate private costs to UK banks at £3.5bn-£8bn**. These additional bank costs are estimated to produce a **gross reduction in GDP of £0.8bn-£1.8bn**, somewhat lower than the ICB's estimate. Against these costs should be set the potentially much larger benefits to the economy from increased financial stability. Based on the ICB's estimate of the annual cost to the economy of financial crises, even if other regulatory reforms reduced the probability of a financial crisis by 30%, and the ICB's recommendations reduced the probability of a crisis by only a further 10%, and the output loss caused by a crisis by 25%, **the ICB's recommendations would yield an incremental economic benefit of £9.5bn per annum. The Government therefore believes that the economic benefits of implementing the ICB's recommendations would significantly outweigh the costs and will deliver significant net benefits to the economy and the public finances.**

On competitiveness, the Government is committed to ensuring that the UK continues to be at the heart of the international banking and finance sector. This is best achieved by establishing a stable financial system in the UK, not by providing implicit taxpayer subsidies to a small proportion of the financial institutions that constitute the City.

More detail on these issues, including the Government's own preliminary analysis of the economic impact and competitive effects of the ICB's recommendations, is set out in Chapter 5.

Implementation

The ICB said that its recommendations should be fully in force by no later than the start of 2019, consistent with the deadline for implementation of the Basel III reforms agreed by G20 leaders. The Government's intention is that implementation should proceed in stages with the final, non structural, changes related to loss absorbency fully completed by the beginning of 2019. **Primary and secondary legislation related to the ring fence will be completed by the end of this Parliament in May 2015 and banks will be expected to be compliant as soon as practically possible thereafter. The Government will work with the banks to develop a reasonable transition timetable.**

This response sets out the Government's initial views on the ICB's principal recommendations. The Government will bring forward a White Paper in Spring 2012 which will set out detailed proposals on the ICB's recommendations, and launch a consultation.

Implementation of the recommendations will strengthen the European single market, as one of the biggest distortions to this market is the perceived implicit government guarantees. The ICB's recommendations represent the UK's contribution to removing these distortions. The Government will work to ensure that current EU legislation does not hinder the reforms necessary to ensure financial stability and a sound financial system.

More detail on the proposed timeline and mechanics for implementation – and their interaction with the development of relevant European legislation – is set out in Chapter 6.

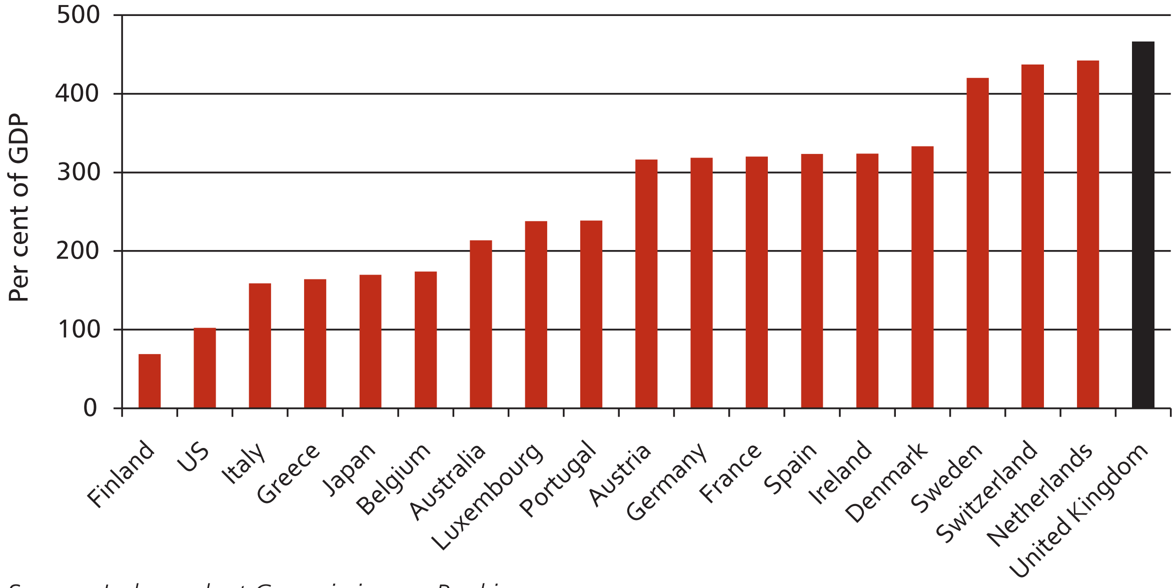
This response contains a number of outstanding policy questions. The responses to these will be used to inform the detailed proposals and further consultation that will be set out in the White Paper. Details on how to respond to the policy questions are set out in Chapter 6.

1 Introduction

Lessons from the recent financial crisis

1.1 The financial crisis that started in 2007 was caused by failures in the financial sector and in the regulation and supervision of that industry. Financial institutions failed to manage their business prudently and, in particular, did not understand the risks inherent in the activities they were conducting. At the same time, these institutions were growing rapidly. The balance sheets of UK banks went from around 300% of GDP in 1998 to around 500% a decade later. See Chart 1.A below. A number of firms became so large, interconnected and complex that their failure posed a serious threat to the financial system, and the regulatory system lacked the tools to deal with this 'too big to fail' problem.

Chart 1.A: Domestic banking assets as a percentage of GDP consolidated by nationality of headquarters (2009)[1]

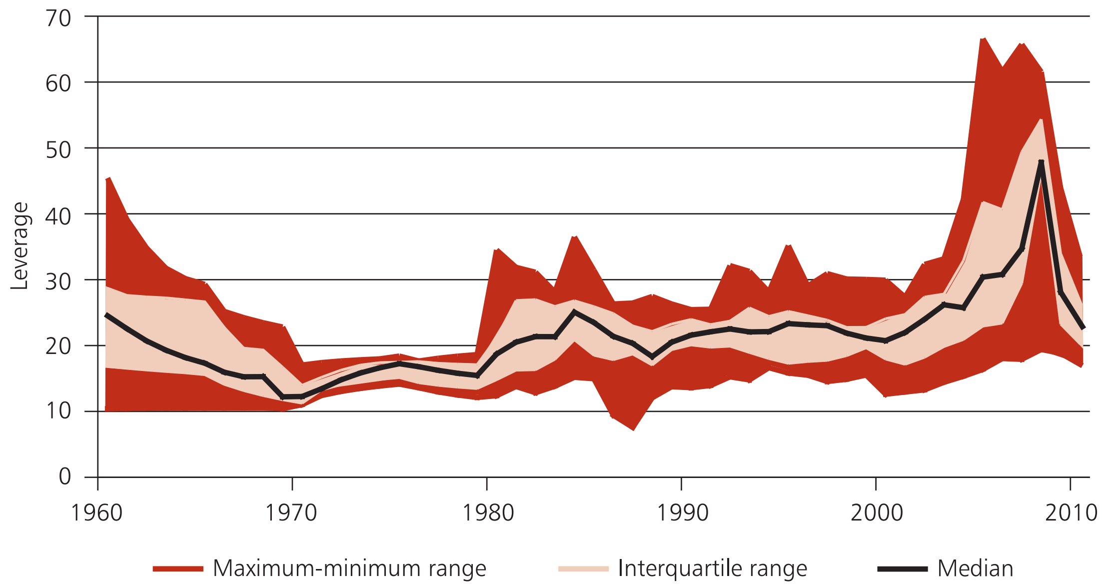


Source: Independent Commission on Banking

1.2 Regulators and supervisors failed to provide the robust scrutiny and challenge that was needed to ensure that the risks building up on the balance sheets of banks and other financial institutions were manageable – not only at the level of individual firms, but across the system as a whole. Levels of UK bank leverage soared in the first decade of this century. See Chart 1.B below.

[1] 'Domestic banking assets' are the global assets of all banks whose global headquarters are located in the relevant country.

Chart 1.B: Increase in UK bank leverage in the past fifty years



Source: Independent Commission on Banking

1.3 The financial crisis exposed the inherent weaknesses in the 'tripartite' system of regulation in the UK. No single institution had the responsibility, authority or powers to oversee the financial system as a whole. Before the crisis, the Bank of England had nominal responsibility for the stability of the financial system, but lacked the necessary tools. Responsibility for the regulation of financial firms was in the hands of the Financial Services Authority (FSA), which placed too much emphasis on 'tick-box' compliance. HM Treasury, meanwhile, had no clear responsibility for dealing with a crisis that put billions of pounds of public funds at risk.

1.4 The crisis showed that when things go wrong in the financial sector, the impact on the rest of the economy can be severe. The Royal Bank of Scotland (RBS) received the biggest bail-out in history, and in spite of part-nationalising two of the largest banks in the world and extending tens of billions of pounds of direct and indirect financial assistance to the sector, the Government at the time was unable to prevent shocks in the financial sector from spilling over into the wider economy. This led to the worst recession in living memory. And as financial institutions were taken over by competitors, or collapsed, competition – that in some markets for banking services was already severely constrained – was further reduced. Weaknesses in the banking system remain a headwind to growth.

1.5 Allowing big banks to collapse would have led to the disruption of vital banking services – including access to bank accounts and payment systems – with disastrous economic consequences. UK taxpayers were called upon to provide many billions of support to avoid a financial meltdown. At its peak, explicit support to the UK banking system was £1.2tn (for a breakdown of taxpayer support to different banks, and of support schemes offered to the financial system as a whole, see Table 1.A).

Table 1.A: Taxpayer support for the UK financial system during the recent crisis[2]

Guarantees and contingent liabilities	Maximum pledged support
Sector-wide schemes	
Credit Guarantee Scheme	£250bn
Special Liquidity Scheme	£200bn
Asset Backed Securities Scheme	£50bn
Recapitalisation Fund	£13bn
Unused facilities for loans to support deposits	£310mn
RBS and Lloyds Banking Group	
Asset Protection Scheme	£457bn
Contingent Capital in RBS	£8bn
Northern Rock	
Guaranteed Liabilities	£24bn
Contingent Capital	£3.4bn
Unused Working Capital Facility	£3.8bn
Bradford & Bingley	
Guaranteed Liabilities	£17bn
Unused Working Capital Facility	£3bn
Total guarantees and contingent liabilities	£1.03tn
Support provided in cash	**Maximum cash support given**
RBS Ordinary and B Shares	£45.8bn
Lloyds Banking Group Shares	£20.6bn
Northern Rock plc Shares	£1.4bn
Northern Rock (Asset Management) Loan	£21.6bn
Bradford & Bingley Working Capital Facility	£8.6bn
Other Loans to Support Deposits	£26bn
Total support provided in cash	£124bn
TOTAL SUPPORT TO UK FINANCIAL SYSTEM	**£1.2tn**
Source: National Audit Office	

[2] *The Comptroller and Auditor General's Report on Accounts to the House of Commons: The financial stability interventions*, National Audit Office, July 2011. Available at: http://www.nao.org.uk/publications/1012/hmt_accounts_2010-2011.aspx. Numbers may not sum due to rounding. The figures above represent the peak amount of support that was explicitly pledged to the financial system during the crisis. Not all pledged support resulted in actual cash payments. For example the peak amount of T-bills actually issued under the Special Liquidity Scheme was £185bn, not the £200bn figure in the table above. In addition, the final amount of assets covered through the Asset Protection Scheme (APS) is significantly different to the one above, as the expectations for the size of the scheme at its inception were much larger than the final covered asset pool (£282bn). The maximum contingent liability for Government arising from the APS was £200bn due to RBS being required to cover some losses itself before any payout would occur.

1.6 Even without a catastrophic banking collapse, the economic damage caused by the financial crisis was enormous, tipping the UK into the deepest recession for many decades. Economists have warned that recoveries from recessions after a financial crisis are slower than recoveries after other recessions,[3] underlining the importance of reforming the financial system to minimise the likelihood of future crises.

1.7 Since coming into office in May last year, the Coalition Government has made financial sector reform one of its top priorities and is delivering a number of targeted policy responses:

- a new UK regulatory framework to correct the failings that became apparent through the financial crisis;
- the FSA to be abolished in its current form, and a new Prudential Regulation Authority (PRA) established in 2013 as a subsidiary of the Bank of England;
- an interim Financial Policy Committee (FPC) has been established to begin monitoring systemic risk and to advise the Government on potential macro-prudential tools, with draft legislation already published to put the FPC on a statutory footing;
- the FSA and Bank of England have begun the process of splitting out prudential from conduct of business regulation, within the FSA, as a precursor to responsibility passing to the Bank of England; and
- the Government has introduced a levy to encourage banks to move to less risky funding profiles, and to ensure that banks make a fair contribution to reducing the deficit.

The British Dilemma

1.8 The legacy of the financial crisis poses what the Chancellor has described as 'the British Dilemma'. A robust banking system that provides important services – such as payment systems, deposit-taking and domestic lending – to households and businesses, is vital to any economy. But the UK also benefits hugely from its position as a global financial centre. As an employer and contributor of tax revenues, as an exporter of UK services to the rest of the world, and as a vital part of the economic infrastructure, a healthy financial sector is an important driver of growth in the UK.

1.9 The very size of the UK financial sector (see Chart 1.A) means that the UK cannot afford to let banks be underwritten by the British taxpayer, putting the broader economy at risk. Reform of financial regulation is needed to make banks more resilient, to allow banks that still fail to do so safely without cost to the taxpayer, and to improve the stability of the financial system. The benefits of reform to the British financial sector are not limited to the UK. As the IMF recently observed, "the stability and efficiency of the UK financial sector is a global public good, requiring the highest quality supervision and regulation."[4]

The Independent Commission on Banking

1.10 It was to address these issues that in June 2010 the Coalition Government set up the Independent Commission on Banking (ICB), with Sir John Vickers (chair), Clare Spottiswoode, Martin Taylor, Bill Winters and Martin Wolf as members. The Government's mandate to the ICB

[3] *Credit Conditions and Recoveries from Recessions Associated with Financial Crises,* Prakash Kannan, IMF Working Paper, March 2010. Available at: http://www.imf.org/external/pubs/ft/wp/2010/wp1083.pdf.

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

was to make recommendations to promote stability and competition in UK banking. In particular, the ICB was asked to make recommendations to address systemic risk and moral hazard in the banking system, and to consider the issue of separating retail and investment banking functions. In making its recommendations, the ICB was asked to have regard to lending to UK consumers and businesses, the pace of economic recovery, consumer choice, competitiveness and the Government's fiscal position. The ICB and its secretariat were set up independently of the Government, the other UK authorities and the banks, to ensure they were able to work freely and consider the issues before them objectively.

1.11 The ICB published its recommendations in September this year. On financial stability, while recognising Basel III and other international reforms as a major improvement, the ICB's view was that these did not go far enough. The ICB proposed that UK banks[5] should be required to 'ring-fence' vital banking services from other activities, and increase loss-absorbing capacity through higher equity and leverage ratios for ring-fenced banks, and via 'bail-in' of bank creditors (bondholders in particular). On competition, the ICB recommended that steps be taken to ensure that a strong and effective challenger comes out of the Lloyds divestiture, and that measures be taken to improve switching and consumer choice, and to secure pro-competitive financial regulation.

1.12 **The Government welcomes the ICB's final report and strongly endorses its conclusions. ICB proposals to ring-fence vital banking services, to increase banks' ability to withstand losses and to improve competition in retail banking in the UK, have provided an answer to the British Dilemma.**

1.13 This response addresses each of the ICB's recommendations and highlights the further work underway to implement them. There will be consultation on the detail. The recommendations go further than current European reform proposals, so the UK will also seek to reach agreement across Europe on robust regulatory reform to strengthen and safeguard the financial system.

The broader programme for reform

1.14 Implementation of the ICB's recommendations is just part of the broader programme of domestic and international reform launched and supported by the Government.

1.15 In his first Mansion House speech, the Chancellor announced the Coalition Government's plans to fundamentally reform the UK's failed system of financial regulation, to fulfil its commitment to provide the Bank of England with control of macro-prudential regulation and oversight of micro-prudential regulation.

1.16 In June the Government published draft legislation setting out its detailed plans for reforming financial regulation in the UK. As above, the Government is establishing a new system of focused financial services regulators:

- the FPC within the Bank of England, responsible for protecting and enhancing financial stability;
- the PRA, a new micro-prudential regulator with responsibility for ensuring effective prudential regulation of individual firms, as a subsidiary of the Bank of England; and

[5] The ICB's recommendations apply to building societies as well as to banks. In this response document, references to banks and/or ring-fenced banks should be taken to include a reference to building societies unless the context requires otherwise.

- a new independent conduct of business regulator, the Financial Conduct Authority (FCA), with responsibility for regulating the conduct of business of all financial institutions.

1.17 The Government's plans have been subject to pre-legislative scrutiny by a joint Parliamentary Committee whose findings are published on the same day as this response document. The Government will consider the Committee's recommendations and will introduce legislation to Parliament early in the New Year.

1.18 As well as protecting vital banking services, ring-fencing and increased loss-absorbency also aim to reduce the likelihood of failure, and improve ease of resolvability, of non-ring-fenced banks. A number of existing reforms – such as increasing the use of central counterparties for standardised derivatives, implementation of the investment bank Special Administration Regime (SAR), the requirement for all global banks to develop recovery and resolution plans (RRPs) and increases in capital for trading book assets – will all advance this objective. But in order to be effective, this will require the introduction of a resolution regime for all non-ring-fenced banks, including any that may not be covered by the Special Resolution Regime. This was contemplated in a consultation document on the proposed European crisis management framework for banks published by the European Commission earlier this year.[6] **The ICB's recommendation should therefore be complemented by the introduction of a resolution regime that should cover investment firms and financial holding companies.** The resolution of investment banks is considered further in Box 1.A.

[6] *Technical Details of a Possible EU Framework for Bank Recovery and Resolution,* European Commission, January 2011. Available at: http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf.

Box 1.A: Resolving investment banks[7]

The failure of Lehman Brothers in September 2008 demonstrated the risks of relying on a conventional insolvency procedure for a large investment bank. The ICB argued that ring-fencing will curb incentives for excessive risk-taking within universal banks, and will insulate retail banking against contagion from the disorderly collapse of investment banks. The ICB's recommendations on bail-in, primary loss-absorbing capacity and resolution buffers will also improve investment bank resolution. **The Government believes the ICB's recommendations would improve the resolvability of investment banks by reducing structural complexity within universal banks, and so incentivise investors to curb excessive risk-taking.**

The Government recognises the challenges in resolving investment banks and is working domestically and internationally on this issue. In February 2011, the Government introduced the Special Administration Regime for investment firms.[8] The UK subsidiary of MF Global was the first firm to be placed into the SAR. But the global nature of the largest firms and the complexity of their trading books means other UK and international policy reforms are necessary to ensure such firms are safely resolvable. **The Government supports the inclusion within the EU crisis management framework of a resolution regime – including a statutory bail-in power – for investment firms, and also for financial holding companies.**

The FSA's recent discussion paper on resolvability[9] highlights the extent to which the blending of different economic activities (e.g. retail and investment banking) within a single legal entity is one of the greatest barriers to resolving systemic UK banks. Recovery and resolution plans (RRPs) improve authorities' ability to diagnose and mitigate the risk of bank failure and to understand the barriers to orderly resolution. The Government therefore supports the extension of RRP rules for UK deposit-takers to include large investment banks. Requiring investment banks to have RRPs is consistent with the Financial Stability Board's (FSB) resolution standards[10] and the likely requirements of the EU crisis management framework.

But more is needed. The Government therefore supports the review by the Basel Committee on Banking Supervision of trading book risk weightings, which will improve the resilience of investment banks. Resolving a trading book will be simplified by international efforts to expand use of central counterparties and the clearing of certain standardised over-the-counter derivatives. The FSA continues to work with international authorities to tighten risk management of non-cleared derivatives through more robust portfolio reconciliation, dispute reconciliation and collateralisation requirements. These reforms will improve trading book transparency and reduce complexity to make it easier, for example, to maintain continuity in the event of failure by transferring client positions from one bank to another.

The Government remains committed to working with global partners to ensure the resolvability of investment banks. A strong global framework is important, to enable co-ordination and co-operation to protect against and respond to investment banks' failure.

[7] In this response paper, the terms 'investment bank' and 'investment firm' are used interchangeably, and should be interpreted to include both non-ring-fenced entities that conduct investment banking activities within a banking group and standalone investment firms and banks.

[8] *Establishing resolution regimes for investment banks,* HM Treasury, February 2011. Available at: http://www.hm-treasury.gov.uk/consult_investment_banks2.htm.

[9] *Recovery and Resolution Plans,* FSA, August 2011. Available at: http://www.fsa.gov.uk/pubs/cp/cp11_16.pdf.

[10] *Key Attributes of Effective Resolution Regimes for Financial Institutions*, Financial Stability Board, October 2011. Available at: http://www.financialstabilityboard.org/publications/r_111104cc.pdf.

1.19 The global nature of financial institutions and markets and the importance of the European single market mean that regulatory reform needs to be co-ordinated internationally, particularly within Europe with high and robust minimum standards underpinning strong national supervision. Key reforms that have been completed or are in train are set out in Box 1.B.

1.20 G20 leaders recognised that the Basel III reforms do not themselves fully address the risks presented by systemically important financial institutions (SIFIs). SIFIs include banks whose size, complexity and interconnectedness are such that their collapse would cause such disruption to the wider financial system and the real economy that they have been regarded as being 'too big to fail', and so effectively government guaranteed. Accordingly, the G20 tasked the FSB with developing a policy framework for addressing the risk posed by SIFIs and in particular financial institutions that are clearly systemic in a global context (G-SIFIs). Key details of the FSB's recommendations – endorsed by the G20 – include requiring countries to put in place measures to ensure that all financial institutions, including G-SIFIs, can be resolved safely and quickly, without destabilising the financial system or exposing the taxpayer to risk of loss. The UK will also press for amendments to recent European Commission proposals, to ensure full and faithful implementation in Europe of G20 agreements on banking reform, with no watering down.

1.21 Individual countries have taken forward their own initiatives to improve the resolvability of their G-SIFIs. For example, in the US the Dodd-Frank Act has introduced the Orderly Liquidation Regime which confers on the Federal Deposit Insurance Corporation the powers necessary to effect the orderly liquidation of covered financial institutions. Banks in Switzerland, Sweden, the Netherlands and Singapore will be required to have higher equity ratios than those mandated under Basel III. And banks in Switzerland will also be required to hold minimum amounts of debt that is designed to be loss-absorbing, if required.

1.22 Each country is finding its own way to establish a stable, sustainable financial sector. This Government is pleased to support the ICB's proposals as a solution to the British Dilemma.

Box 1.B: Other reforms to UK and international financial regulation

Regulatory institutions and supervision

- Radically reforming the UK regulatory and supervisory framework to correct the failings that became apparent through the financial crisis, by replacing the Financial Services Authority with the Prudential Regulation Authority and the Financial Conduct Authority.
- Strengthening the FSA's regime of stress testing financial institutions by requiring firms to improve their stress testing capability.

Capital and liquidity

- Basel III rules published by the Basel Committee on Banking Supervision (BCBS), raising minimum international standards for bank capital requirements (including putting in place a minimum leverage ratio) and introducing minimum standards for liquidity, and amendments to the Capital Requirements Directive and introduction of a Capital Requirements Regulation (together, CRR I/CRD IV) through which the Basel III rules will be implemented in the UK. The UK is seeking amendments to the European Commission proposals to ensure that there is no watering down of the Basel III agreement, or opt-outs for certain countries.
- Rules published by the BCBS requiring significantly more capital to be held against banks' trading book assets.
- Work by the BCBS to improve consistency in the way that global banks calculate risk-weighted assets.
- Measures set out by the Financial Stability Board (FSB) and the BCBS to introduce additional loss absorbency requirements for global systemically important banks (G-SIBs). The UK will seek to ensure that these binding minimum standards are incorporated into European legislation.
- Introduction by the FSA in 2008 of an enhanced regime for bank capital.
- The FSA's enhanced liquidity regime and the Bank of England's discount window facility to improve UK banks' ability to cope with funding stresses.
- The Bank of England's recently announced Extended Collateral Term Repo (ECTR) facility will also allow banks to effectively mitigate market-wide shortages of short-term sterling liquidity, where they arise.

Recovery and resolution

- Putting in place a special resolution regime to enable the orderly resolution of failing UK deposit-taking firms, a special administration regime to deal with failing investment banks, and a requirement under the Financial Services Act 2010 for all UK deposit-takers to have in place a recovery and resolution plan. The FSA is expected to publish final rules on RRPs in the first quarter of 2012 and firms will have until June 2012 to prepare their initial RRPs.
- Recommendations from the FSB on international standards endorsed by the G20 for national resolution regimes (including bail-in), requirements for RRPs for global systemically important financial institutions to be initially reviewed by 2013, the development of cross-border co-operation agreements for their resolution, and more intensive and effective supervision.

Box 1.B (continued): Other reforms to UK and international financial regulation

Recovery and resolution (continued)

- Forthcoming legislative proposal from the European Commission for a directive to establish an EU crisis management framework for the recovery and resolution of banks and investment firms.

Macro-prudential regulation

- Establishing an interim Financial Policy Committee of the Bank of England to monitor systemic risk and provide recommendations to the authorities in relation to oversight of the financial system and the use of macro-prudential tools.
- Setting up the European Systemic Risk Board with responsibility for macro-prudential oversight of the financial system within the EU.
- Work by the FSB, the BCBS and the IMF to develop effective macro-prudential policies and frameworks.

Market infrastructure

- Strengthening financial markets infrastructure and improving transparency internationally by encouraging derivatives trades (over-the-counter or traded electronically including on regulated markets/exchanges) to be centrally reported and/or cleared through central counterparties.

Remuneration

- Proposals for the largest banks operating in the UK to disclose the remuneration of their eight highest paid senior executive officers,[11] putting the UK at the forefront of major financial centres on remuneration transparency.
- The FSB's implementation standards on compensation practices requiring material risk takers at significant financial institutions to make high-level disclosures on some elements of remuneration.
- The revised Capital Requirements Directive (CRD3) – broadly consistent with the FSB standards, the requirements in CRD3 impose more stringent provisions on the structure and disclosure of remuneration.
- The revised FSA remuneration code, implementing the provisions of CRD3, and ensuring that remuneration policies and practices are consistent with and promote effective risk management.

[11] *Bank Executive Remuneration Disclosure: Consultation on Draft Regulations*, HM Treasury, December, 2011. Available at: http://www.hm-treasury.gov.uk/d/condoc_bank_executive_remuneration_disclosure_6122011.pdf.

2 Ring-fencing

The ICB's ring-fencing recommendations

2.1 The ICB recommended that UK banks ring-fence their retail and SME deposit-taking businesses in a separate, financially independent legal entity, subject to higher prudential requirements.

2.2 The ICB set out five principles for the design of the ring-fence. The first three govern the 'location' of the ring-fence and the last two govern the 'height' of the ring-fence. The principles are:

'Location' of ring-fence

1. that there be a set of **mandated services** consisting of retail and SME deposits and overdrafts;
2. that there be a set of services that should be **prohibited** from the ring-fenced bank in order to meet the objectives of the policy;
3. that the ring-fenced bank be allowed to conduct activities that are **ancillary** to the provision of mandated or permitted services;

'Height' of ring-fence

4. that the ring-fenced bank be **legally and operationally independent** from the rest of its corporate group; and
5. that **economically** the ring-fenced bank should not be dependent for its liquidity and solvency on the financial health of the rest of its group.

2.3 The Government has already accepted the case for ring-fencing banks' retail operations and **confirms it will implement the ring-fencing of important banking services whose continuous provision is vital to the economy and bank customers.** This chapter addresses the purpose, objectives and governing principles of the ring-fence. There are a number of questions at the end of this chapter to which responses are invited.

Purpose and objectives of the ring-fence

2.4 The ICB said that the ring-fence should "isolate those banking activities where continuous provision is vital to the economy and a bank's customers to ensure that this provision is not threatened as a result of activities which are incidental to it and can be maintained if a bank does fail, without recourse to the taxpayer."

2.5 The Government supports this purpose. The ICB recommended that the ring-fence should be designed to achieve the following objectives at least cost to the taxpayer:

1. make it easier to sort out both ring-fenced banks and non-ring-fenced banks that get into trouble, without the provision of taxpayer-funded solvency support;

2 insulate vital banking services on which households and SMEs depend from problems elsewhere in the financial system; and

3 curtail government guarantees, reducing risk to the public finances and making it less likely that banks will run excessive risks in the first place.

Improving resolvability

2.6 A bank that gets into trouble is easier to "sort out" – i.e. more resolvable – if the authorities can manage its failure in an orderly way, that is, preserving the continuity of critical economic functions and properly distributing losses among shareholders and creditors, without injecting taxpayer funds.[1]

2.7 The current complex structure of many banking groups is a major impediment to resolution. Multiple business lines with many and complex links between them make it difficult to extract the critical functions on which customers rely, impose losses on creditors and manage the failure of a bank in an orderly way. A recent report by the Financial Stability Board (FSB) – endorsed by the G20 – recommended that authorities should have powers to require changes to firms' structures in order to improve their resolvability: "to enable the continued operations of systemically important functions, authorities should evaluate whether to require that these functions be segregated in legally and operationally independent entities that are shielded from group problems."[2]

2.8 Ring-fencing, alongside the other measures discussed in this document, therefore takes forward these ambitions in applying them to UK banks. The Government believes that ring-fencing will improve the resolvability of both ring-fenced and non-ring-fenced banks, by making them easier to separate and reducing the risks of contagion from failing banks.

Insulating vital banking services

2.9 The Government believes that ring-fencing will reduce the risk that volatility in financial markets, or shocks arising in other parts of the financial system, will jeopardise the provision of critical banking services to the UK real economy. This does not imply that ring-fenced banks will be risk-free. The process of banking intermediation – accepting deposits and making loans – is inherently risky. Maintaining banking intermediation within the ring-fence is a central distinction between the ICB's proposals and proposals relating to so-called 'narrow' or 'limited purpose' banking. Ring-fenced banks should continue to be exposed to the risks of their lending decisions and funding structures, and so be exposed to the risk of failure. This is why the ICB also recommended increasing the loss-absorbing capacity of ring-fenced banks, as discussed in the next chapter.

Curtailing government guarantees

2.10 The Government believes that no bank – ring-fenced or non-ring-fenced – should benefit from an implicit government guarantee. Such guarantees arise when authorities are unable to resolve banks without taxpayer support. The expectation that investors will, at least in part, be protected with taxpayer funds means that they are poorly incentivised to discipline banks' risk-taking. The first two objectives for the ring-fence – improving resolvability and insulating vital banking services – should therefore curtail government guarantees to both ring-fenced and non-ring-fenced banks, reduce the risk to the public finances and limit excessive risk-taking.

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[1] This follows the definition as applied by the Financial Services Authority, and, internationally, by the Financial Stability Board. See *Recovery and Resolution Plans*, Financial Services Authority, November 2011. Available at: http://www.fsa.gov.uk/pubs/cp/cp11_16.pdf.

[2] *Key Attributes of Effective Resolution Regimes for Financial Institutions*, Financial Stability Board, October 2011. Available at: http://www.financialstabilityboard.org/publications/r_111104cc.pdf.

2.11 Accordingly the Government believes that the objectives of improving bank resolvability, insulating vital banking services and, therefore, curtailing government guarantees, should be adopted as the objectives of the policy.

The 'location' of the ring-fence

2.12 The first governing principle that the ICB set out is that only ring-fenced banks should be permitted to undertake certain vital banking services, where customers are ill-equipped to prepare for even a temporary disruption ('mandated' services). The second principle the ICB recommended was that these vital banking services be kept separate – legally, operationally and economically – from financial services that would increase their exposure to global financial shocks, and that make the banking entity conducting them hard to resolve ('prohibited' services). These two principles largely determine the location of the ring-fence. Services that fall into neither category are 'permitted'.

2.13 The Government believes that the location of the ring-fence should be flexible, with a limited set of mandated and prohibited services. The Government believes that the provision of corporate deposits and corporate lending should be permitted within the ring-fence. Flexibility allows banks to access a wider range of lending opportunities, maintaining diversification and the efficiency of intermediation.

2.14 The Government does not intend to set out detailed definitions of mandated and prohibited services in legislation. Rather the Government will establish a clear set of objectives, principles and regulatory outcomes that ring-fencing should achieve. The characteristics for services that should be mandated or prohibited will be set out in legislation and supported by more detailed regulatory rules. The Government anticipates that the rules governing the ring-fence will provide scope for the regulator to apply their own judgement and discretion, guided by the outcomes set out in legislation. This is consistent with the supervisory approach to be adopted by the Prudential Regulation Authority.

2.15 The ring-fencing requirements will apply to any company or other body incorporated in the UK which undertakes a banking business with permission from the UK regulator. This will include any UK bank or building society, including UK subsidiaries of wider banking groups headquartered in the UK or elsewhere. The requirements will not apply directly to foreign subsidiaries of UK ring-fenced banks, but limitations may be imposed on the activities that subsidiaries of a ring-fenced entity may undertake (see Paragraph 2.48). The UK branches of banking groups from outside the UK will generally be unaffected by ring-fencing provisions, although the Government would expect the prudential supervisor of branches of banking groups based outside the European Economic Area (EEA) to give careful consideration to whether it is appropriate to permit significant amounts of mandated services to be undertaken in a branch rather than through a UK subsidiary. UK branches of EEA banks would remain unaffected.

Principle 1: Mandated services

2.16 The ICB's first governing principle was that certain vital banking services can only be provided by ring-fenced banks. The ICB recommended that these 'mandated' services be those where:

- even a temporary interruption to the provision of service resulting from the failure of a bank has significant economic costs; and
- customers are not well equipped to plan for such an interruption.

2.17 The ICB said that mandated services currently comprise the taking of deposits from, and the provision of overdrafts to, individuals and SMEs, excluding deposit-taking from very high net worth individuals.

2.18 **The Government supports the ICB's definition of mandated services, and agrees that at a minimum, these should include taking deposits from, and providing overdrafts to, individuals and SMEs (subject to some exemption for the provision of private banking services to high net worth individuals).**

2.19 The key questions that follow are:

- whether there is a case for further services – in particular, the provision of credit to households and/or SMEs – to be mandated within the ring-fence;
- how 'SMEs' should be defined for these purposes; and
- how private banking services should be treated.

The provision of credit

2.20 Credit provision is generally a service where *temporary* disruption may be tolerated. However, in some circumstances – for example, a disruption in the provision of credit to SMEs by a bank that has a large market share – there may be significant economic costs. More generally, were the provision of credit to the UK economy to be provided largely by ring-fenced banks, it would arguably be better insulated from shocks to the wider financial system. Requiring retail and SME deposits to be within ring-fenced banks, but allowing 'matching' assets – i.e. lending (including mortgages) to individuals and SMEs – to be placed outside the ring-fence, may result in a ring-fenced bank with a mixture of assets and liabilities,[3] that makes the bank, or parts of it, less attractive to private buyers in a resolution.

2.21 On the other hand, the destruction of information concerning a bank's clients (a key cost of banking failure) need not be threatened by a temporary interruption arising from bank failure, so long as the bank can be wound down in an orderly fashion and its relevant functions transferred. The recent crisis has shown that the contraction of credit can occur whether banks fail or not, and so policies aimed at improving the failure regime may only deliver a marginal benefit in maintaining the supply of credit. The ICB also suggested that, in practice, a significant proportion of credit is likely to follow mandated deposits, and so the risks to resolvability described above may remain theoretical.

2.22 **The Government does not believe that the case *has yet* been made for mandating further services, but will undertake further analysis on this issue and will consult at a later stage.**[4]

Definition of SMEs

2.23 There are a number of challenges in defining SMEs. Banks vary in the criteria they use to define 'SMEs', and still more definitions are set out in various regulations. Moreover, different types of SMEs will have different needs. Some very small customers will have sophisticated requirements and multi-bank relationships, while some larger SMEs may have more limited requirements and bank relationships. The growth of businesses will also present a challenge, as companies reach the point at which they have a choice over where they place their deposits. **The Government will undertake further analysis of the definition of SMEs.**

[3] For example, domestic retail deposits in a ring-fenced bank funding not residential mortgages, but loans to large European corporates.
[4] Unlike deposit services, there is a greater role for non-banks in providing credit. In its treatment of credit provision within the ring-fence, the Government would not intend to stop these sources of credit provision to the extent that they provide alternative sources of funding and greater credit stability.

Private banking

2.24 The ICB recommended that deposit-taking and overdraft services to high net worth individuals be exempted from the mandatory requirement to sit within ring-fenced banks, arguing that such customers should be well equipped to cope with temporary disruptions to banking services. The definition of private banking presents similar challenges to those for SMEs. Banks use very different definitions of private banking clients, and there are likely to be practical challenges as customers move across the threshold. In addition, any exemption regime would have to be policed to ensure that it does not allow scope for evading the objectives of the ring-fence. **The Government believes that high net worth individuals should be exempted from the mandatory requirement to sit within a ring-fenced bank and will undertake wider analysis of the definition of private banking.**

Principle 2: Prohibited services

2.25 The ICB's second principle was that ring-fenced banks providing vital banking services should not be allowed to provide certain 'prohibited' services, being services which:

- make it significantly harder and/or more costly to resolve the ring-fenced bank;
- directly increase the exposure of the ring-fenced bank to global financial markets;
- involve the ring-fenced bank and are not integral to the provision of payment services to customers, or the direct intermediation of funds between savers and borrowers; or
- in any other way threaten the objectives of the ring-fenced bank.

2.26 The ICB recommended that prohibited services should include (but not be limited to) any services to financial institutions or to non-EEA customers, services relating to secondary market activities, services that require firms to hold regulatory capital against market risk and derivatives or other contracts which result in a requirement to hold capital against counterparty credit risk.

2.27 **The Government agrees that certain services must be prohibited in order to meet the objectives of the ring-fence, particularly services which impede resolution and/or increase the ring-fenced bank's exposure to volatility in global financial markets. The Government will consult on the precise characteristics of those services.**

2.28 Recent experience has shown that the resolution of some activities, for instance a large trading book, can be both costly and complex.[5] Co-mingling these and other activities with retail services makes resolving a bank without exposing the taxpayer to large costs difficult. Such services should therefore be prohibited.

2.29 The Government proposes to undertake further analysis on the following:

- the characteristics of financial institutions that may be permitted as counterparties of ring-fenced banks;
- the characteristics of products prohibited by reference to their function, e.g. derivatives or trading book assets (in particular whether a definition can be developed for simple derivatives and investment products which may be permissible according to the principles of the ring-fence and which prevents the inclusion of a wider set of investment products); and

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[5] *Recovery and Resolution Plans*, Financial Services Authority, November 2011. Available at: http://www.fsa.gov.uk/pubs/cp/cp11_16.pdf.

- the approach to cross-border activities and clients, and the treatment of UK Overseas Territories and Crown Dependencies.

Financial institutions

2.30 The Government accepts that exposure to other financial institutions, and certain activities, must be limited in order to insulate effectively ring-fenced banks from shocks arising elsewhere in the financial system. Further analysis is required in order to characterise the types of institution and activity that should be prohibited. For example, certain types of counterparty ordinarily defined as 'financial', such as independent financial advisors, are unlikely to increase a bank's exposure to global financial markets or shocks. Others, such as hedge funds, broker-dealers and asset managers are much more clearly subject to volatility within financial markets, and linked in complex ways to other parts of the financial sector. Prohibited counterparties are in general likely to be large, have numerous connections to other financial institutions, extend across borders and undertake a significant number of complex trading activities.[6] At the same time, the provision of certain services, even to such entities, such as cash management, may provide limited risk and be permissible. Exposure to the shadow banking system should be restricted through this prohibition.

2.31 The Government agrees that this prohibition should not limit the ability of wholesale investors to hold the debt instruments of ring-fenced banks, although it will be necessary to ensure that the distinction operates effectively in practice.

2.32 The Government agrees that the provision of payment services, exposures between ring-fenced banks and interbank deposits as part of ring-fenced banks' liquidity management (see ancillary activities) should be excluded from the general prohibition on services to financial institutions, subject to appropriate safeguards. However, further analysis is required to ensure that these exemptions are not open to abuse, and to determine whether any further restrictions are required; for example whether an exemption can or should be extended to non-EEA financial institutions, and the risks around the provision of intra-day liquidity.

Financial product restrictions

2.33 Much of banks' capital markets and global banking businesses should clearly be prohibited on the basis that they would impede the resolvability of the ring-fenced bank and increase exposure to global financial markets. However, further analysis and consultation is required to ensure that this restriction neither includes nor excludes too much, and that it can be easily supervised. The ICB laid out an illustrative set of six characteristics for services that would undermine the objectives of the ring-fence, including: any services that would result in a trading book asset; any services that would result in a requirement to hold regulatory capital against market risk; the purchase or origination of derivatives or other contracts that would require capital to be held against counterparty credit risk; and services related to secondary markets activity, including the purchase of loans or securities.

2.34 Defining the characteristics of prohibited services is a challenging process, and needs careful judgement. For example, providing firms with certain forms of insurance against interest rate or exchange rate risk can involve little or no market risk and could be argued to be integral to the function of ring-fenced banking services. But equally these services increase exposure to volatile financial markets, move ring-fenced banks away from the central function of

[6] See *Global systemically important banks: assessment methodology and the additional loss absorbency requirement*, Basel Committee on Banking Supervision, November 2011. Available at: http://www.bis.org/publ/bcbs207.pdf.

intermediation and the provision of payments and may create opportunities for banks to try to circumvent the objectives of the policy.[7]

2.35 The Government supports the principle that prohibition should not be driven solely by the riskiness of the activity. As explained above, ring-fenced banks will be exposed to risks that are integral to financial intermediation – not only credit risk, but also exposure to changes in interest and exchange rates, changes in asset values and broader macroeconomic risks that come from lending.[8] But the ring-fence should be designed to limit the exposure of vital functions of banks to risks that are not integral to providing those functions.

2.36 **In general, the Government believes that a precautionary principle should be adopted in determining which services are prohibited. That is, the presumption should be that services are prohibited until it can be shown that they do not jeopardise the objectives of the ring-fence and support the core functions of the ring-fenced bank.**

2.37 The Government recognises that some prohibited services could be systemically important. Examples may include clearing and settlement services of securities, or market making. The example of the collapse of Lehman Brothers demonstrated the adverse consequences of the failure of an investment bank. Ring-fencing should enhance the resolvability of non-ring-fenced banks by making them more separable and reducing their links to vital retail services. However, the Government recognises the particular challenges inherent in managing the orderly resolution of a systemic investment bank, and therefore has been pursuing work domestically and internationally on this. This is discussed in Box 1.A.

Geographic restrictions

2.38 The Government agrees that restricting the geographic scope of the ring-fenced bank's activities would enhance resolvability, facilitate better supervision and limit risks to the ring-fenced bank. Cross-border holdings and activities can materially increase the complexity of resolution.[9] There may be a number of ways to define the geographic focus of permitted services, including the residence of the client, the location of assets and liabilities, and the laws under which activities are written. As discussed in Paragraph 2.15, geographic restrictions, however defined, would not apply to the activities of ring-fenced banks within the EEA. **The Government will undertake further analysis on the best way to address this issue.**

2.39 An illustration of how assets and liabilities may be split between the ring-fenced and the non-ring-fenced bank, and consequences for different customers, is set out in Box 2.A below.

[7] As ring-fenced banks would be permitted to provide such services as agents of other banks, the Government agrees with the ICB that the impact on customers of prohibiting some services would be mitigated.
[8] A ring-fenced bank would be permitted, and expected, to hedge these risks in its treasury function as part of its ancillary activities.
[9] *Effective resolution of systemically important financial institutions*, Financial Stability Board, July 2011. Available at: http://www.financialstabilityboard.org/publications/r_110719.pdf.

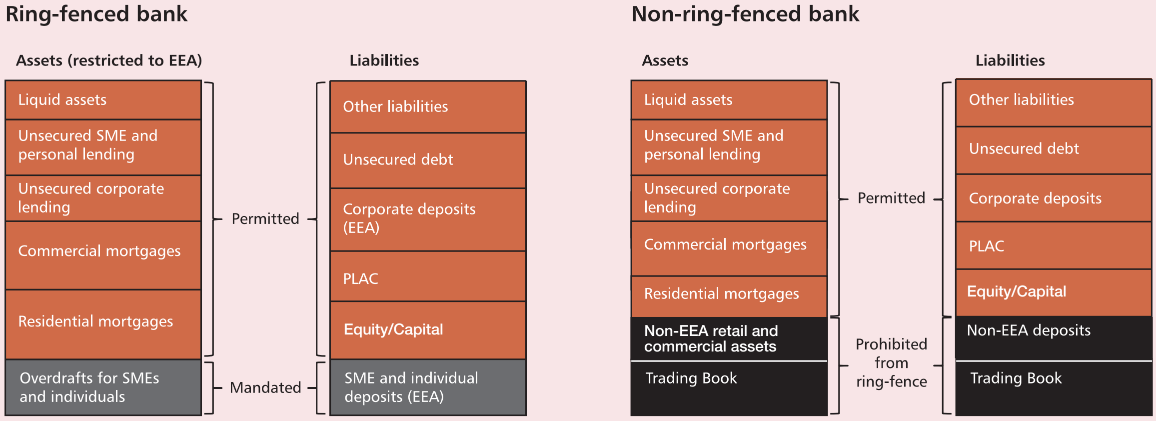
Box 2.A: Ring-fencing, bank structures and bank customers

The ICB's recommendations allow banks a significant degree of flexibility in placing assets and liabilities inside or outside the ring-fence. Customer preferences will play a role in the ultimate location of many of the services. This box follows the ICB's definitions of prohibited services covering products, financial institutions and geographic restrictions (e.g. prohibiting services outside the EEA), and is therefore illustrative. The ultimate location of activities will depend on the finalisation of the ring-fencing rules.

On the liabilities side of its balance sheet, a ring-fenced bank would have EEA retail and SME deposits (mandated services). It could also hold EEA corporate deposits, wholesale funding and (in connection with the provision of payment services) deposits from financial institutions. Its assets would consist of lending in the EEA, as well as cash and liquid assets. It would have only limited amounts of lending to other banks and financial institutions for the provision of payments and management of its balance sheet. It would hold some derivatives and other financial instruments for managing its balance sheet risks. The ICB suggested that the majority of UK banks' retail businesses would sit within the ring-fence. A stylised balance sheet for the ring-fence entity is below.

The non-ring-fenced bank would be funded through wholesale funding, and could also accept non-EEA deposits. Its assets could include lending outside the EEA, as well as lending to corporates and households within the EEA. It could also undertake trading activities both as principal and on behalf of customers.

Chart 2.A: Illustrative balance sheets of ring-fenced and non-ring-fenced banks[10]



[10] Note that this structure is not intended to mirror the creditor hierarchy.

Box 2.A (continued): Ring-fencing, bank structures and bank customers

The ICB's ring-fencing recommendations will impact bank customers in different ways depending on the nature of their relationship with the bank, the types of services they require, their location and legal status. These factors will help decide whether a customer is in the ring-fenced or non-ring-fenced bank. Ring-fencing should allow for customers to continue to deal with a single point of contact for their banking services.

- Individual: Retail depositors will access deposit and overdraft services from within the ring-fence. They will be able to access loans and mortgages from either inside the ring-fence or from other banks or non-bank providers. They will be able to access a range of retail investment products from outside the ring-fence, or bought through the ring-fenced bank on an agency basis from non-ring-fenced providers. High net worth individuals may choose to place their deposits outside the ring-fence.
- Businesses: SME deposits and overdrafts will have to be inside the ring-fence. SMEs and larger EEA corporates may borrow from ring-fenced banks, and larger EEA corporates may place deposits with them, if they choose to provide these services. Access to markets and derivatives products may be provided on an agency basis by ring-fenced banks or directly by non-ring-fenced banks. Larger corporates may have access to a full range of deposit, lending and capital markets services directly from non-ring-fenced banks. Payment services may also be provided to businesses from both entities.
- Institutional investors/financial institutions: Financial institutions will receive most of their services from non-ring-fenced banks. Investors will still be able to fund ring-fenced banks by holding wholesale debt. Financial institutions will be able to access payment systems and potentially a limited set of other services on either side of the fence.

Principle 3: Ancillary activities

2.40 The ICB's third principle was that ring-fenced banks can conduct ancillary activities that are necessary for the efficient provision of services. For example, a ring-fenced bank may enter into derivatives contracts to manage the risk arising from its provision of loans to clients.

2.41 As part of its ancillary activities, the ICB recommended that backstop limits be placed on the proportion of wholesale funding permitted for a ring-fenced bank.

2.42 **The Government agrees that ring-fenced banks should be allowed to undertake ancillary activities for the purposes of risk management, liquidity management and funding of non-prohibited services. It will consult further on limiting a ring-fenced bank's wholesale funding beyond existing regulation.**

2.43 Allowing banks to undertake activities that support the effective provision of mandated and permitted services is consistent with the objectives of the ring-fence. However, care must be taken in the design and implementation to avoid ancillary activities becoming a method of evading the ring-fence objectives. A number of workable models have been proposed for the rules governing ancillary activities, including building societies, insurance and utilities regulation. Further analysis is required to determine a model that is most effective for the particular characteristics of ring-fenced banks. As the Building Societies Act contains similar provisions and building societies will come under the scope of ring-fencing legislation, there may be a case for modernising it as part of the development of ring-fencing.

2.44 The Government agrees that it would be undesirable for ring-fenced banks to become over-reliant on wholesale funding. However, the Government will undertake further analysis, in conjunction with the Financial Services Authority (FSA), to determine whether such an objective is best achieved through the imposition of a backstop limit as suggested by the ICB, or whether it would be better to achieve this through the implementation of existing liquidity regulations, amending them where necessary to take account of the specific characteristics of ring-fenced banks.

The 'height' of the ring-fence

2.45 **The Government strongly supports the ICB's conclusion that a high degree of legal, operational and economic separation is needed between the ring-fenced bank and the rest of its group, for the ring-fence to be effective and credible. This should be supported through regulatory requirements and independent governance.** In particular, economic links within banking groups must be carefully policed in order to ensure separability and to limit channels for contagion. However, ring-fencing should allow some residual connection to its wider banking group, especially so that the rest of the group can support the ring-fenced bank in times of stress.

Principle 4: Legal and operational links

2.46 The ICB recommended that ring-fenced banks should be legally and operationally separable and the authorities should have confidence that they can isolate it from the rest of the group in a matter of days. In particular the ICB said that:

- ring-fenced banks should be separate legal entities;
- any financial organisation owned or partly owned by a ring-fenced bank should conduct only activities permitted within a ring-fenced bank;
- the ring-fenced bank needs to have 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; and
- the ring-fenced bank should either be a direct member of all the payment systems that it uses or should use another ring-fenced bank as an agent.

2.47 **The Government agrees that the ring-fenced bank should be legally and operationally separable from the rest of the group as a matter of principle. It will undertake further work to assess the operational separability necessary to give force to ring-fence resolvability and the appropriate restrictions on ownership of other financial entities.**

Legal separation

2.48 The Government agrees that a ring-fenced bank should be a separate legal entity. The Government also agrees that equity participation in other financial institutions can create risks for the ring-fenced bank, impeding supervision and hindering resolvability and separability. Limits on ownership or participation in other financial institutions undertaking prohibited activities may also therefore be appropriate. Further analysis is required on the practical implications, particularly for mutual societies, of requiring a ring-fenced bank to own only financial institutions undertaking activities that would arise within the ring-fence.

Operational separation

2.49 The ICB discussed a number of ways that a ring-fenced bank might choose to ensure operational separability, so that the ring-fenced bank has an uninterrupted supply of essential operational services even when other parts of the group face insolvency. But the ICB was not prescriptive on how this might be achieved. One way would be through the provision of such services by a separate, bankruptcy-remote group company (an 'operational subsidiary'). Alternatively, the ring-fenced bank could own an entire operational infrastructure separate from the rest of the group.

2.50 The Government agrees the ring-fenced banks need to be able to demonstrate operational separability.

2.51 The following principles need to be considered by firms when designing their future structures to ensure operational separability:

- independent capitalisation and funding for any operational subsidiaries, to ensure they can continue to provide essential services when other parts of the group fail;
- effective service level agreements to support the continued provision of essential services in the event of the failure of any part of a banking group;
- the provision of services by operational subsidiaries on an arm's length basis, so that such entities are economically viable should part of a banking group fail; and
- operational assets used by critical economic functions in support of their activities should, where possible, be owned by the operational entity providing those services.

2.52 The Government believes that the FSA should, as part of its work on recovery and resolution plans, ensure that arrangements for the provision of operational infrastructure that a bank chooses to put in place for its ring-fenced operations, including their staff, technology platforms and management information, are consistent with these principles. The Government recognises that these principles may result in prudential requirements being placed on often unregulated operational entities within banking groups. The appropriate regulatory regime for operational subsidiaries of banking groups, and whether to create new regulated activity around the provision of essential services to critical economic functions in the ring-fence and non-ring-fenced entities, will need to be considered.

2.53 In addition, the Government agrees that it would be appropriate for a ring-fenced bank to be a direct member of all payment systems it uses or to use another ring-fenced bank as agent. However, this requirement should be monitored carefully for any anti-competitive effects, and to ensure that all ring-fenced banks continue to have open and fair access to payment systems.

Principle 5: Economic links

2.54 The ICB recommended that:

"where a ring-fenced bank is a 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 group. This should be ensured through both regulations and sufficiently independent governance."

2.55 The ICB makes a number of specific recommendations in support of this principle, including:

- all transactions should be treated for regulatory purposes no more favourably than those between third parties;
- ring-fenced banks should be subject to regulatory requirements, including those for capital, large exposures, liquidity and funding on a solo basis;
- assets should be sold to and from the ring-fenced bank at market value;

- dividend payments should be made conditional on the board satisfying itself that the ring-fenced bank has sufficient financial resources; and
- the board of the ring-fenced bank should have a majority of independent non-executives of whom one is the chair and no more than one sits on the board of the parent or another part of the group, and should have a duty to maintain the integrity of the ring-fence at all times.

2.56 In addition, the ICB identified a number of details to govern arm's length transactions between ring-fenced banks and the rest of their corporate groups, including: 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 for third parties, and that secured exposures between the ring-fenced bank and the rest of the group be no more than twice those unsecured third party limits; no forms of unlimited guarantee, or joint liability should arise outside of the large exposure limits; and the ring-fenced bank should not be party to agreements containing cross-default clauses or similar arrangements. **The Government believes that the ring-fenced bank should not be dependent on the financial health of the rest of its corporate group for its solvency or liquidity. The Government will consult further on the regulatory and governance requirements necessary to implement this.**

2.57 The ring-fenced bank must be economically independent of the rest of its corporate group in order to ensure that the ring-fenced and non-ring-fenced banks can be resolved separately, and to limit the risks that a failure in the rest of the corporate group will transmit to the ring-fenced bank. With respect to the detail of the ICB's recommendations, the Government will undertake further analysis of, and consult on, the following issues:

- the extent to which existing regulation between third parties needs to be supplemented with additional rules to ensure the economic independence of the ring-fenced bank;
- limits on intragroup exposures; and
- governance of the ring-fenced bank.

Relationships on a third party basis

2.58 There are certain types of contractual arrangement – such as cross-default clauses and intragroup guarantees – that often bind together companies in the same group, are likely to present significant obstacles to rapid separation and resolution and create a means for transmission of financial contagion. Many of these are likely to require additional rules and limits, as they do not typically arise in relationships between third parties. In particular, robust rules will be required to ensure that intragroup asset transfers and secured lending are conducted on an arm's length basis. The recommendations for specific rules set out by the ICB provide a basis for establishing such a set of rules and the Government will develop this analysis further.

Limits on intragroup exposures

2.59 **The Government agrees that, in order to maintain the economic independence of the ring-fenced bank, it should meet at a minimum capital and liquidity requirements on a solo basis, and that the large exposures regime for third parties should be applied to the ring-fenced bank in its relations to the rest of its corporate group. In addition to the wholesale funding limit discussed above, specific restrictions on the amount of funding the ring-fenced bank receives from the rest of its group may also be appropriate, to the extent that rules on wholesale funding are not sufficient.**

2.60 With respect to exposures *from* the rest of the group *to* the ring-fenced bank, the Government recognises that some of the benefits of ring-fencing over full separation are that it allows for some sharing of activities to create a seamless service for customers provided that the ring-fenced bank is not put at risk and allows for the possibility of the rest of the group supporting the ring-fenced bank in times of stress. This means that there will be some asymmetry in the relationship between the ring-fenced bank and the rest of its group. For example, to allow for a single corporate group approach the ICB envisaged that a non-ring-fenced bank could own a ring-fenced bank, but not the other way round. Further, there should be very few restrictions on the ability of the corporate group to downstream capital to the ring-fenced bank, so as to support it in times of difficulty, but there should be safeguards around the ability of the ring-fenced bank to upstream capital to ensure that it would not put its own capital position at risk.[11]

2.61 At the same time, if exposures from the rest of the group to the ring-fenced bank were left unconstrained, this could undermine the authorities' ability to separate one entity from the other, significantly impeding resolvability on both sides of the fence. And it could also result in the perception in the market that the firm continued to operate as a single entity, undermining the objective of curtailing implicit government guarantees. **The Government therefore believes that imposing equivalent limits on exposures from the rest of the corporate group to the ring-fenced bank may be appropriate, but will undertake further analysis to ensure that the limits proposed by the ICB are optimal.**

2.62 The Government recognises the risk that, without further regulation, secured lending could form a means by which financial contagion between the ring-fenced bank and the rest of the group arise. While secured funding can be relatively safe, the recent crisis also demonstrated that difficulties in secured funding markets can also arise and provide a means for contagion to spread. High levels of secured funding may also undermine the separability of the entities and their viability as standalone institutions in times of stress. Additional restrictions on secured funding may therefore be appropriate. The Government will therefore undertake further analysis on the case for a secured funding limit, including how any such limit should be calibrated, the definition of appropriate collateral and appropriate haircuts.

2.63 The interaction between the ICB's ring-fencing proposals and amendments to the Capital Requirements Directive, and the introduction of a Capital Requirements Regulation, is discussed in Chapter 6.

Governance

2.64 The governance of the ring-fenced bank will be central to ensuring its economic independence. At the same time, where the ring-fenced bank contains most of a banking group's business, the delivery of the group's strategy on a day-to-day basis may be complicated by separate board arrangements. The ICB recognised this tension and suggested that flexibility may be appropriate in such circumstances. Any such flexibility must not undermine the important role that governance will play in the success of the policy. The Government will consult on the best approach to achieving the appropriate balance, including through the composition, duties and objectives of the ring-fenced bank's board.

2.65 Disclosure will also provide an important means of maintaining a clear and credible separation between ring-fenced banks and the rest of their group. The Government will undertake further analysis and consultation on the most appropriate forms of disclosure and

[11] Ring-fencing also allows for some limited support from the ring-fenced bank to the rest of the group, but only provided this does not jeopardise its own financial health, and subject to board and regulatory approval.

whether, and how, disclosure requirements ought to vary depending on the nature of the ring-fenced institution.

Tax and pensions

2.66 There are other circumstances in which the ring-fenced bank may be liable for obligations of the broader group. Two particularly significant examples are liabilities for VAT and for deficits of group pension funds. Such liabilities could endanger the economic independence of the ring-fenced bank, for example, were a wholesale bank to collapse and leave the ring-fenced bank with a large liability for the pension deficit of the whole group. The ICB recommended removing these involuntary obligations or otherwise mitigating their impact.

2.67 Removing joint and several liability may lead to new costs for banks, or result in existing liabilities being brought forward. For example, where banks' pension funds are in deficit, pension trustees may require this to be addressed more quickly if recourse to the ring-fenced bank is reduced. Insofar as these costs represent a bank creditor reappraising risk in response to the curtailment of the implicit government guarantee, they are an inevitable consequence of the ICB's objectives. However, different ways of addressing such liabilities will have different costs. **To the extent that such obligations can be met without undermining the objectives of the ring-fence, the Government will seek to mitigate their impact.**

De minimis exemptions

2.68 **The Government believes that the case for *de minimis* exemptions from ring-fencing, in particular for very small firms, should be reviewed.**

2.69 A number of *de minimis* exemptions to the ring-fencing rules may be considered:

- banks below a certain size could be excluded from the ring-fencing rules;
- entities (which may or may not be systemic) that undertake a small amount of either mandated or prohibited services could be excluded; or
- individual transactions under a certain threshold could be excluded.

2.70 With respect to the first type of exemption, it is arguable that banks that are small enough to be allowed to fail without government support are by definition resolvable, do not benefit from implicit guarantees, and so imposing the ring-fence rules is disproportionate, and may create barriers to entry. On the other hand, such an exemption may prove difficult to set in a principled fashion, be hard to police and create cliff-edge effects as banks approached it. And allowing some institutions to depart from the ring-fencing rules may present an unfair competitive advantage. But there may be a case for considering this type of exemption, possibly subject to any exempt institution having a high degree of resolvability and/or meeting higher prudential standards. **The Government will undertake further consideration of this issue.**

2.71 On the second type of exemption, it could be argued that the provision of a small amount of prohibited services by a ring-fenced bank would not significantly undermine its resolvability, nor create a risk of financial contagion to vital banking services. However, in addition to the risks mentioned above, once the precedent had been set, there would be a risk that the threshold for exemptions would be weakened over time. This would ultimately undermine the objectives of the ring-fence. **The Government does not currently believe that there is a strong case for such an exemption, but will undertake further analysis on this issue.**

2.72 The case for *de minimis* exemptions for small individual transactions is not clear. A bank undertaking a large number of small transactions that constitute prohibited services is likely to represent a significant resolution challenge, represent a meaningful channel for contagion, and offer opportunities for arbitrage. It would therefore appear unlikely that such an exemption would meet the principles of the ring-fence. **The Government does not currently believe that there is a strong case for such an exemption, but will undertake further analysis on this issue.**

Box 2.B: Some outstanding policy questions

The Government will undertake a formal consultation in Spring 2012. However, there are a number of issues set out in this chapter on which earlier views would be welcome, in particular:

- including further services, e.g. credit provision to households and/or SMEs within the definition of mandated services;
- the characteristics of financial institutions that may be permitted as counterparties to ring-fenced banks;
- the characteristics of products to be prohibited by reference to their function, e.g. derivatives or trading book assets;
- the approach to EEA activities and clients, and the treatment of UK Overseas Territories and Crown dependencies;
- the possibility of *de minimis* exemptions from the ring-fencing rules;
- the best approach to updating the Building Societies Act to reflect the introduction of ring-fencing;
- the application of wholesale funding limits to ring-fenced banks;
- the provision of payment services inside and outside ring-fenced banks;
- amendments to existing rules governing third party exposures to meet the objectives of ring-fencing, including secured exposure limits, acceptable collateral, securitisation and asset sales; and
- the composition and duties of the board of the ring-fenced bank.

3 Loss-absorbency

The ICB's loss-absorbency recommendations

3.1 The key financial stability objectives set out by the ICB were to make banks better able to absorb losses; to make it easier and less costly to sort out banks that still get into trouble; and to curb incentives for excessive risk-taking. As part of its package of reforms to advance these objectives, the ICB made recommendations on:

- equity requirements – higher equity[1] requirements for ring-fenced banks;
- leverage ratio – minimum leverage ratio for all banks, higher for ring-fenced banks;
- bail-in – there needs to be a mechanism for exposing creditors to losses in resolution;
- depositor preference – insured depositors preferred to other unsecured creditors;
- primary loss-absorbing capacity (PLAC) – minimum level of capital plus bail-in debt; and
- resolution buffer – banks that are not readily resolvable should have more PLAC.

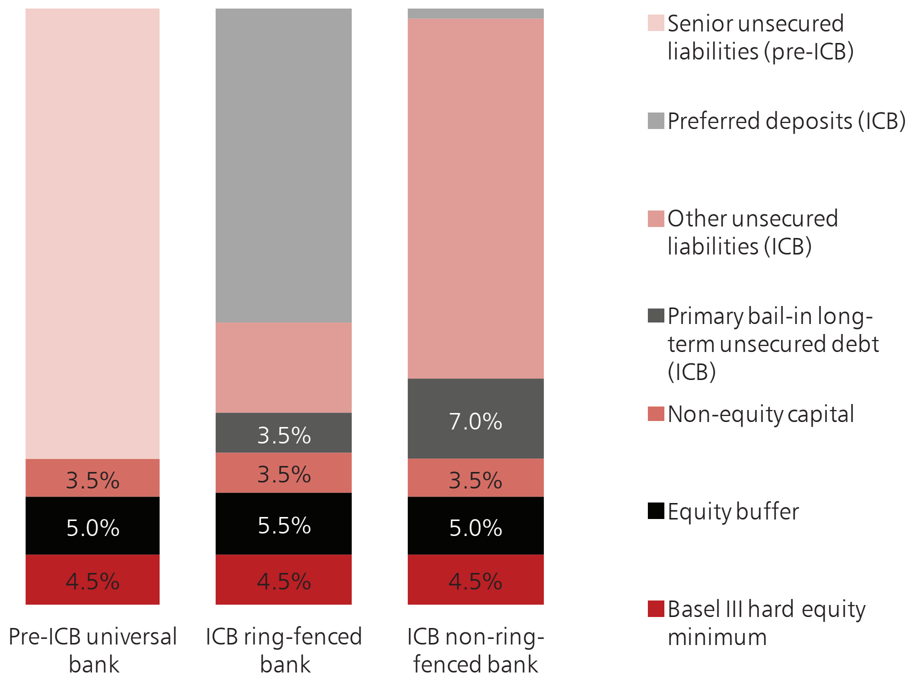
3.2 The ICB's recommendations build on the capital standards agreed under Basel III. An illustrative example of how this might work is shown in Chart 3.A.

3.3 This chapter considers each of the recommendations in turn, setting out a brief summary of the international regulatory position, the ICB's recommendations and the Government's response. There are a number of questions at the end of the chapter to which responses are invited.

[1] References to 'equity' in this response document are to common equity, except where the context requires otherwise.

Chart 3.A: The ICB's loss-absorbency recommendations

This chart illustrates the possible impact of the ICB's loss-absorbency recommendations – described in more detail in the rest of this chapter – on the liability structure of a universal bank. The 'Pre-ICB universal bank' column illustrates the Basel III plus G-SIB surcharge (see Paragraphs 3.4 and 3.5) capital requirements only, on the assumption a 2.5% G-SIB surcharge applies. The 'ICB ring-fenced bank' and 'ICB non-ring-fenced bank' columns show how the ICB's loss-absorbency requirements might apply to that bank under ring-fencing, assuming no resolution buffer (see Paragraphs 3.65 onwards) is applied to the ring-fenced bank and a resolution buffer of 3% of primary bail-in debt (see Paragraph 3.25 onwards) is applied to the non-ring-fenced bank. All requirements are shown as a percentage of risk-weighted assets (RWAs).



Equity requirements

3.4 Significant progress has already been made internationally in increasing banks' minimum equity requirements. Under Basel III, banks are required to have a 'hard' minimum ratio of equity to RWAs of 4.5%, up from a minimum of 2% under Basel II, and minimum total capital of 8% of RWAs.[2] On top of the hard equity minimum, there is a 'capital conservation buffer' of a further 2.5%, giving a baseline equity-to-RWAs ratio of 7%. Basel III also provides for a 'counter-cyclical capital buffer' of up to a further 2.5%[3] – this could be applied by regulators when the economy is booming, with the aim of slowing the growth of credit, and bolstering banks' capital positions to absorb losses during bad times. The Basel III capital requirements will be implemented in the EU through amendments to the Capital Requirements Directive and the introduction of a Capital Requirements Regulation (together, CRR I/CRD IV).

3.5 In addition, banks identified as global systemically important banks (G-SIBs) will be required to have a 'G-SIB surcharge' in the range of 1%-2.5% of equity to RWAs (see Box 3.A). Four UK

[2] Hence 3.5% of non-equity capital shown in Chart 3.A.
[3] The counter-cyclical capital buffer can be set above 2.5% within national jurisdictions.

banks – Barclays, HSBC, Lloyds and RBS – have been identified as G-SIBs[4] (although the size of the G-SIB surcharge that will apply to each has not yet been determined).

3.6 The ICB recommended that:

- ring-fenced banks should be required to meet capital and liquidity regulations – including minimum equity requirements – on a solo basis;
- ring-fenced banks with a ratio of RWAs to UK GDP of 3% or more 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;[5]
- ring-fenced banks with a ratio of RWAs to UK GDP in between 1% and 3% should be required to have a ring-fence buffer set by a linear scale from zero to 3% of equity to RWAs; and
- in order to allow operations of UK banking groups that are conducted *outside* the ring-fence 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.

3.7 The ICB argued that banks should have more loss-absorbing capacity to reduce their probability of failure, and to make banks that do still fail easier and less costly to resolve. The ICB regarded equity as by far the best form of loss-absorbing capacity, and expressed some support for much higher equity requirements.

3.8 But the ICB acknowledged a number of drawbacks to imposing very high requirements, including the risk of regulatory arbitrage (activities would shift from regulated UK banks to branches of foreign banks, or to the shadow banking sector), and the risk that banks would respond by rapidly de-leveraging, leading to a contraction in the supply of credit.

3.9 Following the ICB's reasoning, and supported by the cost/benefit analysis set out in Chapter 5, **the Government supports the ICB's recommendation that large ring-fenced banks should be required to have an additional equity 'ring-fence buffer', and that calibrating this at 3% of RWAs is proportionate.** The Government agrees with the ICB that this should not be in addition to any G-SIB surcharge – instead, only the higher of a ring-fenced bank's ring-fence buffer and G-SIB surcharge should apply.[6]

3.10 The ICB's view was that small banks are disproportionately affected by prudential regulation, giving larger banks a competitive advantage. In addition, smaller banks pose less of a risk to financial stability than larger banks. The ICB therefore recommended that the size of the ring-fence buffer that banks are required to maintain should vary depending on the size of the banks.

3.11 **The Government supports setting a smaller ring-fence buffer for smaller banks (with no buffer for the smallest banks).** The Government's view is that the ICB's proposal of calibrating the buffer against the ratio of RWAs to UK GDP has merit. Ring-fenced banks will have simpler balance sheets and less complex linkages to the rest of the financial system than other banks. So a simple size measure may be a good proxy for the risk such banks pose to financial stability.

[4] *Policy Measures to Address Systemically Important Financial Institutions,* Financial Stability Board, November 2011. Available at: http://www.financialstabilityboard.org/publications/r_111104bb.pdf.

[5] Under the ICB's recommendations, it is only the bigger of the ring-fence buffer and the G-SIB surcharge that applies – they are not additive.

[6] But the ring-fence buffer should be in addition to the baseline capital conservation buffer of 2.5%, and any counter-cyclical capital buffer.

Box 3.A: Global systemically important banks

The G20 has emphasised the importance of increasing capital requirements for global systemically important banks. In 2009, the G20 commissioned the Financial Stability Board (FSB) to develop a methodology for identifying G-SIBs and to define the magnitude of additional capital requirements. This process has now been completed. At the Cannes Summit in November 2011, G20 leaders accepted the recommendations of the Basel Committee on Banking Supervision (BCBS) and the FSB on this.

The BCBS has proposed an identification methodology based on five criteria:

- cross-jurisdictional activity – measures a bank's activities outside its home jurisdiction;
- size – measures total exposures (e.g. leverage ratio);
- interconnectedness – measures a bank's exposure to other financial institutions;
- substitutability/financial institution infrastructure – measures the proportion of services a bank provides to individual clients and the market as a whole, e.g. the flow of market and infrastructure liquidity; and
- complexity – measures the business, structural and operational complexity of a bank. The more complex a bank, the larger its expected systemic impact of failure.

Using this methodology, and data submitted by banks, the BCBS has initially identified 29 G-SIBs. The BCBS will, on an annual basis, publish a list of G-SIBs ranked by systemic importance.

G-SIBs will be divided into four 'buckets', depending on their systemic importance. G-SIBs in the top bucket will be subject to a maximum equity surcharge of 2.5% (against RWAs). Moving down the buckets this drops 0.5% at a time, to 1% for the bottom bucket. An additional, (currently) empty bucket (carrying a surcharge of 3.5%) has been proposed, to discourage institutions already in the 2.5% bucket from becoming still more systemically important. The BCBS has recommended that the surcharge is incorporated into the capital conservation buffer, as laid out in Basel III, and be phased in incrementally, from 2016, until full implementation from 2019.

At the Cannes summit, G20 leaders asked the FSB to continue its work, in consultation with the BCBS, on expanding the G-SIB framework to domestic systemically important banks. The FSB will provide an update on this work to G20 Finance Ministers in April 2012.

3.12 However, the BCBS has set out a different methodology for assessing the systemic importance of global banks (see Box 3.A).[7] There may be elements of this methodology that would also be useful in calibrating the ring-fence buffer. But the forthcoming work on domestic systemically important banks (D-SIBs) to be carried out by the FSB may be more relevant, as the operations of ring-fenced banks are likely to be more domestic, and less international, than those of G-SIBs.

3.13 In calibrating minimum equity requirements for ring-fenced banks, there would be advantages in adopting a methodology that was consistent with any international proposals. Further analysis is therefore required to determine whether using the linear scale proposed by the ICB is the optimal way of calibrating the ring-fence buffer for smaller banks, or whether this

[7] *Global systemically important banks: assessment methodology and the additional loss-absorbency requirement*, BCBS, November 2011. Available at: http://www.bis.org/publ/bcbs207.pdf.

methodology could be improved with reference to any proposals from the BCBS (and/or the European Commission) on identifying D-SIBs.

3.14 An important part of both the Basel III capital requirements and the ICB's recommendations on equity ratios is the distinction between the hard regulatory minimum (the Basel III 4.5% equity floor) and equity buffers (everything else – the Basel III capital conservation buffer, as extended by any G-SIB surcharge, counter-cyclical capital buffer or ring-fence buffer). In normal times banks will aim to operate with capital levels above these buffers. However, if the buffers are to work as intended, a bank that comes under stress needs to be able to operate within them for some period, rather than such buffers simply being regarded as raising the hard minimum. The ICB clarified that the authorities should make it clear they do not consider such buffers as extending the hard minimum, and that due regard should be given to this when conducting stress-testing. The Government supports this position.

3.15 The interaction between the ICB's recommendations on minimum equity requirements and CRR I/CRD IV is discussed in Chapter 6.

Leverage ratio

3.16 Capital requirements are primarily based on RWAs. But risk weights can be inaccurate, and so there are advantages to having, in addition, a minimum leverage ratio of capital to *unweighted* assets or exposures. (There is also significant divergence in how RWAs are calculated – see Box 3.B.) The BCBS has therefore proposed that banks should have a binding minimum ratio of Tier 1 capital to total exposures of 3% by 2018. The BCBS has said that the period to 2018 should be used to monitor banks' leverage to assess whether the proposed design and calibration of this binding leverage ratio is appropriate over a full credit cycle for different types of business model, and that banks' leverage ratios should be disclosed. The Government believes that disclosure is important for improving transparency around bank balance sheets.[8] The binding leverage ratio will be implemented in Europe through EU law.

Box 3.B: Divergences in RWA calculations

The integrity of RWA calculations is critical to calculations of bank capital ratios. Currently in Europe and internationally, there are significant divergences in the way authorities and banks calculate RWAs. This can mean that for the same assets different banks have to hold significantly different amounts of capital. One way to mitigate this risk is to operate the BCBS 'floors' below which RWA calculations cannot fall. However, here too there is divergence in interpretation. In the ongoing European Banking Authority (EBA) exercise, authorities in different Member States use different approaches to calculating these floors, which are more binding in some countries than others – the differences can in some cases be very large, and reduce significantly the effectiveness of this risk mitigation strategy. The EBA has explained the two different approaches in its technical papers.[9] It would be beneficial if all banks and authorities disclosed their calculations according to both approaches, to maximise transparency and investor understanding.

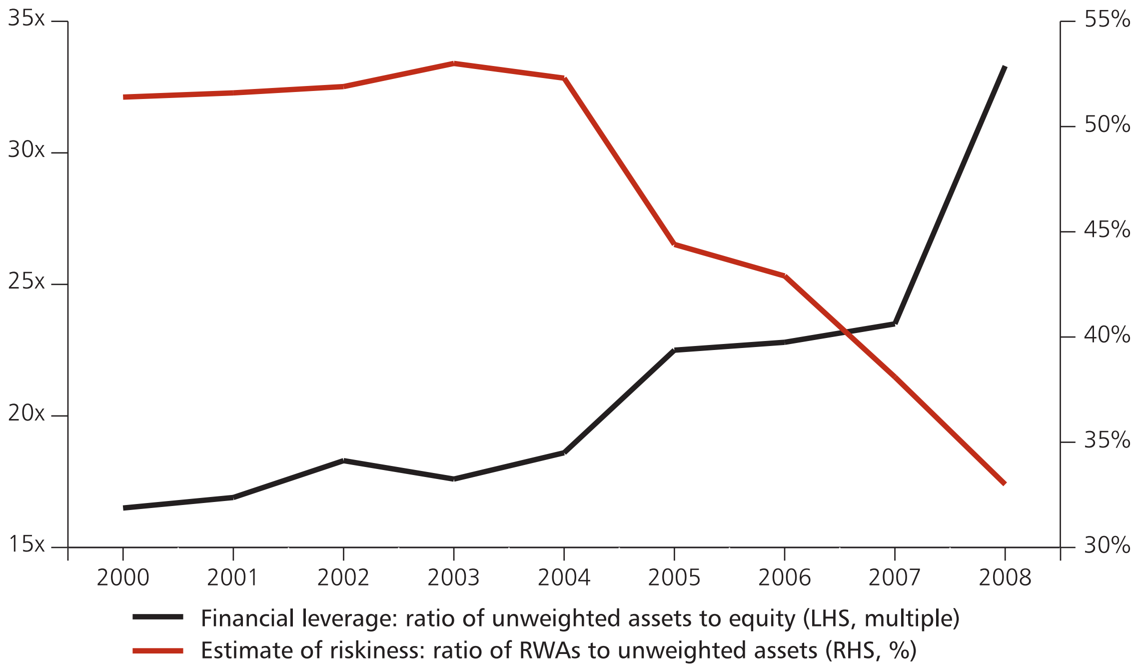
[8] The Basel III rules contemplate disclosure of leverage ratios from 2015. In the Bank of England's most recent Financial Stability Report (http://www.bankofengland.co.uk/publications/fsr/2011/fsrfull1112.pdf), the interim Financial Policy Committee recommended that the FSA encourage banks to disclose their leverage ratios from 2013.
[9] *Capital buffers for addressing market concerns over sovereign exposure,* European Banking Authority, December 2011. Available at: http://stress-test.eba.europa.eu/capitalexercise/Methodology%20FINAL.pdf.

3.17 The ICB recommended that:

- all UK-headquartered banks should maintain a Tier 1 leverage ratio of at least 3%. All ring-fenced banks should do so on a solo basis; and
- in addition, 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 up to a maximum of 4.06% for those ring-fenced banks with a RWAs-to-UK GDP ratio of 3%.

3.18 The ICB's view was that basing capital requirements on RWAs rather than unweighted assets provides better incentives with regard to risk-taking, and for this reason RWAs should remain the primary determinant of loss-absorbing capacity. But the ICB followed the BCBS in endorsing the idea that a minimum ratio of capital to *unweighted* assets or exposures should also apply, as a backstop to capital-to-RWA requirements. The dangers of relying solely on risk-based capital requirements is shown by Chart 3.B which illustrates how in the run-up to the crisis the financial leverage of the UK's biggest banks was increasing, as the riskiness of their assets – as measured by risk weights – was falling. It has since become clear that those lower risk weights were wrong for important asset classes.

Chart 3.B: Ratio of RWAs to unweighted assets falls as financial leverage increases



Source: Independent Commission on Banking

Note: Aggregated for the four largest UK-headquartered banks. 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.

3.19 The Government agrees with the ICB that RWAs should remain the primary determinant of loss-absorbing capital and that this should be combined with a mandatory, minimum leverage ratio as a backstop for all banks. The Government supports the ICB's recommendation that all ring-fenced banks should meet this requirement on a solo basis.

3.20 The ICB's view was that any increase in the minimum equity-to-RWAs ratio should be matched by a *pro rata* increase in the minimum leverage ratio. Otherwise, the leverage ratio would become a less potent backstop as the capital-to-RWAs ratio increases. Hence the ICB proposed that the leverage ratio should be increased to a minimum of 4.06% for the largest banks (who would face the 10% minimum equity-to-RWAs ratio).

3.21 However, the ICB noted that in the case of a bank whose assets appear to be largely low risk – for example, prime residential mortgages – that bank may operate with an average risk weight so low that the leverage ratio has in fact replaced the equity-to-RWAs ratio as the main driver of the capital requirement. If these assets are genuinely low risk, this is arguably a perverse outcome.

3.22 **The Government supports the ICB's endorsement of the Basel III 3% minimum leverage ratio as a backstop for all banks. The Government believes that there may be a case for increasing the minimum leverage ratio for ring-fenced banks with higher (risk-based) capital requirements and, in line with the BCBS, believes that further work is required to determine whether different minimum leverage ratios should apply to banks with different business models.**

3.23 The ICB's recommendation on higher equity requirements is that they should be imposed as buffers, not as higher, hard regulatory minima. There may be advantages in taking the same approach for a higher, minimum leverage ratio. If a bank's leverage ratio fell into this buffer (but remained above the hard minimum), similar sanctions could be imposed as for falling into an equity-to-RWAs buffer, i.e. restrictions on discretionary distributions (possibly with a grace period for temporary and/or modest breaches). The Government will undertake further analysis on this issue.

3.24 The interaction between the ICB's recommendations on minimum leverage ratios and CRR I/CRD IV is discussed in Chapter 6.

Bail-in

3.25 There is a broad consensus that in the future taxpayers should not be required to bail out failing financial institutions while investors are protected. So there needs to be a way of exposing the creditors of failed banks to losses. Accordingly, the G20 has endorsed recommendations by the FSB that resolution authorities should have tools to 'bail in' unsecured and uninsured creditor claims to absorb losses and to re-capitalise a failing firm.[10]

3.26 The European Commission published a consultation document on a crisis management framework in January 2011.[11] This discussed proposals for improving the recoverability and resolvability of banks and investment firms, and included proposals for a bail-in tool. To ensure that the new European-wide framework is credible, it is essential that Member States present a coherent message to banks and their creditors on how they will be treated in a resolution situation and also that state aid is regarded as very much a last resort rather than the default option. It is unacceptable that firms benefit from either explicit or implicit state support without being scrutinised. Robust state aid principles, including imposing private sector burden-sharing conditions on a bail-out, will help shape *ex ante* incentives in order to tackle moral hazard and the implicit government guarantee. Viability assessments under state aid rules should also make

[10] *Key Attributes of Effective Resolution Regimes for Financial Institutions*, Financial Stability Board, October 2011. Available at: http://www.financialstabilityboard.org/publications/r_111104cc.pdf. This recommendation is an international standard that G20 countries have agreed to implement.

[11] *Technical Details of a Possible EU Framework for Bank Recovery and Resolution,* European Commission, January 2011. Available at: http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf.

certain that a bank that has received state aid delivers a restructuring plan that ensures it is resolvable. A legislative proposal on the crisis management framework is expected to be published in the coming months.

3.27 The ICB recommended that:

- the resolution authorities should have a 'primary' bail-in power allowing them to bail-in long-term unsecured debt in resolution – whether by write down or conversion into equity – before imposing losses on other non-capital, non-subordinated liabilities;
- the resolution authorities should have a 'secondary' bail-in power allowing them to bail-in all other unsecured liabilities if the exercise of the primary bail-in power does not prove sufficient;
- subject to the above, the creditor hierarchy should be respected. In order to achieve this, resolution authorities should also have the power to wipe out (or massively dilute) bank capital in resolution;
- bail-in powers should be extended beyond deposit-taking institutions – which are currently the only entities covered by the UK's existing resolution regime (the Special Resolution Regime, or SRR) – to ensure that bail-in can be applied to entities within banking groups[12] that are not deposit-takers; and
- liabilities already in issue should not be exempted from these bail-in powers (or from depositor preference – see Paragraph 3.43 onwards); i.e., there should be no 'grandfathering'.

3.28 If the social cost of a systemically important bank going into liquidation is intolerable, there needs to be some mechanism for imposing losses on liabilities in resolution, without requiring liquidation. If not, they benefit from an implicit government guarantee. Bail-in provides this mechanism. Moreover, even for banks that are not systemically important, bail-in may provide a way of minimising losses on failure. **The Government supports the ICB's recommendation that the resolution authorities be equipped with a statutory bail-in power to assist in the resolution of failed banks (and, in addition, investment firms and financial holding companies).**

3.29 The ICB's final report argues that in resolution it is debt that is long-term and unsecured on which it would be most practicable for the resolution authorities to impose losses. The ICB's view was that this should be recognised in advance by making it clear that such debt will be bailed in ahead of other liabilities. In order to ensure clarity about which instruments fall under the primary bail-in power, the ICB recommended that they have specific risk disclosure.

3.30 **The Government supports the view that long-term unsecured debt that is clearly identified as being subject to a primary bail-in power should be bailed in first (provided all capital[13] is wiped out or severely diluted). Such debt should be unambiguously subject to the UK authorities' statutory bail-in power. There are also benefits to providing resolution authorities with the power to bail in other unsecured liabilities next, should that prove necessary.** This would fit within the FSB's standards and the principles discussed in the European Commission's crisis management framework consultation document, and the Government will seek agreement on a consistent European bail-in regime. Bailing in unsecured liabilities other than long-term unsecured debt is in practice likely to be more problematic – in particular, imposing losses on short-term funding and derivatives exposures (to the extent uncollateralised) may increase disruption in financial markets in a crisis. But giving the authorities the flexibility to do so –

[12] And also entities outside banking groups that conduct significant amounts of financial services activity.
[13] And any contingent convertible debt instruments.

through a 'secondary' bail-in power – would expand the options available to them in resolving a bank.

3.31 However, there are a number of important issues on this topic that will need further consideration. The ICB recommended that all long-term unsecured debt be subject to primary bail-in. But there may be advantages in identifying some long-term debt instruments as subject to primary bail-in, while allowing other long-term debt to be subject to secondary bail-in only. This may avoid perverse incentives on banks to move towards shorter term funding to restrict the range of instruments caught by a primary bail-in power. There are other questions – for example, whether retail products that take the form of long-term unsecured debt should be subject to primary bail-in. These issues, and others, will be the subject of further consultation and analysis.

3.32 Bail-in is a resolution tool, and any new powers would be introduced alongside the tools available under the SRR. However, the SRR currently only applies to deposit-taking institutions. The ICB recommended that bail-in needs to be available as a tool for dealing with a wider range of financial institutions. **The Government supports this position, and is of the view that a broader comprehensive resolution regime is required that extends to investment firms and financial holding companies.** This is consistent with the FSB's recommendations, and was discussed in the European Commission's consultation on a crisis management framework.

3.33 The ICB argued that liabilities already in issue should **not** be exempt from its recommendations on bail-in (i.e. there should be no 'grandfathering').

3.34 Reasons for not grandfathering include that if it is only new long-term debt that is bail-inable, the first issue of such debt will be subordinated and expensive and it will be a long time before banks have significant volumes of bail-inable debt in issue.

3.35 However, it is possible that these issues could be mitigated in a number of ways – for example, one way would be to provide that new issues of debt would only become subject to a specific bail-in power once such debt makes up a certain percentage of a bank's funding. Coupling this with a requirement that this condition be reached within a given period of time would address the second point.

3.36 But it should be noted that even without grandfathering, a new bail-in power would not apply to the outstanding stock of debt until the necessary legislation was passed and activated.

3.37 Moreover, under the SRR, the authorities can in any case impose losses on creditors in some circumstances (subject to certain safeguards). This provides the resolution authorities with some ability to bail in existing creditors, even if the new bail-in power recommended by the ICB were made subject to grandfathering.

3.38 The issue of bail-in (including grandfathering) will be considered further in the continuing discussion on resolution among the authorities at European and global level. **The Government will revert to this issue in its White Paper next year, in the light of global regulatory developments.**

3.39 Note that the ICB recommendation is for the resolution authorities to have bail-in *powers*; it does not follow from this that bail-in would necessarily be applied to a failing bank (i.e. the use of the tool will be at the discretion of the resolution authority) – in particular to a bank that is put into insolvency. This raises the question of whether the order in which debt can be bailed in in resolution should be reflected in the creditor hierarchy that applies in insolvency, by amending insolvency law.

3.40 The ICB suggested that this may be appropriate. This would remove uncertainty that would arise from having a different order of priorities in resolution and in insolvency. And where the ability to impose losses on creditors in resolution is restricted with reference to the losses they may have suffered in the counterfactual insolvency, having the same hierarchy in insolvency as in resolution minimises the extent to which this restriction would constrain the ability of resolution authorities to expose creditors to losses. Further consultation and analysis are required on this question.

3.41 The ICB also made recommendations on minimum amounts of capital plus long-term unsecured bail-inable debt that banks should be required to hold; see under 'Primary loss-absorbing capacity' below.

3.42 The design of the bail-in tool will need to be developed in light of European negotiations and implemented in a manner that is consistent with the finally adopted EU crisis management framework. This interaction is discussed further in Chapter 6.

Depositor preference

3.43 There is no internationally agreed approach to depositor preference, although a number of major jurisdictions already have it in place, including the US, Switzerland, China, Hong Kong, Australia and Argentina. 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.

3.44 The ICB recommended that:

- all deposits insured by the Financial Services Compensation Scheme (FSCS) should rank ahead of other creditors to the extent that those creditors are either unsecured or secured only with a floating charge; and
- this should apply to all insured deposits, whether within the ring-fenced bank or not.[14]

3.45 The ICB made a number of arguments in favour of insured depositor preference, including that insured depositors have no incentive to exert market discipline on banks and are not well-placed to do so; the incentives of other unsecured creditors to exert discipline are blunted by the fact that they rank *pari passu* with deposits; and requiring the FSCS to pick up the tab either requires well-run banks to pay for the failure of others (a channel for contagion) or leaves the taxpayer exposed to some extent. (In the recent crisis, the FSCS has borrowed around £20bn from the Government to fund payouts to eligible depositors following the failure of several banks.)

3.46 Arguments against include that depositor preference will affect the price and availability of wholesale funding, and that it unfairly penalises other creditors such as banks' own pension funds and trade creditors. However, long-term unsecured wholesale funding would (under the ICB's primary bail-in recommendation) be bail-inable ahead of deposits with or without depositor preference. So the impact on the price of such funding is questionable.[15]

3.47 Short-term wholesale funding would, however, rank lower in the creditor hierarchy with depositor preference. It is therefore possible that there would be some impact on its price and availability – and indeed, that is necessary if depositor preference is to improve market discipline. However, depositor preference should not alter the *likelihood* of such funding bearing loss – although if a loss materialised, it would be larger. If the pricing and availability of such funding

[14] Note that under current proposed amendments to the Deposit Guarantee Scheme Directive, European guarantee schemes would be extended to cover all non-financial companies, as well as retail depositors.
[15] This may not hold true if any long-term unsecured wholesale funding would – in the absence of depositor preference – continue to rank *pari passu* with insured deposits in insolvency. See Paragraph 3.40.

is largely determined by the likelihood of a loss occurring, rather than by the likely magnitude of loss, depositor preference may have a relatively small impact.

3.48 On the other hand, if short-term funders do take some account of depositor preference, it may make them more likely to withdraw funding from a bank that is under pressure, and so have a pro-cyclical effect – exacerbating any stress in the market. Expanding the scope of depositor preference to include all deposits would mitigate this impact on uninsured deposits. But it would also reduce the benefits, in particular as it would incentivise creditors to re-characterise their exposures to banks as deposits, if possible.

3.49 Further, under existing legislation the FSCS can be required to contribute to the cost of a bank resolution. Its contribution is capped at the amount it would have had to pay out to depositors had the bank been put into insolvency less (i) any recoveries the FSCS would have made in the insolvency; and (ii) any amount actually paid out to depositors in the resolution. By potentially increasing the amount the FSCS would recover in insolvency, depositor preference reduces the extent to which resolution expenses can be reclaimed from the FSCS and, through the FSCS' levy, from the wider industry. One proposal for funding resolution expenses is the establishment of a resolution fund that is built up over time and that can then be used as necessary. However, such funds have a number of significant drawbacks – see Box 3.C.

Box 3.C: Pre-funded resolution financing

Resolution authorities need to be able to fund resolution proceedings. However, the Government does not believe that a pre-funded resolution financing mechanism – where banks would be required to contribute in advance to a resolution fund – would advance this objective, and it may in fact be harmful.

Any such fund would be very unlikely to be large enough to provide the required amount of up-front financing needed during a resolution – in particular should the crisis be systemic, not idiosyncratic. Requiring very large pre-fund contributions from banks to address this would significantly increase banks' costs, risking more expensive credit provision and/or de-leveraging, with a likely adverse impact on economic growth. Any pre-fund would also generate moral hazard – investors would expect to be bailed out in the event of bank failure, and so their incentives to exert market discipline on banks' risk-taking would be undermined.

The Government believes that the best way of addressing the issue of financing resolution expenses is through the development of more effective resolution frameworks, including by the introduction of a bail-in resolution tool. This would expose creditors of failed banks to loss – in the same way that creditors of failed non-financial firms are exposed to loss – without requiring the use of taxpayer funds or other state resources.

3.50 The ICB recommended that insured deposits (only) be preferred, but there are other options. For example, all deposits could be preferred. Or all deposits of depositors who are eligible for deposit insurance. The pros and cons will be different for each model. Further analysis and consultation is needed, including on the impact of depositor preference in those jurisdictions – such as the US – which have already implemented one form or another.

3.51 On balance, the Government supports depositor preference. However, the Government believes that further analysis and consultation is needed on the scope – in particular on the relative merits of limiting depositor preference to insured deposits, as opposed to extending it to either all deposits, or a different subset.

Primary loss-absorbing capacity

3.52 The FSB's standards on bail-in do not specifically endorse a minimum amount of bail-inable debt, although they are consistent with requiring one. The consultation document on the proposed European crisis management framework discussed a minimum bail-inable debt requirement (but did not examine how it could be calibrated).[16]

3.53 The ICB recommended that:

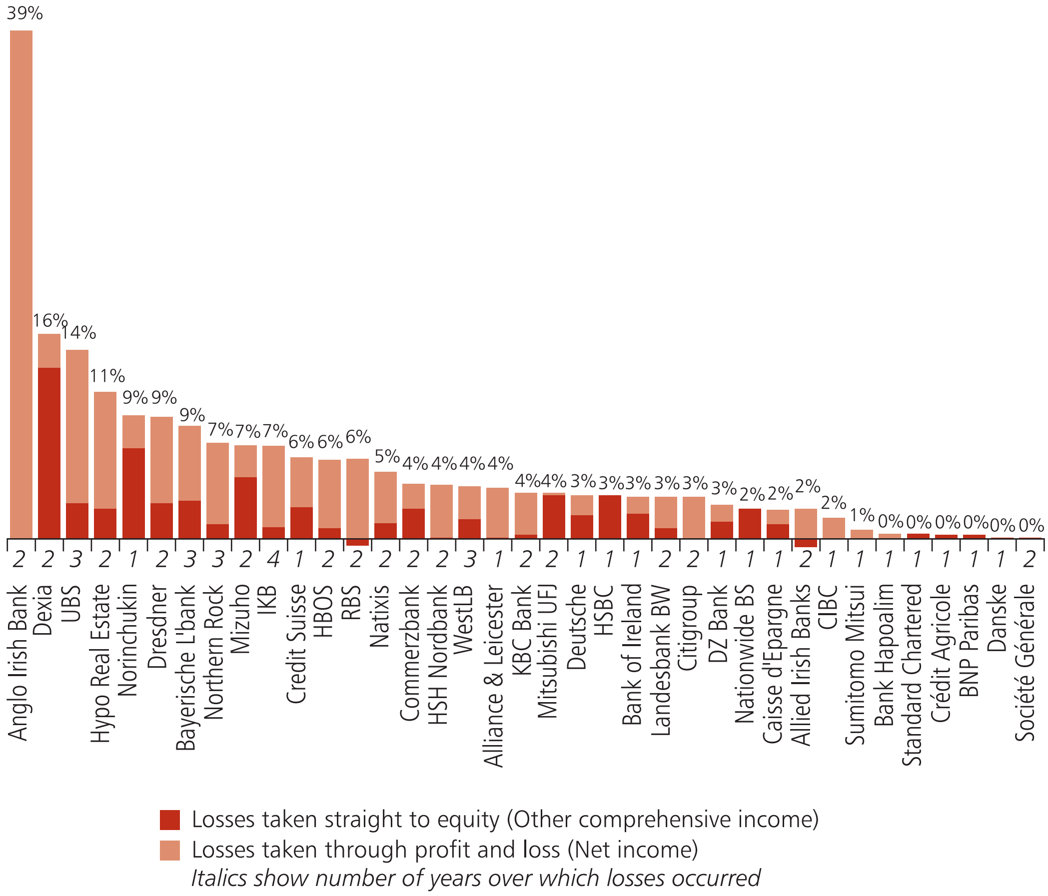
- UK-headquartered G-SIBs with a 2.5% G-SIB surcharge, and all ring-fenced banks with a ratio of RWAs to UK GDP of 3% or more, should be required to have regulatory capital plus long-term unsecured debt subject to the primary bail-in power equal to at least 17% of RWAs;
- UK G-SIBs with a G-SIB surcharge 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; and
- these requirements should apply to UK-headquartered G-SIBs at the level of the consolidated group, and in addition to UK-domiciled banks within the group on a solo basis.

3.54 Implementing a bail-in regime that allows resolution authorities to expose certain types of liability of failed banks to losses before others incentivises banks (and their investors) to migrate away from those liabilities that bear losses first. A complement to the ICB's recommendation for a primary bail-in power is therefore to require banks to hold a minimum amount of loss-absorbing capacity that is either (i) regulatory capital; or (ii) long-term unsecured debt that is clearly identified as being subject to a primary bail-in power[17] ((i) and (ii) together constitute 'primary loss-absorbing capacity', or 'PLAC'). **The Government is strongly supportive of this approach.**

3.55 The ICB has recommended that the minimum level of PLAC be set at 17% for the biggest G-SIBs and for large ring-fenced banks. The ICB reached this conclusion with reference to levels of loss that have been suffered by banks in historical crises, observing that loss-absorbing capacity of at least 17% of RWAs would have been sufficient to cover the losses of nearly all the banks in its sample (see Chart 3.C for bank losses in the recent crisis). The ICB also argued that to the extent banks in any case choose to fund themselves using long-term unsecured wholesale funding, and on the assumption that making such debt explicitly bail-inable adds 100bps to its cost, a minimum PLAC requirement of 17% would have a small impact on banks' average cost of funding.

[16] *Technical Details of a Possible EU Framework for Bank Recovery and Resolution,* European Commission, January 2011. Available at: http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf.
[17] And is unambiguously subject to the UK authorities' statutory bail-in powers.

Chart 3.C: Losses suffered by banks in the crisis as a percentage of RWAs (2007-2010)[18]



Source: Independent Commission on Banking

3.56 It could be argued that the tightening up of risk-weights under Basel III means that calibrating future loss-absorbing capacity requirements with reference to losses as a percentage of historical RWAs will lead to those requirements being set too high – so that the ICB's 17% figure should come down. But on the other hand, if a systemically important bank is to be resolved without taxpayer solvency support, there is an argument that it will need a level of loss-absorbing capacity to ensure the viability of at least some of its operations *after* all losses have been absorbed – so that the ICB's 17% figure is too low.

3.57 **The Government's view is that 17% is likely to be the appropriate number for the largest institutions, but that further consultation and analysis should be conducted to confirm this. The Government supports setting lower PLAC requirements for smaller banks.** As discussed in Paragraph 3.13 above, further consultation is required to determine whether the calibration of PLAC for smaller ring-fenced banks recommended by the ICB is optimal. The Government supports the ICB's recommendation that the PLAC requirements be imposed as a buffer, rather than a hard minimum requirement (see Paragraph 3.14 for a discussion on this).

3.58 The ICB recommended that the PLAC requirement apply to banks on a consolidated group basis, and also that UK-domiciled banks meet the requirement on a solo basis. Where this requirement covers group assets outside the UK, the ICB's recommendations are not prescriptive

[18] The losses shown in Chart 3.C 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 Chart 3.C may be offsetting previous unrealised gains, the impact of these losses on bank viability may appear overstated.

on where such loss-absorbing capacity is issued – as long as it is either capital, or bail-inable under the ICB's primary bail-in power. This is consistent with an approach under which the purpose of requiring PLAC to be held against group-wide assets is to ensure that failures of non-UK operations do not endanger UK financial stability and so put UK taxpayer funds at risk.

3.59 However, international regulatory developments are aimed at requiring all G-SIBs to develop RRPs that minimise the need for solvency support from home or any host authorities in the event of firm failure. 'Crisis management groups' for all G-SIBs – consisting of all relevant supervisors and resolution authorities – are tasked with ensuring that through co-ordination and co-operation of recovery and resolution planning and actions, G-SIBs are resolvable.

3.60 The Government strongly supports putting in place institution-specific cross-border co-operation agreements that define the roles and responsibilities of different authorities both pre-crisis, and during a crisis. In line with the FSB's recommendations (endorsed by the G20), these agreements should:

- set out the processes for co-ordination in the development of RRPs, including for any parent or holding company and significant subsidiaries, branches and affiliates; and
- provide an appropriate level of detail with regard to the cross-border implementation of specific resolution measures, including with respect to the use of bridge institutions and bail-in powers.

3.61 The Government is also strongly supportive of the FSB's recommendation that resolution authorities should co-ordinate in regularly undertaking resolvability assessments for G-SIFIs, to evaluate the feasibility of resolution strategies and their credibility in light of the likely impact of the firm's failure on the financial system and the overall economy. These assessments should examine in particular:

- the extent to which critical financial services and payment, clearing and settlement functions can continue to be performed; and
- the nature and extent of intra-group exposures and their impact on resolution if they need to be unwound.

3.62 Concerted action by crisis management groups and relevant resolution authorities to agree RRPs, put in place cross-border co-operation agreements, and conduct co-ordinated resolvability assessments are important steps in improving the resolvability of UK-headquartered (and other) G-SIBs, and so reducing the risk of UK taxpayers being exposed should they fail.

3.63 Where, as a consequence of these co-ordinated actions, a G-SIB has operations in another jurisdiction that do not pose a risk to the UK taxpayer, it should not be necessary for the UK regulatory authorities to impose additional requirements on those operations – and doing so may risk reinforcing any perception that the UK authorities were holding themselves out as responsible for the bailing out of overseas operations.

3.64 **The Government's view is that UK-headquartered G-SIBs should have to meet minimum PLAC requirements across their global operations, as well as in the UK, except where it can be shown that any non-UK operations do not pose a risk to UK financial stability and thus to the UK taxpayer. In this case, the loss-absorbing capacity of those foreign operations need not exceed any international or local standards. This would be evidenced by, for example, a robust, credible plan for the resolution of foreign operations separately from the resolution of UK operations. Such a plan would of course need to be consistent with the ongoing responsibilities of the UK authorities for the consolidated group supervision of such entities and for co-ordination of group-wide resolution plans of UK-headquartered G-SIBs. The Government intends to set out further details on this in its White Paper.** Such an approach:

- achieves the objective – shared by the ICB and the Government – of ensuring that the failure of non-UK operations[19] does not result in exposures for the UK taxpayer;
- is consistent with the FSB's recommendations that institution-specific agreements between regulators of G-SIBs define the roles and responsibilities of the various relevant regulators and resolution authorities in a crisis; and
- furthers the ICB's objective of allowing international regulatory standards to apply to UK banks' international operations *provided that* those operations do not pose a threat to the UK taxpayer, so ensuring a level playing field for the UK's banks in the global market for financial services.

Resolution buffer

3.65 The G20 has endorsed the FSB recommendation that robust and credible RRPs should be put in place for all firms whose failure could have an impact on financial stability, and that authorities should be able to take appropriate measures to address any deficiencies identified in the plans. The EU crisis management framework is expected to include recovery and early intervention tools and powers for the EU supervisors to avert firm failure, as well as resolution tools and powers for resolution authorities to manage effectively a financial institution failure.

3.66 The ICB recommended that:

- the supervisor of any UK-headquartered G-SIB, or any ring-fenced bank with a ratio of RWAs to UK GDP of 1% or more, should have the discretion to require the bank to have additional loss-absorbing capacity – a 'resolution buffer' – 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; and
- the discretion should extend to determining the nature of the resolution buffer (e.g. equity, or non-capital long-term unsecured debt); the calibration (within the range 0%-3% of RWAs); and which entities in a group the requirement should apply to.

3.67 The ICB's view was that across systemically important banks, minimum loss-absorbing capacity requirements should differ according to banks' relative levels of resolvability. The ICB accepted that the proposed, variable G-SIB surcharge will address this to some extent, but argued that the surcharge is focused on how systemic banks are, and is primarily designed to provide additional going-concern loss-absorbency. As such, it does not specifically focus on resolvability.

3.68 There is an argument that banks' resolvability is addressed through the RRP process – and the Government strongly supports their development. But – in particular as firms transition to a situation in which all UK banks have comprehensive, effective RRPs – supervisors may still have some concerns about resolvability. **The Government therefore supports supervisors having the ability to require a firm to have additional loss-absorbing capacity if there are concerns about its resolvability.**

3.69 There is broad consensus on the need to end 'too big to fail'. So it is appropriate that supervisors should have considerable flexibility in addressing resolvability concerns. Following this reasoning, **the Government is of the view that 0%-3% of RWAs is likely to be the appropriate range for a resolution buffer.** The Government is also of the view that supervisors should have the flexibility to determine how it should be constituted (e.g. with bail-inable debt, equity, etc.) and to which entity or entities it should be applied (e.g. the ring-fenced bank only,

[19] It is of course the case that UK operations must not result in exposures to the UK taxpayer, either. This objective is advanced by the imposition of minimum PLAC requirements on UK entities.

non-ring-fenced bank only, etc.) – although application to non-UK operations would be subject to the qualifications discussed in Paragraph 3.64. Further analysis and consultation will be required on these points.

3.70 **The Government notes, and strongly supports, the ICB's view that the resolution buffer should in no way be seen as an acceptable long-term substitute for robust RRPs.** Thus the need to impose a resolution buffer should be an indication of an inadequate RRP – the Government's view is that the best outcome is for all firms to have credible, robust RRPs, with no need for application of the resolution buffer. (On the other hand, if a firm still gives rise to resolvability concerns in spite of the application of a full resolution buffer, this should in no way limit its supervisor's scope to use further powers to address the problem.)

3.71 Note that supervisors already have the flexibility to increase capital requirements on an institution-specific basis under the Basel regulatory framework (under 'Pillar 2'). Pillar 2 requirements are not published; rather they are communicated privately to a firm by its supervisor. The interaction between the resolution buffer and Pillar 2 requirements – and whether or not the details of any resolution buffer should be published – will require further consideration. One advantage of keeping the details of any resolution buffer private is that it may be more likely to operate as a buffer that a bank can use if necessary, rather than as a new, hard minimum – see Paragraph 3.14 for a discussion on buffers. And it may mitigate any moral hazard that may arise from a public awareness that the authorities considered a bank unresolvable.

3.72 Neither the resolution buffer, nor the minimum PLAC requirements described in the previous section, are designed as macro-prudential tools. However, the Government is strongly supportive of improved macro-prudential regulation, and has established an interim Financial Policy Committee of the Bank of England to monitor systemic risk and provide recommendations to the authorities in relation to oversight of the financial system and the use of macro-prudential tools.

Box 3.D: Some outstanding policy questions

The Government will undertake a formal consultation in Spring 2012. However, there are a number of issues set out in this chapter on which earlier views would be welcome, in particular:

- Is the ratio of a bank's RWAs to UK GDP the appropriate indicator to calibrate its ring-fence buffer?
- How should the minimum leverage ratio for large ring-fenced banks be calibrated?
- Should bail-in cover all unsecured liabilities, but with long-term unsecured debt that is clearly identified as being subject to a primary bail-in power being required to bear losses ahead of other (non-capital) liabilities?
- What are the relative merits of the different forms of depositor preference?
- Do you agree that the biggest G-SIBs, and large ring-fenced banks, should be required to have a minimum PLAC-to-RWAs ratio of 17% (reduced for smaller banks)?
- Do you agree that the supervisors of UK-headquartered G-SIBs and ring-fenced banks above a certain size should be able to require such firms to have additional loss-absorbing capacity – a 'resolution buffer' – to the extent there are any concerns about the firms' resolvability?

4 Competition

The ICB's competition recommendations

4.1 On competition, the ICB made recommendations:

- to improve the prospects for a strong and effective challenger to result from the Lloyds Banking Group (Lloyds) divestment;
- to ensure that prudential requirements do not result in excessive barriers to entry for prospective new entrants wishing to enter the market;
- to improve the process for switching personal and small business current accounts;
- to enhance transparency in the retail banking market, in part by making more information available to customers;
- to secure pro-competitive financial regulation via the Financial Conduct Authority (FCA); and
- on a possible future market investigation reference to the competition authorities.

4.2 The Government welcomes these recommendations as an important contribution to the debate on competition in financial services. This chapter takes the ICB's recommendations in turn and sets out the Government's position.

4.3 **The Government is committed to fostering a strong, competitive banking sector.** A competitive banking sector is necessary to ensure that the UK economy can benefit from banking products and services at efficient prices. Effective competition is also a spur to innovation and economic growth, and can lead to better quality and service for consumers. The emergence of a strong and effective challenger bank from the Lloyds divestiture – that would exert real, competitive pressure on the big banks – would be good for competition.

4.4 Changes have already been made which will improve competition in banking. The Government has addressed the issue of unfair overdraft charges as part of the Consumer Credit and Personal Insolvency Review, published in November. Changes have also been made to the Financial Services Authority (FSA) bank authorisation process. This is the process all prospective new banks must go through to receive authorisation. It is right that the process is thorough and robust, but recent changes, including the use of pre-application meetings and 'milestone' documentation mean that the process is smoother and easier to navigate for potential new banks than it once was.

4.5 The ICB's recommendations on financial stability will also help to address competition concerns in financial services, and complement the competition recommendations. As the ICB noted in its final report, financial stability recommendations that eliminate the implicit government guarantee are themselves pro-competitive. Where banks are regarded as 'too big to fail', market participants – in particular debt investors – will contract with them on more favourable terms than with smaller banks, distorting competition in the UK and in the European single market.

The Lloyds Banking Group divestment

4.6 The ICB recommended that the Government reach agreement with Lloyds to ensure that the Lloyds divestment has a strong funding position relative to its peers, and that it has a share of the personal current account (PCA) market of at least 6%.

4.7 **The Government agrees that a strong funding position for the Lloyds divestment as measured against its peers will be important for the new challenger bank to enable it to compete effectively in the market. An increased divestment, which resulted in an entity with a larger share of the PCA market, might give the new challenger bank a better chance to challenge effectively.**

4.8 The Government does believe that Lloyds should do all it can to create a strong and effective challenger, by addressing the recommendations of the ICB on funding and PCA market share, subject to the responsibilities set out in the Companies Act and without endangering its own viability or funding stability. The Government notes Lloyds' recent announcement to move to exclusive discussions with the Co-operative Group about the divestment. If a transaction were to go ahead, this would deliver a significant enhancement of the PCA market share, to approximately 7%-8%, which would have an additional positive impact on competition compared to an initial public offering.

4.9 The Government is the largest shareholder in Lloyds, with a 40.2% stake in the bank. But there are constraints on the extent to which the Government's ownership enables it to direct the board or management team. As set out in the Companies Act 2006, the bank's directors have fiduciary duties to act in the commercial interests of all shareholders, not just the largest shareholder. The execution of the divestment is a commercial matter for Lloyds, provided they adhere to the terms of the state aid agreement between the UK Government and the European Commission. Therefore, the Government does not intend to use its shareholding in Lloyds to deliver an enhancement of the divestment. This is consistent with the Government's stated approach of managing its investments in UK financial institutions on an arm's length and commercial basis, because this is the best way to deliver the Government's objectives to restore the banks to health and return them to the private sector, realising value for the taxpayer as shareholder.

Barriers to entry and prudential requirements

4.10 The ICB recommended that the Prudential Regulatory Authority (PRA) work with the Office of Fair Trading (OFT) to review the application of prudential standards to ensure that requirements for capital and liquidity do not pose excessive barriers to entry or expansion for new entrants and prospective new entrants to the market. In particular, the ICB recommended that the use of standardised risk weightings should not penalise banks that do not move to an advanced tailored approach due to the high costs of doing so.

4.11 The Government is clear that prudential standards for capital and liquidity should not act to dampen effective competition, and agrees that new banks should not be treated disproportionately, subject to the level of risk. As mentioned, improvements have already been made to the FSA's authorisation process, which could act as a barrier to entry for prospective new banks.

4.12 **The Government agrees that the OFT and PRA should work together closely to consider this recommendation, taking into account what further improvements can be made to the FSA's authorisation process and prudential requirements.**

4.13 In its interim report, the ICB raised possible concerns about the ability of small banks to access the payment systems. It said there was some evidence to suggest that the ability of banks to access the payment systems through incumbents, and the ability of the Payments Council to maintain a level playing field in payments, were not conducive to a competitive market. However, the evidence was not clear-cut, and this was not raised as a substantial barrier by most new entrants. Therefore, the ICB did not make recommendations in this area, beyond suggesting that the Bank of England, in collaboration with the FCA and OFT, should monitor access to the payment systems and the effectiveness of the Payments Council in providing adequate governance to ensure innovation and competition.

4.14 **The Government believes that more needs to be done to bring the Payments Council within the scope of financial regulation, taking into account the relationship between the Payments Council, its members and inter-bank payment systems.** The Government is therefore developing a number of options for potential reforms. HM Treasury will publish a consultation on the options, including options for creating a new regulatory structure for the Payments Council and the inter-bank payments regime, taking into account the need to preserve the stability and integrity of payment systems; enhance open competition by reducing barriers to entry; promote innovation; and reflect the needs of end users, as well as the needs of payment service providers. The consultation will take place early in 2012.

Switching

4.15 The ICB recommended that a current account redirection service should be established to smooth the process for individuals and small businesses wishing to switch their bank account to a different provider. The service should be free to use for the customer, catch all credits and debits into the old (closed) account, send reminders to direct debit originators to update their details, and provide a guarantee that customers will not suffer any loss if mistakes occur.

4.16 The ICB recommended that the service should be fully operational by September 2013, and should be designed and implemented in such a way that does not impose disproportionate costs on new entrant banks, smaller players or direct debit originators. Finally the ICB recommended that to ease the switching process for small business customers, who may have secured loans outstanding when they wish to switch banks, the banks should improve the process for transferring security. This could include a maximum timescale for the release of security.

4.17 The analysis conducted by the ICB suggests that the low levels of switching in banking are in part a problem of perception. For example, the ICB's final report highlights that a significant proportion of customers may be deterred from switching as they believe the process to be cumbersome, complicated or risky. In some instances this apprehension regarding the switching process by consumers is justified. The ICB highlighted that almost half of consumers who switched accounts encountered a problem of some kind with the switching process.

4.18 A low level of switching is not in itself a cause for concern, as in a competitive market switching rates can remain low as all firms offer customers good deals, reducing the need for customers to switch to rivals. It is for this reason that raising switching rates *per se* is not an objective for the Government. However, customers who wish to switch should not be prevented from switching by actual or perceived risks to their ability to use their current account.

4.19 The Government therefore strongly supports the ICB recommendation on switching. It is clear that for effective competition to operate in retail banking consumers and businesses must be able to switch their accounts quickly and easily. Switching between providers is a key way for consumers to hold their bank to account, to seek out better deals, and for competition to deliver better outcomes for consumers. The switching process therefore needs to be as safe, robust, and easy for consumers to understand as possible. In a well functioning market without barriers to switching, consumers and businesses both benefit. Consumers who can identify better deals are able to switch provider to benefit directly. Consumers who choose not to switch can also gain from better prices and service, as firms faced with a competitive threat from rivals are forced to adjust their offering to customers accordingly. Finally firms benefit, as those with good products and services are rewarded with more custom.

4.20 The banking industry, via the Payments Council, have committed to implementing the ICB's recommendations on switching.[1] The new service will be in place by September 2013 and will provide a guarantee that the switching process will take no longer than seven working days. This is a significant programme of work. HM Treasury will monitor the project's progress by holding quarterly meetings with the Payments Council and industry representatives, holding the industry to account. **The Government is clear that the system must be designed, tested and delivered on time, while having regard to programme costs, particularly for smaller banks.**

4.21 **Once the service is operational, the Government will assess whether or not the service has delivered the expected consumer benefits. If not then further measures, including 'full account portability', will be considered.**

4.22 The Government has noted the submissions to the ICB, made by industry bodies, which suggested that the release of security (applicable for secured borrowers wishing to switch provider) may be an issue for some small business banking customers. The time it takes to release security for switching purposes should not be a disproportionate obstacle to switching. The Government will explore this issue in more detail, and would be interested in receiving further evidence from small business customers and from the industry on the extent of any problem, and on the scope for new and existing lenders to improve the process for releasing security.

Transparency

4.23 The ICB made a number of recommendations aimed at improving the level of transparency in the UK retail banking market. The ICB recommended that the OFT and the FCA should work together and with the financial services industry to improve transparency across all retail banking products, in particular PCAs and business current accounts (BCAs). Regarding the transparency of prices in the market, the ICB recommended that banks should provide data on the cost of their services for a sample of representative customer profiles, and should make price information available in accessible formats.

4.24 As a first step to improving transparency, the ICB recommended that interest foregone on credit balances, relative to the Bank of England base rate, should be incorporated into the annual statements currently being introduced by the industry, and that the FCA should conduct consumer research regarding the best way to present this information to consumers.

4.25 In addition, the ICB highlighted a number of areas worthy of further consideration to improve transparency in future, such as firms making account usage data available to customers in electronic form, requiring product ranges to include an easily comparable standardised product and developing comparison tools for non-price product characteristics.

4.26 **The Government is clear that financially capable consumers are needed to drive competition in the banking sector. Banking is a diverse and complex industry, and the levels of transparency have fallen short of expectations in the past. Increased transparency in the marketplace can help people better understand the products and services on offer, manage their money more effectively, and, by making it easier to compare products, make an informed choice. The Government will continue to consider the best ways to promote transparency in the market and is clear that the OFT and the FCA should work closely together to improve transparency.**

[1] See Payments Council press release at: http://www.paymentscouncil.org.uk/media_centre/press_releases/-/page/1618/.

4.27 The OFT and FSA have both investigated transparency in the market in recent years. The OFT's market study in 2008 into PCAs resulted in a number of voluntary initiatives, agreed by the banks, in 2009. These included the introduction of annual statements of the cost of accounts to customers, making charges more prominent on bank statements, providing average credit and debit balances, and producing illustrative scenarios for unauthorised overdrafts. The illustrative scenarios have been available from bank websites since 2010 and the majority of the remaining information should be provided to consumers by the end of 2011.

4.28 The OFT has also committed to review the market again in 2012. This review will consider, among other things, the impact of the transparency initiatives already in place and whether further measures, such as information on interest forgone, are required in the future.

4.29 The OFT's 2008 market study also identified specific issues around the transparency of unarranged overdraft charges, which account for a significant proportion of banks' revenue from PCAs. In line with the Coalition commitment to end unfair bank and financial transaction charges, the Government has addressed this issue as part of the Consumer Credit and Personal Insolvency Review. On 21 November the Government announced a new agreement with the five major personal current account providers to give consumers more transparency and control over their charges. Under this agreement, which applies to all full facility accounts offered by the major banks, over 85% of PCA customers will be able to receive a text message when their balance falls below a certain level and will be made aware of the time of day by which they need to pay in funds to cover any payments and avoid a charge. Banks will also provide a small buffer zone to ensure that customers are not charged for going over their limit by a small amount. The text alerts will be available to customers by March 2012, with the other two measures in place by March 2013.

4.30 There is also a key role for the Money Advice Service (MAS) in increasing transparency in the marketplace and helping consumers make better decisions. The MAS is an independent body which provides free and impartial information and advice to members of the public on money matters. Following a review of its products and services, the MAS intends to provide a more personalised multi-channel service, more focused on digital tools and advice rather than information. This will include exploring the demand for, and feasibility of, a comparison tool for PCAs in the context of a wider review of comparative data.

4.31 The Government is also taking forward further steps to improve transparency as part of the 'Midata' programme. Midata is a voluntary programme the Government is undertaking with UK businesses and industry groups to give consumers increasing access to their personal data in a portable, electronic format. Individuals will then be able to use this data to make more informed choices about products and services and to manage their financial lives more efficiently.

4.32 The Department for Business, Innovation and Skills and the Cabinet Office are working with the banking industry towards achieving this goal for current account and credit card users through Midata's Finance Sector Board.

Competition in the Financial Conduct Authority's objectives

4.33 The FCA will be the new integrated conduct of business regulator for financial services, and will take a tougher, more proactive and more focused approach to regulating conduct in the financial services industry and markets and securing better outcomes for consumers. The FCA's draft objectives were published in a White Paper in June.[2] The ICB recommended that the efficiency and choice operational objective should be replaced with an objective to "promote effective competition" in markets for financial services. It was also recommended that the

[2] *A new approach to financial regulation: the blueprint for reform*, HM Treasury, June 2011. Available at: http://www.hm-treasury.gov.uk/consult_finreg_blueprint.htm.

Government reconsider the FCA's strategic objective to provide greater clarity on competition, choice, transparency and integrity.

4.34 **The Government agrees with the ICB that effective competition is essential in delivering the right outcomes for consumers and that the FCA has a key role to play in promoting effective competition in financial services markets.** A new statutory competition remit will provide the FCA with a clear mandate for swifter more effective action to address competition problems in financial services. For example, in the case of payment protection insurance (PPI) the Competition Commission found that there was a lack of effective competition when PPI was sold alongside a loan. This resulted in consumers facing higher prices and less choice. It also allowed conditions in which significant mis-selling could take place. In future, a clear competition mandate will enable the FCA to use its powers to tackle the problems encountered with PPI more quickly and effectively.

4.35 The Government has therefore already committed to reconsider the FCA's objectives in light of the ICB's recommendations. In doing so, the Government has taken into account the recommendations of the Joint Committee of Parliament, established to conduct pre-legislative scrutiny of the draft Financial Services Bill, and other stakeholders. The pre-legislative scrutiny process has now concluded, and the findings of the Committee are published on the same day as this response document. The Committee's recommendations are broadly consistent with those of the ICB. The Government will therefore be taking on both of the ICB's recommendations, reframing the FCA's strategic objective in terms of ensuring that markets work well, and recasting the efficiency and choice operational objective in terms of promoting effective competition in the interests of consumers. The Government will introduce the Bill – including these redrafted objectives – into Parliament in early 2012.

4.36 The Joint Committee also recommends that the FCA's strengthened competition remit should be matched with new competition powers and responsibilities. These include market investigation reference powers, (to be held concurrently with the OFT, in line with other sectoral regulators) and a requirement to respond to 'super-complaints' made by interested stakeholders on consumer and competition issues. The Government will consider these and other recommendations made by the Joint Committee before introducing the Bill early next year.

Market investigation reference

4.37 The ICB did not recommend an immediate market investigation reference to the Competition Commission for the personal or business current account markets. However the ICB did note that such a reference may be necessary in the future. Specifically, if the combination of an effective challenger resulting from an enhanced Lloyds divestment, the creation of a strong FCA, and an improved switching service has not resulted in demonstrable improvements by 2015, then the ICB recommended that a market investigation reference should be actively considered.

4.38 The Government is clear that the UK's competition authorities are able to scrutinise the financial services market as they see fit. The OFT can make a market investigation reference to the Competition Commission at any point if they have reasonable grounds to suspect that a feature or features of a market prevents, restricts or distorts competition. However, any future market investigation reference must be taken on its merits at the time – a decision which is primarily a matter for the relevant authorities.

5 Economic impact and competitiveness

Introduction/summary

5.1 In its final report, the ICB estimated that the total private costs to banks of its proposals would be in the range of £4bn-£7bn per year, and the resulting social cost would be £1bn-£3bn per year, or roughly 0.1% of GDP. Set against this social cost, the ICB estimated that the annualised cost of financial crises is around 3% of GDP, or £40bn in 2010 terms. The ICB concluded that its recommendations therefore need only reduce the costs of future crises by between $1/40^{th}$ and $1/13^{th}$ in order to deliver net social benefits.

5.2 This chapter presents the Government's own assessment of the costs and benefits of the ICB's recommendations. This has been informed by a review of the ICB's methods and results, supported by additional cost and benefit analysis undertaken on the basis of modelling conducted by the major UK banks.

5.3 **The Government has concluded that the costs to banks are broadly as estimated by the ICB, but the impact on GDP will be somewhat less than the ICB's estimates. The measures that the ICB recommended will therefore deliver significant net benefits to the UK economy and the taxpayer.** The rest of this chapter is set out in the following sections:

- economic costs of the ICB's recommendations – this sets out a review of the ICB's costs analysis, and describes the costs analysis done by the Government;
- benefits of the ICB's recommendations – this looks at the ICB's financial stability benefits analysis, sets out the Government's financial stability benefits analysis, and examines other economic benefits of the ICB's recommendations;
- weighing the costs against the benefits of implementing the ICB's recommendations; and
- further cost/benefit analysis.

Economic costs of the ICB's recommendations

The ICB's costs analysis

5.4 On the basis of independent analysts' reports and data supplied confidentially by banks, the ICB estimated the total private cost of its recommendations to affected banks to be in the range £4bn-£7bn per year. The ICB estimated that at least half of the total private costs to banks arose from curtailing the implicit government guarantee to banks seen as 'too big to fail', and argued that withdrawing this subsidy would simply transfer costs within the economy, not create any new costs. The ICB therefore estimated that the total private costs could be reduced by this proportion to give a total social cost in the range £1bn-£3bn per year.

5.5 The ICB's costs analysis was subject to a number of criticisms. One challenge is that the data on bank costs that the ICB used were themselves based on an incomplete understanding of the ICB's proposals, having been produced (by banks and analysts) before the ICB's final recommendations were known. A second challenge to the ICB's costs analysis is that although the ICB estimated the impact of its recommendations on GDP, it did not attempt to quantify some other costs, in particular the impact on the public finances.

The Government's costs analysis

5.6 In order to check independently the ICB's costs estimates, and to address the challenges that have been made to it, the Government commissioned new cost modelling from the major UK banks based on the full ICB package.[1] On the basis of data supplied confidentially by the banks, the Government estimated the aggregate private costs of the ICB's recommendations. The Financial Services Authority's (FSA) macroeconomic tools were then used to model the effect of higher bank costs on GDP, and the Government estimated the knock-on impact of ICB implementation on the public finances.

Estimating the private costs to banks

5.7 The Government estimated the private costs of the ICB's recommendations by asking banks to model how the recommendations would affect banks' balance sheets. The banks' modelling was based on a number of very significant assumptions, which are discussed below. Aggregating these model results gave an estimate of the total private cost.

5.8 To separate the *incremental* costs of the ICB's recommendations from the costs imposed by other regulatory changes (principally Basel III), banks were first asked to model 'baseline' balance sheets, including the new Basel III capital requirements, the capital surcharge for global systemically important banks, and FSA liquidity requirements, but not taking account of the ICB's recommendations.

5.9 Having established their baselines, the banks were then asked to model how those balance sheets might be split between a ring-fenced and a non-ring-fenced bank in line with the ICB's recommendations. Additional capital and bail-inable long-term unsecured debt needed to meet the ICB's proposed requirements was then added to the balance sheets, and the cost of this additional capital and funding calculated. Initial and ongoing operational costs of the ICB package were also taken into account.[2]

5.10 This modelling exercise required banks to apply very substantial assumptions and simplifications. The output of the exercise is therefore subject to the following caveats:

- banks had to make assumptions about the performance of their various business lines and of the wider economy;
- beyond splitting businesses across the ring-fence and issuing any necessary additional capital and/or funding, no account was taken of how banks might adjust their own business plans in response to the ICB's recommendations;
- no behavioural response by customers was taken into account: customers were assigned to one side or other of the ring fence, and assumed not to move; and
- it was assumed that any additional equity and funding required by the banks to meet the ICB's requirements would be available from investors.

5.11 The ICB assumed that smaller banks and building societies already operate within the bounds of the ring-fence, so that any costs to them of its recommendations would be

[1] With the exception that the ICB's recommendation that UK G-SIBs be required to hold minimum levels of PLAC against group-wide RWAs has not been fully included in the costs analysis. See Paragraph 3.64 above.
[2] Some potential costs were excluded from the analysis, including the costs of severing joint and several liabilities for VAT and to occupational pension schemes. These were excluded as policy options to minimise them may be available and as they were not consistently modelled by the different banks.

negligible. The Government agrees that the great majority of the costs of the ICB's recommendations are likely to fall on the larger banks and building societies. Beyond this group, while the impact of the ICB's recommendations may be significant for some smaller banks' business models, in absolute terms the aggregate cost to these institutions is likely to be small. Introducing a form of *de minimis* exemption, as discussed in Paragraph 2.68 onwards above, could also minimise the costs to smaller banks.

5.12 On the basis of this modelling, **the Government estimates that the aggregate private costs to UK banks of the ICB's recommendations will fall in the range £3.5bn-£8bn per annum,** although this does need to be considered in light of the significant caveats discussed above. This estimate of the private costs to affected banks is similar to that produced by the ICB. The range of aggregate costs is the product of uncertainties around how the cost of wholesale funding would be affected by the introduction of a bail-in power, and how much banks would need to raise additional equity, and at what cost, in order to comply with the ICB's recommendations. The assumption that banks would not adjust their business models in response to the ICB's recommendations, e.g. by shrinking assets, is likely to exaggerate the amount of additional equity required, and hence the aggregate cost to the banks.

Impact on GDP

5.13 To estimate the impact of additional bank costs on GDP, the Government used FSA macroeconomic models, including a version of the 'NiGEM' model originally developed by the National Institute of Economic and Social Research. NiGEM has been extensively used in projects for the UK Government, the European Commission and governments around the world. Its strength is that it is based on long-run historical data (over 25 years' worth) on a wide range of economic relationships, across multiple economic cycles.

5.14 Using FSA models and the data on private costs supplied by the banks, **the Government estimates that the increased costs imposed by the ICB's recommendations would result in an average reduction in GDP of £0.8bn-£1.8bn per annum, equivalent to a reduction of 0.07%-0.14% in the long run**. The range of estimated GDP impacts is principally driven by the extent to which banks would need to raise additional equity in response to the ICB's recommendations. While the lower end of this range is broadly consistent with previous FSA analysis, the higher estimate assumes much larger additional equity requirements, taking no account of any mitigating action by banks (e.g. shrinking assets) in response to higher capital requirements. The higher estimate may therefore exaggerate the GDP impact of the ICB's recommendations.

5.15 The Government's estimate of the GDP impact is somewhat lower than that produced by the ICB, and does not, of course, take account of the corresponding benefits to GDP from enhanced financial stability, which are discussed below.

Impact on the public finances

5.16 Over the long term, the primary driver of tax receipts is GDP. Assuming that the overall tax burden as a share of GDP is unchanged, a reduction in GDP will result in a proportionate fall in total tax receipts. Over the last decade, the average tax/GDP ratio has been 35.3%. It could be argued that this ratio should be adjusted to take account of the financial services sector's disproportionate contribution to overall receipts. However, the impact on GDP modelled as described above will already include the impact of reduced activity in the financial sector. Adjusting the tax/GDP ratio when calculating the impact on the public finances would therefore risk double-counting some of the costs of the ICB's recommendations.

Box 5.A: Impact on bank equity and attractiveness for investment

It has been argued that, by imposing higher costs on banks, the ICB's recommendations will reduce banks' return on equity, and so make banks unattractive to investors. However, financial instability is also extremely damaging to shareholder value, as periodic crises can wipe out years of accumulated returns to equity holders. For example, losses from the recent financial crisis left equity investors with a cumulative real return over the last decade of nil, as shown in the chart below.

Chart 5.A: Cumulative total real returns on bank equity (2000-2009)[3]

Source: Bloomberg, CreditSuisse/Tremont and Bank of England calculations.

Greater financial stability reduces the likelihood of such catastrophic losses, so reforms that improve the stability of the UK banking system will benefit long-term value investors in bank equity. Removing incentives for banks to deploy resources on high-risk and highly volatile activities will thus support returns to equity in the long run.

5.17 Applying the long-run tax/GDP ratio to the estimated GDP impact of the ICB's recommendations, **the Government estimates that implementing the ICB's recommendations would reduce total tax receipts by around £300mn-£650mn per annum**. This does not factor in the public finances benefits of enhanced financial stability, and fewer, less severe financial crises.

5.18 In addition to the impact on tax receipts, there could also be an effect on the value of Government shareholdings in banks, such as RBS and Lloyds. By imposing additional costs on banks, the ICB's recommendations could push down banks' share prices, reducing the market value of Government holdings. It should be noted, however, that this effect may be partly mitigated to the extent that investors perceive banks as less risky with the reforms in place; see Box 5.A above. Bank managements may also be able to mitigate the impact on return on equity

[3] Sample based on banks and insurers in S&P 500, FTSE All Share and DJ EuroSTOXX indices as of March 2009. Excludes firms for which returns not quoted over entire sample period.

by adjusting their internal business plans, for example by cutting costs. Market expectations of future regulatory reform are in any case likely to be already factored into banks' share prices.

Conclusions on costs of ICB implementation

5.19 The Government therefore estimates the total private costs to UK banks of implementing the ICB's recommendations at £3.5bn-£8bn. These additional bank costs are likely to result in an average gross reduction (i.e. ignoring the corresponding benefits) in GDP of £0.8bn-£1.8bn, equivalent to a reduction of 0.07%-0.14% in the long term, somewhat lower than the ICB's estimate. All else equal, this reduction in GDP would result in a fall in total tax receipts of £300mn-£650mn per annum.

Benefits of the ICB's recommendations

5.20 Against the costs of implementing the ICB's recommendations, discussed above, should be set the potentially much greater benefits that they will bring to the UK economy. By increasing financial stability, the ICB's recommendations will increase GDP in the long run by more than the GDP costs imposed by the ICB's recommendations (thus yielding a net benefit), by reducing the frequency and/or severity of financial crises, and hence the costs those crises impose on the economy and public finances.

The ICB's financial stability benefits analysis

5.21 The ICB estimated that the annual cost of financial crises to the UK economy was around 3% of GDP, equivalent to around £40 billion in 2010 terms. This figure was based on a survey of academic studies of past financial crises compiled by the Basel Committee on Banking Supervision. From this literature, the ICB estimated the probability of a crisis occurring in any given year (4.5%), and the net present value of the fall in GDP caused by a crisis when one does occur (63% of GDP).[4] The product of these figures gave the ICB's annualised cost estimate of around 3% of GDP. Comparing this figure with its estimate of the costs of its recommendations (£1bn-£3bn per year), the ICB argued that implementing its proposed measures would only need to reduce the costs of financial crises in the future by between 1/40th and 1/13th in order to deliver net benefits.

The Government's financial stability benefits analysis

5.22 Implementing the ICB's recommendations will increase financial stability by:

- curbing incentives for excessive risk-taking;
- making banks better able to absorb losses;
- insulating vital banking services from shocks elsewhere in the financial system; and
- making bank resolution easier and less costly.

Curbing incentives for excessive risk-taking

5.23 Creditors who believe that they are protected against losses by a government guarantee will have little incentive to restrain banks from taking excessive risks. The ICB's recommendation

[4]An assessment of the long-term economic impact of strong capital and liquidity requirements, BCBS, 2010. Available at: http://www.bis.org/publ/bcbs173.pdf. It should be noted that these figures are subject to significant uncertainty. For example, in the literature surveyed by the BCBS, estimates of the output cost of crises range from 16% to 302% of GDP. Crises may also be more costly in countries with very large banking systems relative to GDP (e.g. the UK) than for the whole set of countries covered by the academic literature. Future crises may also be more costly than past ones, as banks become larger, more complex and more interconnected. Regulatory reforms, e.g. Basel III, may however mitigate this effect, as noted at Paragraph 5.34 below.

that regulators be able to impose losses on creditors before an insolvency, together with the development of a robust resolution regime, will make it clear that in future bank creditors will not be bailed out by the taxpayer. This will create much stronger incentives for creditors to monitor banks' levels of risk and to demand a premium for investing in riskier banks. Ring-fencing will reinforce this effect by increasing the transparency of banks' activities, so leading to better pricing of risk. The market failure that in the run-up to the recent crisis allowed universal banks to obtain funding at prices that did not properly reflect their levels of risk will thus be corrected. **With more complete information and with the distortion of an implicit government guarantee removed, market discipline will restrain banks from excessive risk-taking**.

5.24 Incentivising banks to become less risky has two related benefits. First, it will make individual banks more resilient. In the event of a shock, a bank that is less risky will suffer fewer losses, and so be less likely to fail. But it will also inevitably reduce the level of risk in the financial system as a whole, making the system, as well as its individual parts, more stable.

Making banks better able to absorb losses

5.25 **The ICB's recommendations on higher equity requirements will make ring-fenced banks better able to absorb losses while remaining viable**, preventing moderate shocks from leading to widespread bank failures. Extended buffers of equity will be particularly valuable, as they will allow banks whose equity is brought down into the buffer (e.g. by a financial shock) but remains above the hard minimum to keep on lending to the economy. This will reduce the impact on the real economy of a moderate financial shock. The ICB's recommendation that ring-fenced banks be bound by minimum leverage ratios as a backstop to higher capital ratios will ensure that banks' loss-absorbing capacity is less vulnerable to poor calibration of risk weights.

5.26 The ICB's recommendations on bail-in and minimum primary loss-absorbing capacity (PLAC) requirements (as discussed in Chapter 3) improve banks' loss-absorbing capacity, but principally in resolution. This is discussed below.

Insulating vital banking services from shocks elsewhere in the financial system

5.27 **Making UK banks better able to absorb losses, and incentivising them to moderate their risk-taking will make them safer**. But it will not entirely eliminate shocks, in particular shocks originating in the global financial system. The ICB's recommendations would better protect the UK real economy against such shocks by reducing the linkages between ring-fenced banks, providers of essential services such as deposit-taking and payment services, and the wider financial system.

5.28 The restrictions on the services that a ring-fenced bank can provide, and on the links it can have with the rest of its banking group, are both important. Under the ICB's recommendations, a ring-fenced bank could not engage in investment banking activities or provide services to financial institutions. This would limit its direct exposure to the broader financial system. In addition, it could only have very limited exposures to the rest of its banking group, and should not be dependent on the rest of the group for its solvency or liquidity. This would limit a ring-fenced bank's indirect exposure to the financial system through the rest of its group. This would reduce the chances of a global financial shock interrupting the continuous provision of those vital banking services, limiting a major potential channel of contagion to the UK real economy.

Making bank resolution easier and less costly

5.29 Notwithstanding their improved resilience, both ring-fenced and non-ring-fenced banks will still occasionally fail. Indeed, allowing firms to fail and exit the market is a key element of market discipline: badly managed, uncompetitive firms should face the real prospect of failing. But banks must be able to fail safely, without cost to the taxpayer, and in a way that ensures the continuous provision of essential banking services is maintained.

5.30 The ring-fence will improve the resolvability of a banking group by reducing structural complexity, identified by the Financial Stability Board as one of the most important barriers to successful bank resolution. Prohibited from carrying out complex investment banking activities (such as running trading books, which may contain large numbers of complex, bespoke contracts that would be extremely difficult for the authorities to unwind in an orderly manner), ring-fenced banks will be easier to break up or transfer to new ownership in the event of failure. The authorities will therefore be better able to ensure that the continuous provision of essential banking services is maintained without the need for a taxpayer-funded bail-out.

5.31 The bail-in power will aid resolution by allowing the authorities to re-capitalise a bank by imposing losses on creditors before an insolvency. This would be particularly useful for resolving non-ring-fenced banks, because of the difficulty of breaking up trading books and terminating derivatives contracts. Some simplified illustrations of how the ICB's recommendations would aid the resolution of each of a ring-fenced bank and an investment bank are set out in Box 5.B.

Box 5.B: How would the ICB's reforms improve resolution in the event of bank failure?

This box describes in simple terms how the ICB's recommendations would aid the resolution of each of a ring-fenced bank and a non-ring-fenced investment bank (assumed here to be separate legal entities each wholly-owned by the same parent). As resolution strategies will vary from case to case, these scenarios are not intended as predictions of how the authorities would act in each case: rather, they offer simplified illustrative examples of the added value that implementing the ICB's recommendations would bring to resolution authorities.

Failure of the investment bank

In this scenario, as a consequence of significant losses, the viability of the investment bank is called into question. The pricing and availability of, first, long-term funding, and then short-term funding, deteriorates due to a loss of market confidence, and the investment bank is shut out of the wholesale funding markets. Short of suitable collateral and with its solvency not assured, it is unable to access central bank liquidity, and comes to the point of failure.

The ring fence should protect the ring-fenced bank from the failure of its partner investment bank. Limits on exposures between the two would cap the losses suffered by the ring-fenced bank. The ring-fenced bank's equity ratio may fall into its buffer, but would be less likely to breach its hard minimum requirement. The ring-fenced bank may suffer funding difficulties as the supply from the failed investment bank is no longer available, and 'brand contagion' may mean it is unable to raise funds from the market. But if it remained solvent, it would be able to access central bank liquidity facilities until market conditions improved. By mitigating the risks to the ring-fenced bank's solvency and liquidity, the ring-fence would help ensure that the continuity of services essential to the real economy would be maintained, and very significant economic disruption thus avoided.

With vital banking services protected by the ring fence, it may be that the authorities could allow the failing investment bank to go into insolvency. If, however, the investment bank were deemed systemic, the authorities might need to apply resolution powers in order to stabilise it. The bail-in power could under the right conditions be used to recapitalise the bank by imposing losses on creditors. Nonetheless, significant challenges to investment bank resolution remain. These challenges, and the reforms being brought forward by the Government to address them, are discussed in Box.1.A.

Box 5.B (continued): How would the ICB's reforms improve resolution in the event of bank failure?

Failure of the ring-fenced bank

In this scenario, the ring-fenced bank suffers heavy losses, for example from its exposures to UK residential or commercial property markets. These losses reduce the ring-fenced bank's capital, and as a result the bank experiences some difficulties in accessing wholesale funding. At this stage, surplus capital resources elsewhere in the group (e.g. from the investment bank) could be injected into the ring-fenced bank to stabilise its position.

If this does not occur, or does not work, further losses and the unwillingness of the central bank to provide liquidity facilities to a bank that is not clearly solvent may lead regulators to conclude that the ring-fenced bank is on the point of failure, and put it into resolution. Resolution of the ring-fenced bank would be aided by the relative simplicity of a bank focused on retail banking operations, with no significant trading book or derivative positions to be unwound. It may be that the whole bank can be sold to a third party. Alternatively, key operations including high street branches and insured deposits with matching assets, may be sold, with the rump of the bank being put into insolvency. If no sale is feasible in the short term, other resolution tools may be used, such as the transfer of businesses to a bridge bank. The bank could also be recapitalised through bail-in, with debt being written down and/or converted to equity.

Successful resolution through sale, transfer or recapitalisation by bail-in would help ensure the continuity of essential banking services provided by the ring-fenced bank to the UK economy. The damage to the real economy of the ring-fenced bank's failure would thus be minimised, without the need for taxpayer solvency support.

Meanwhile, for its partner ring-fenced bank to have failed, the investment bank must have been either unwilling or unable to support it. To the extent that other market actors believe this to be a sign of the investment bank's weak financial position, it may suffer a loss of investor confidence, restricting its access to wholesale funding. If the investment bank is well-capitalised and has a strong liquidity position, it may be able to survive a temporary funding freeze (particularly if it remains solvent and able to access central bank liquidity facilities) but if not the investment bank could also be brought to the point of failure. In that case, as explained above, the resolution authorities will need to decide whether to allow the bank to go into insolvency or resolve it using the new tools currently under development.

5.32 In both scenarios described in Box 5.B, in the short to medium term any successor or bridge banks, whether a ring-fenced bank or an investment bank, may well be operating in their capital and/or PLAC buffers. Discretionary distributions of earnings such as dividends and bonuses will be restricted while capital is built up. Access to funding markets may be constrained, requiring reliance on central bank liquidity facilities. And both in the run-up to a crisis, and its aftermath, banks are still likely to shrink their balance sheets to improve their capital positions, with an adverse impact on the supply of credit to the economy. However, the ring-fence and strengthened resolution powers including bail-in will improve the authorities' ability to deal swiftly with a failing bank, allowing viable businesses to be restored to financial health so that any impact on the wider economy is kept to a minimum.

Economic benefits of improved financial stability

5.33 The Government therefore believes that **the ICB's recommendations would deliver very significant benefits to UK financial stability.** Greater financial stability will mean fewer and/or less severe financial crises in future, which will lead to higher GDP, and stronger public finances, in the long term, though the exact extent of the benefit to GDP will depend on how frequent and severe future financial crises will be, which is difficult to forecast with precision.

5.34 Using the ICB's estimate of the annualised cost of financial crises, however, it is possible to illustrate the benefits that increased financial stability would bring. The ICB estimated that financial crises cost the UK economy around £40bn each year (based on estimates of the probability of a crisis occurring in a given year and of the output cost of crises when they do occur). As an illustration, if regulatory reforms such as Basel III were to reduce the likelihood of crises by 30%, this would yield a benefit to GDP of around £12.5bn per annum. If additionally to this the ICB's recommendations reduced the probability of crises by only a further 10% (by moderating financial sector risk and increasing bank resilience), and reduced the GDP cost of a crisis by 25% (by protecting vital banking services and enhancing bank resolution powers), the ICB's recommendations would yield an incremental economic benefit of £9.5bn per annum. This is approximately five to ten times the estimated GDP cost of the ICB's recommendations.

5.35 The Government believes that the impact of the ICB's recommendations in increasing UK banks' resilience and resolvability in the event of a crisis would be very significant. By increasing financial stability, the ICB's recommendations would therefore produce very substantial benefits to GDP, possibly as much as £9.5bn per annum in the long run, with a subsequent benefit to the public finances.

Other economic benefits of the ICB's recommendations

5.36 In addition to improved financial stability, the ICB's recommendations would also deliver a range of other benefits to the UK economy and the taxpayer. These benefits include:

- increased economic welfare arising from greater financial and economic stability;
- increased efficiency from the withdrawal of subsidies to credit and risk; and
- welfare gain from enhanced competition within the UK banking sector.

Welfare benefit from increased financial and economic stability

5.37 Independently of the higher level of GDP that fewer, less severe financial crises will produce, greater financial and economic stability will bring significant welfare benefits to society. This is because individuals and firms value stability of income as well as income levels, for example valuing greater security against sudden falls in income, such as could result from redundancy or bankruptcy. Moderate, stable growth in GDP will therefore be preferable to a GDP path that ends at the same level but sees both spectacular increases and periodic busts along the way.

5.38 The welfare benefit from greater economic stability is extremely hard to quantify, and no widely accepted methods for doing so with any precision yet exist. However, given that individuals are known to be more averse to potential losses than attracted to potential gains, the value attached by society to greater stability of income is likely to be significant.

Efficiency gain from subsidy withdrawal

5.39 As the ICB pointed out, the implicit government guarantee represents a subsidy from government to those banks considered 'too big to fail'. To the extent that other market actors believe a bank to be government guaranteed, that bank will be able to borrow more cheaply and take greater risks (for example by being more leveraged) than would otherwise be possible. At the same time, the government takes on a contingent liability to stand behind the bank, and this liability would crystallise as a large loss to the public finances in the event of the bank failing. Estimates of the value of this guarantee to banks range widely: the ICB estimated the current value of the implicit government guarantee to UK banks at "over £10 billion" per annum.

5.40 This subsidy to risk-taking in the financial sector distorts the allocation of resources across the economy. The amount of both capital and labour channelled into banking activities will, in the presence of the subsidy, be higher than the socially optimal level. Removing the subsidy would allow resources to follow market price signals and be allocated more efficiently, increasing economic efficiency and welfare as well as supporting the rebalancing of the economy, in line with the Government's wider economic strategy.

5.41 The subsidy represented by the implicit guarantee also transfers wealth within society in ways that are difficult to justify. The contingent liability to banks that are 'too big to fail' transfers wealth from taxpayers to bank customers, employees and shareholders, to the extent that these groups enjoy lower prices, higher pay or higher returns as a result of the subsidy. So while the benefits of the subsidy accrue to particular groups (some of whom may be overseas), the costs fall on UK taxpayers as a whole, which is inequitable. Over time, the subsidy also has a pro-cyclical effect, increasing GDP in boom years by making credit more cheaply available, but making recessions deeper when they do occur (and financial crises more severe), as a result of higher levels of debt. The subsidy thus undermines economic stability in the long run.

Benefits of increased competition in the UK banking sector

5.42 The ICB's recommendations on increasing competition within the UK banking sector will also deliver significant economic benefits. Competitive pressures on banks will be intensified by the emergence of challenger banks (including from the Lloyds divestment), reduced barriers to entry, greater transparency of prices and increased possibilities for customers to switch banks.

5.43 The extent of those benefits will largely depend upon the behavioural responses of bank customers and how these are perceived or anticipated by bank managements. For example, the greater the increase in account switching, the more banks will face pressure to offer better terms to their customers, benefitting all customers, not just those who switch. Similarly, the extent to which new challenger banks force incumbents to improve terms or services will depend on how much incumbents fear that existing or potential future customers might prefer a challenger.

5.44 The extent of the competition benefits of the ICB's recommendations is therefore uncertain, but much of the uncertainty lies on the upside, with the ICB's recommendations yielding a potentially very large increase in competitive pressure within the UK banking sector, at relatively low cost. The Government therefore expects an economic benefit from the ICB's competition recommendations, and notes that UK banks have already agreed, through the Payments Council, to implement the account switching service that the ICB recommended.

Box 5.C: The ICB's recommendations and the competitiveness of the UK financial services sector

The ICB terms of reference required it to have regard to the effect of its recommendations on the competitiveness of the UK financial and professional services sector. The ICB's assessment was that the impact of its recommendations would be broadly neutral and in the long-term positive. In particular:

- by targeting its recommendations primarily on the domestic retail activities of UK banks, its recommendations would largely allow the wholesale and investment banking sides to compete on the basis of international norms and standards;
- even where they are affected, the proportion of activities directly affected by its recommendations would be relatively small. The wholesale and investment banking divisions of UK banks constitute around 15% of the City, with the great majority comprised of foreign institutions and non-banks; and
- broader domestic financial stability would create a more stable and welcoming environment for investment from financial services companies around the world.

The Government agrees with this analysis. The Government supports strong, stable and successful UK banks, and is committed to maintaining the current position of London as a world-leading financial centre. But this success should not be at the expense of financial stability, nor be maintained through implicit subsidies to the banking sector. Implicit government guarantees to UK banks hinder the competitiveness of other sectors and damage the City's reputation for a fair and level playing field, one of its key strengths as a financial centre.

More broadly, a strong financial sector depends on domestic financial and macroeconomic stability. As the recent crisis has shown, domestic financial instability can have a very large negative impact on the public finances and the wider economy. This reduces investor confidence, and reduces the scope for government to create attractive conditions for investment, for example through creating a welcoming tax environment.

This is a particular risk where the financial sector constitutes such a large part of the economy, as it does in the UK. The Government is committed to creating a tax and infrastructure environment that will make the UK the most attractive environment for financial services in the world. But to maintain its position in the long term, it is imperative to introduce targeted reform that makes the UK's banking sector more stable and intervention at the taxpayers' expense less likely in the future.

Weighing the costs against the benefits of ICB implementation

5.45 **The ICB's recommendations will deliver very significant benefits to UK financial stability, and hence to the economy, potentially increasing GDP by as much as £9.5bn per annum, with consequent benefits to the public finances**. In addition, the ICB's recommendations will produce substantial benefits to economic efficiency and social welfare in the long run. Quantifying these benefits is necessarily subject to some uncertainty, but as the illustrative calculation presented at Paragraph 5.34 above demonstrates, the economic benefits of even relatively modest improvements in financial stability are very substantial, given the extremely high costs that financial crises impose on the economy. Such benefits can therefore significantly outweigh the economic costs of implementing the ICB's recommendations, which the Government estimates at £0.8bn-£1.8bn per annum.

5.46 The Government believes that the economic benefits of implementing the ICB's recommendations would significantly outweigh the costs and therefore deliver significant net benefits to the economy and the public finances.

Box 5.D: Mitigating short-term risks from ICB implementation

It has been argued that focusing solely on the long-term costs and benefits of the ICB's recommendations overlooks some potentially significant economic costs in the short term. In particular, the argument has been made that by imposing higher costs on banks, the ICB's recommendations will encourage them to shrink their balance sheets and cut back on lending to the real economy. With de-leveraging by households, companies and banks already acting as a drag on the economy, accelerating this process could risk undermining the current recovery.

It was in recognition of this risk that the ICB recommended a final deadline of 2019, the same as for full implementation of the Basel III requirements. However, the ICB also said that efforts should be made to implement the ring-fence sooner. The Government will ensure that all the necessary legislation to implement the ring-fence is in place by the end of this Parliament in May 2015, and banks will be expected to be compliant as soon as practically possible thereafter. The Government will work with the banks to develop a reasonable transition timetable.

In the short term, the Government continues to support greater access to credit for SMEs in order to fuel recovery, for example through the 'Merlin' lending agreements with major banks and the Credit Easing scheme announced by the Chancellor in the Autumn Statement in November.

Further cost/benefit analysis

5.47 Having considered the overall principles of the ICB's recommendations, further cost/benefit analysis will focus on specific questions of policy design, as the best ways to implement those principles are developed, in consultation with the banking industry and other interested parties. The objective of further cost/benefit analysis will be to inform the precise design of measures such as the ring-fence and loss absorbency requirements, in order to identify the most cost-effective way of implementing the ICB's recommendations.

5.48 During this process, the Government will continue to engage with banks, industry representatives and other interested groups, to continue developing its impact modelling methods, and to address concerns raised in response to its findings to date.

6 Implementation

Introduction

6.1 The ICB recommended that the necessary legislation and rules for implementing its reform proposals be put in place rapidly, with the reforms to be completed by no later than the beginning of 2019. The Government's intention is that implementation should proceed in stages with the final, non structural, changes related to loss absorbency fully completed by the beginning of 2019. **Primary and secondary legislation related to the ring-fence will be completed by the end of this Parliament in May 2015 and banks will be expected to be compliant as soon as practically possible thereafter. The Government will work with the banks to develop a reasonable transition timetable.**

6.2 The rest of this chapter sets out a fuller timetable for implementation of the ICB's recommendations, and discusses implementation options.

Timetable for implementation

6.3 The Government will bring forward a White Paper in Spring 2012, in which it will set out in detail its proposed methodology for implementing the ICB recommendations, and its thinking on how to make the principles the ICB set out workable from a practical and legislative perspective. This will include a cost benefit analysis on the implementation options.

6.4 Following a three month consultation, the Government will introduce primary legislation into Parliament. **The Government will ensure that all the necessary legislation to implement the ring-fence is in place by the end of this Parliament in May 2015, and banks will be expected to be compliant as soon as practically possible thereafter. The Government will work with the banks to develop a reasonable transition timetable.**

6.5 In implementing the ICB's recommendations, consideration will also need to be given to developments at international and European level. Of particular relevance are amendments to the Capital Requirements Directive and the introduction of a Capital Requirements Regulation (together, CRR I/CRD IV) and proposals to develop a European crisis management framework.

6.6 On CRR I/CRD IV, the European Commission published its legislative proposals on prudential requirements for credit institutions and investment firms in July 2011. This will, in part, implement the Basel III accords in the EU. However, amendments are needed to ensure full compliance with Basel III, particularly for certain global systemically important banks (G-SIBs).[1] The current draft EU legislation restricts the ability of Member States to impose tougher minimum regulatory standards on banks on a permanent basis, and significantly constrains Member States' ability to use some macro-prudential tools. However, negotiations are ongoing

[1] An example of this is in Basel III's treatment of significant investments in insurers. The Basel Committee on Banking Supervision agreed that no more than 10% of a bank's capital could come from investments in insurance subsidiaries, with a lengthy transition period starting from 1 January 2013 to allow banks time to adjust. This aims to remove the double counting of capital and ensure a level playing field. The current Commission proposal allows alternative approaches to the deduction of these investments that market analysts suggest could be significantly less prudent'. In particular, this could mean lower capital requirements for certain G-SIBs.

and the Government will continue to work with the European Commission, the European Parliament and like-minded Member States with a view to ensuring that Member States have the flexibility necessary to implement more stringent minimum requirements in order to safeguard financial stability and tackle distortions in the single market. Such amendments would provide the basis in EU legislation to enable the Government to implement the ICB package.

6.7 On the crisis management framework, the European Commission intends to publish its legislative proposal on establishing an EU crisis management framework in the coming months. The Government expects the European Commission to set out proposals that will equip authorities with a robust set of common recovery and early intervention tools for supervisors to better diagnose and mitigate against bank failure, bail-in powers, and other new powers for resolution authorities to manage a future financial crisis.

Implementation options

6.8 The ICB's recommendations require implementation in a variety of ways. Some will require new primary legislation and others will need secondary legislation or changes to existing legislation. Regulatory rules will also need to be put in place. Table 6.A sets out possible implementation methods for each measure:

Table 6.A: Implementation options

	ICB measure	Possible implementation methods
Structural reform	Ring-fencing	Primary legislation; secondary legislation; regulatory rules
Loss-absorbency	Equity requirements	Secondary legislation; regulatory rules; European legislation
	Leverage ratio	Secondary legislation; regulatory rules; European legislation
	Primary loss absorbing capacity	Secondary legislation; regulatory rules
	Bail-in	Primary legislation; secondary legislation; European legislation
	Resolution buffer	Secondary legislation; regulatory rules; European legislation
	Depositor preference	Primary legislation; secondary legislation
Competition	Market structure	No legislation
	Barriers to entry	Ongoing supervision by regulator
	Switching	Industry led
	Transparency	Regulatory rules; voluntary agreements
	Financial Conduct Authority competition duty	Primary legislation (Financial Services Bill)
	Market investigation reference	For the Office of Fair Trading, depending on market developments

6.9 Where regulatory rules are required, they should be put in place by the relevant authority – either the Prudential Regulation Authority (PRA) or the Financial Conduct Authority (FCA) (once the Financial Services Bill has come into force). They will continue to make rules and issue guidance in the manner consistent with their obligations under the Financial Services and Markets Act 2000 (as amended by the Financial Services Bill).

6.10 The industry will itself lead the development of switching proposals, which the Government will monitor.

6.11 The nature of the legislation required to implement statutory bail-in will depend on the final form of the EU crisis management framework. If this includes bail-in proposals, the Government would seek to put a bail-in regime in place as part of the implementation of the crisis management framework.

6.12 Consequently, primary legislation is required for the following ICB recommendations:

- ring-fencing;
- depositor preference; and
- the competition objective for the FCA.

6.13 As noted in Chapter 4, the Government will take forward the ICB's recommended changes to the FCA's objectives in the draft Financial Services Bill.

Ring-fencing legislation

6.14 In order to implement ring-fencing, the Government will need to bring forward primary legislation. The Government's preference is to set out clear guiding principles in primary legislation. This primary legislation would also confer powers on HM Treasury and the PRA to set out the more detailed aspects of the ring-fence design, operation and enforcement in secondary legislation/rules. These powers would need to provide HM Treasury and the PRA with sufficient flexibility to accommodate developments in the future (for example, financial innovation or the creation of new markets).

Depositor preference

6.15 Implementing depositor preference would require changes to insolvency law to amend both the Insolvency Act 1986 and secondary legislation. Primary legislation would be required to do this.

Other legislation

6.16 The UK would be required to legislate to implement both CRD IV and legislation implementing the European crisis management framework once they have been adopted by the European Parliament and the Council. Such legislation could be brought forward under section 2(2) of the European Communities Act 1972; it would not require primary legislation.

6.17 There may be areas where the ICB proposals overlap with existing legislation for building societies. The Government will work with building societies to assess any overlaps and will consider whether changes to building societies legislation are needed to ensure the ICB proposals are applied appropriately to the building society sector.

How to respond

6.18 The Government will undertake a formal consultation in Spring 2012. However, there are a number of issues set out in this chapter on which earlier views would be welcome. The Government is seeking to understand how stakeholders would be affected by aspects of these recommendations.

6.19 Responses are requested by 12 March 2012. The Government will also engage directly with relevant stakeholders ahead of this date. Please ensure that responses are submitted before the closing date. The Government cannot guarantee that responses received after this date will be considered.

6.20 The Government's response is available electronically at: www.hm-treasury.gov.uk. You may make copies of this document without seeking permission. Printed copies of the document can be ordered on request from the address below.

6.21 Responses can be sent by e-mail to: banking.commission@hmtreasury.gsi.gov.uk. Alternatively, they can be posted to:

ICB Implementation Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

6.22 When responding, please state whether you are doing so as an individual or representing the views of an organisation. If you are responding on behalf of an organisation, please make clear who the organisation represents and, where applicable, how the views of members were assembled. If you have concerns about the way in which this document is being managed or conducted, please contact:

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A List of acronyms

BCA	Business Current Account
BCBS	Basel Committee on Banking Supervision
EEA	European Economic Area
EU	European Union
FCA	Financial Conduct Authority
FPC	Financial Policy Committee
FSA	Financial Services Authority
FSB	Financial Stability Board
G-SIB	Global Systemically Important Bank
G-SIFI	Global Systemically Important Financial Institution
GDP	Gross Domestic Product
ICB	Independent Commission on Banking
IMF	International Monetary Fund
Lloyds	Lloyds Banking Group
OFT	Office of Fair Trading
PCA	Personal Current Account
PRA	Prudential Regulation Authority
RBS	Royal Bank of Scotland
RRP	Recovery and Resolution Plan
RWA	Risk-Weighted Asset
SAR	Special Administration Regime
SMEs	Small and Medium-Sized Enterprises
SRR	Special Resolution Regime

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ISBN 978-0-10-182522-1

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