Members’ Briefing Call,
20th April 2011

The Independent Commission on Banking (ICB) Interim Report
Background to ICB

• 16 June 2010: Chancellor of Exchequer announces creation of ICB

• Members:
  • Sir John Vickers (Chair)
  • Clare Spottiswoode
  • Martin Taylor
  • Bill Winters
  • Martin Wolf

• 24 September 2010: ICB publishes issue paper calling for evidence and holds five public meetings across the country

• 11 April 2011: ICB publishes interim report with provisional views. Calls for responses by 4 July
• Charged with considering structural and non structural measures to reform banking system and promote competition

• Recommendations to be directed at:
  • Reducing systemic risk in the banking sector – looking at risks posed by banks of different size, scale and function
  • Reducing the likelihood and impact of bank failure
  • Promoting competition in both retail and investment banking

• Consideration to be given to structural reform to banks

• And non-structural measures to promote stability and competition

• Commission to have regard to the impact of its recommendations on financial stability, lending, customer choice and competitiveness of the UK financial services sector
Initial reactions to interim ICB report

• Some **media** think report is too soft on banks; others acknowledge difficulty of ICB’s task
• Surprising consensus amongst **politicians** across the main political parties
• **Markets** broadly positive both from sell and buy side
• Small net positive share price reaction (ex Lloyds) indicates worst fears not realized but still lot of uncertainty on details
Headlines on the need for reform

• Reforms necessary to reduce **probability** of failure of systemically important banks by improving their resilience
• Reforms also needed to reduce the **impact of failure** of systemically important banks by providing for orderly resolution of any institutions that fail
• Both the above to be achieved without disproportionately affecting financial system ability to provide financial services
• Cause for concern re competition in retail banking especially current account and SME markets
• ICB surprised that “despite lack of transparency and high prices...” customers appear content with functioning of wholesale market
• ICB minded not to explore competition in wholesale banking but invites further evidence
Making the banking system safer: Basel III

- Capital must be able to absorb losses at or before resolution
- Deductions applied to gross capital to remove non loss absorbent elements
- Minimum net common equity capital: risk weighted assets (RWAs) of 4.5%
- To avoid dividend and bonus restrictions, banks must hold a common equity capital conservation buffer of a further 2.5% of RWAs
- ...giving effective minimum common equity: RWA ratio of 7%
- Basel III also requires another 3.5% of capital which may be in loss absorbing debt
- Regulators may additionally temporarily require banks to hold countercyclical buffer of up to 2.5% RWAs to help slow excessive lending
Making banks safer: more **equity** capital

- Studies of potential levels of core equity capital come up with range of 7%-20%
- ICB believes minimum credible level is 10%
- Translates into charge of 3% of core equity: RWAs for systemically important banks
- ICB believes 3% surcharge should be applied internationally
- Also considering whether 3% leverage ratio is appropriate
- Capital for wholesale and investment banking operations need not exceed international standards **provided** they have credible resolution plans including loss absorbing debt
- **Large UK retail banking operations** to have minimum capital of 10% regardless (see below)
Making banks safer: more loss absorbing debt

- Minimum equity requirements much higher without loss-absorbing debt
- One option is contingent capital which aims to recapitalise a viable bank
- Debt converted to equity or written down when ratios fall below a certain level
- Questions of who would buy contingent capital and dynamic impacts near conversion trigger
- Second option is Bail-inable debt. Used for non viable banks
- Regulator to decide point of non viability
- Issues over which of a bank’s liabilities should be bail-inable and ensuring creditor hierarchy
ICB sees combination of retail and wholesale/investment banking within a universal bank as risky:

- Size and complexity require taxpayer support for whole institution in event of crisis
- More difficult to prevent contagion e.g. from wholesale to retail
- Increased vulnerability in crisis due to holding less capital than separated entities
- Implicit taxpayer support increases risk taking

Some benefits of universal banks recognised:

- Economies of scale
- Ability for customers to get all services from a single supplier
- Diversification benefits; possibility that one part of group saves the other
• Without appropriate safeguards, universal banks viewed as increasing risk of financial system failure

• Various options for dealing with above risk:
  • Full separation – guarantees separability, but costs too high
  • Operational separation of key infrastructure – viewed as insufficient
  • Size limits – difficult to set, calibrate and change
  • Ring fencing retail banking operations – preferred option (see below)
Making banks safer – ring fencing retail banking activities

• ICB proposes ring fencing UK retail banking activities in a separately capitalised subsidiary
• UK retail banking subsidiary to maintain a minimum core equity Tier1 ratio of 10% together with loss absorbing capital (see above)
• Capital may be transferred between retail and investment banking operations, subject to observance of minimum levels of capital in retail banking operations
• Additional limits on intra company loans and activities
• Ring fencing UK retail banking activities seen as having many benefits:
  • Curtail government guarantees as govt. support for wholesale banking lessened
  • Makes it easier/less costly to sort out banks that get into trouble
  • Shields the retail bank from problems elsewhere in the bank or system
  • Preserves the possibility that retail bank could be saved by rest of the bank
• Proposal seen as minimizing risk of failure at times of stress but retaining benefits of universal banking in good time
• Still many details to be worked out e.g. on design of retail ring-fence
• Rules based on conduct of retail banking activities not location of a universal bank’s headquarters
• Rules can be imposed on UK-authorised banks, including UK subsidiaries of foreign banks
• Not applicable to UK branches of banks incorporated in another member state
• Main costs to fall on UK banks with significant retail and wholesale operations
• ICB sees costs as significantly lower than bottom end of £12-15bn mooted range
• Recognition that proposals could affect attractiveness of UK for some parts of affected firms
Making banks safer – impact on City competitiveness

• ICB currently views reforms as having broadly neutral impact on City competitiveness
• Proportion of wholesale financial services activities in City provided by affected banks of 14%-16%
• No evidence that affected banks play more important role than other banks
• London’s importance as a financial centre based on many factors:
  • Time zone
  • English language and English law
  • Depth and liquidity of markets and skilled labour markets
  • Regulation and tax regimes
  • Macro economic, financial and political stability
• Reform proposals not expected to change substantially these factors
Lots of questions still to be answered

- Significant clarification needed on how retail separation will work in practice:
  - What must be within the fence, what must not and what may be?
  - How strictly should the “fence” be enforced – limitations on intra group transfers/ownership?
- What will be the cost of the proposals in terms of additional funding and capital and other costs?
- How will the additional capital buffers for significant financial institutions fit with other Basel proposals?
- How exactly will loss absorbing capital work? What exactly is the trade off with higher equity capital? “Living Wills”? 
ICB proposes three core elements to reduce probability and impact of bank failure:

- Higher core equity capital – 10% min. for systemically important banks; mandatory for UK retail banks
- Use of loss absorbing capital on a going and gone basis
- Ring fencing of UK retail banking operations

ICB recommends more extensive divestment by Lloyds Banking Group

- Many details still to be determined
- Many of the questions raised cut across different organisations, including the BBA
- AFME work to focus on level of incremental capital for systemically important banks and use of loss absorbent debt
Next steps

• September 2011: ICB to publish final report to the Cabinet Committee on Banking chaired by Chancellor
• There will be differing views on how to proceed inside Government
• Do nothing in response is not a political option
• Key decision is whether primary legislation is required
• Could be tagged onto regulatory reform bill or taken through direct regulatory action
• If primary legislation required it may not be passed until Spring / Summer 2012