# Insight: Regulatory

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# The Independent Commission on Banking publishes recommendations on UK banking reform

The ICB, chaired by Sir John Vickers, the former head of the UK Office of Fair Trading (OFT), was established in June 2010. Its mandate was to make recommendations for enhancing financial stability and competition in the UK banking sector. In its Final Report, the ICB calls for fundamental and wide-ranging changes.

## Recommendations to improve financial stability

### Retail ring-fencing

The ICB proposes to ring-fence the retail operations of UK banks. More precisely, the ICB distinguishes between mandatory services that are required to be within the ring-fence, prohibited services which must remain outside the ring-fence and other activities which are permitted on either side of the ring fence. The table below gives an overview of these categories:

| Category | Description | Examples |
|---|---|---|
| mandated services | banking services where (a) even a temporary interruption to service provision as a result of the failure of a bank has significant economic costs, and (b) customers are not well equipped to plan for such an interruption | ■ taking deposits from individuals and small and medium-sized enterprises (SMEs)*<br>■ provision of overdrafts to individuals and SMEs* |
| prohibited services | banking services which (a) make it significantly harder and/or more costly to resolve the ring-fenced bank, (b) directly increase the exposure of the ring-fenced bank to global financial markets, (c) involve the ring-fenced bank taking risk *and* are not integral to the provision of payments services to customers, or the direct intermediation of funds between savers and borrowers within the non-financial sector, or (d) in any other way threaten the objectives of the ring fence | ■ services to customers outside the European Economic Area (EEA)<br>■ services (other than payments services) resulting in exposure to a non-ring-fenced bank or a non-bank financial organisation<br>■ 'trading book' activities<br>■ services relating to secondary markets activity (including the purchases of loans or securities)<br>■ derivatives trading (except as necessary for the retail bank prudently to manage its own risk) |
| other activities | services which are not prohibited and ancillary activities required for the efficient provision of services which are not prohibited, subject to backstop limits on wholesale funding and on total exposures to non-ring-fenced banks and other non-bank financial companies | ■ lending to large companies outside the financial sector*<br>■ taking deposits from customers other than individuals and SMEs*<br>■ financial activities required for the purposes of its treasury function |

* if not classified as prohibited

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The ICB proposes a strong ring-fence. Ring-fenced banks should be legally separate entities and able to continue their operations irrespective of the financial situation of the rest of their group. Ring-fenced banks should also meet prudential regulatory requirements on a standalone basis and conduct their relationship with other parts of their group on an arms-length basis. The extent to which a ring-fenced bank may be exposed to other group entities will be subject to the limits derived from the CRD large exposures rules. Currently, the UK imposes no such limits on intra-group exposures.

## Additional capital requirements, enhanced loss-absorbency and depositor preference

The ICB's Final Report includes proposals to (i) increase equity capital requirements as well as the leverage ratio for certain ring-fenced banks, (ii) enhance the loss-absorbency of capital instruments held by certain UK banks and ring-fenced banks and (iii) introduce a form of depositor preference. These proposals go beyond Basel III requirements.

### Additional equity capital

The ICB proposes to impose a ring-fence equity buffer on certain ring-fenced banks. Large ring-fenced banks with a ratio of risk-weighted assets to UK GDP of at least 3% would be subject to a ring-fence buffer of 3% equity to risk-weighted assets. Smaller ring-fenced bank with a ratio of risk-weighted assets to UK GDP between 1% and 3% would be subject to ring-fence buffers between 0% and 3% on a sliding scale.

The ring-fence buffer would be on top of the Basel III minimum ratio of common equity to risk-weighted assets of 4.5%, the capital conservation buffer of 2.5% and the additional countercyclical buffer. However, the ring-fence buffer would not add to any surcharge on global systemically important banks (G-SIBs); rather, only the higher of the two would apply.

### Enhanced leverage ratio

The ICB broadly supports the Basel III proposals on a leverage ratio of Tier 1 capital to total exposures, to be set at 3% during an initial observation period. It proposes that ring-fenced banks should meet the leverage ratio also on a solo basis. In addition, the leverage ratio requirement should be progressively increased to between 3% and 4.06% for ring-fenced banks with a ratio of risk-weighted assets to UK GDP of between 1% and 3% and remain at 4.06% for banks with a still higher ratio of risk-weighted assets to UK GDP.

### Bail-in powers

The ICB proposes primary and secondary bail-in powers for resolution authorities. Their primary bail-in power would allow them to impose losses in resolution on a pre-determined set of the most readily loss-absorbing liabilities. This would include (but not necessarily be limited to) unsecured debt with a term of at least 12 months when issued ("bail-in bonds"). In addition, they could exercise their secondary bail-in powers to impose losses on all other unsecured liabilities if necessary.

### Primary loss-absorbing capacity and resolution buffer

The ICB recommends that UK G-SIBs subject to a G-SIB surcharge of 2.5% and ring-fenced banks with a ratio of risk-weighted assets to UK GDP of 3% or more should hold "primary loss-absorbing capacity" (recognised regulatory capital instruments and certain bail-in bonds) of at least 17% of risk-weighted assets. UK G-SIBs subject to a lower G-SIB surcharge and ring-fenced banks with a ratio of risk-weighted assets to UK GDP between 1% and 3% should hold primary loss-absorbing capacity of at least 10.5% to 17% of risk-weighted assets in accordance with a sliding scale.

UK G-SIBs and ring-fenced banks with a ratio of risk-weighted assets to GDP of at least 1% may be required by supervisors to hold additional primary loss-absorbing capacity of up to 3% of risk-weighted assets to reflect any concerns about their resolvability, for example arising from deficiencies in recovery and resolution plans. The extent and form of the resolution buffer and the manner of its application within a group would be within supervisors' discretion.

### Depositor preference

The ICB proposes that deposits insured by the Financial Services Compensation Scheme (FSCS) should rank ahead of other unsecured debt on insolvency. This is essentially a form of depositor preference.

## Commentary

### Practical impact

The ICB's proposals seek to address concerns that UK banks with large retail operations are likely to be "too big to fail" and thus would need to be bailed out by the government in the event of financial difficulty. The proposals on increasing regulatory capital and enhancing loss-absorbency are intended to promote risk monitoring by investors, enhance banks' resilience to shocks and reduce the public funds put at risk in a crisis situation. The ring-fencing proposals aim to insulate retail operations from shocks to other banking activities and to limit the scale of resolution if required.

However, the proposals come at a cost. UK banks may have to make structural changes to ring fence their retail activities. This will be particularly costly for UK banks with significant investment and wholesale activities. In addition, the proposals on additional regulatory capital and enhanced loss-absorbency would require UK banks to re-assess their capital planning at a time when banks are already under pressure to make changes to their capital structure in preparation for Basel III. Besides, the ICB proposals invoke some rather novel concepts such as "bail-in bonds" and "primary loss-absorbing capacity", and banks will need to adjust their disclosure frameworks accordingly.

There is also cause for concern that the proposals could affect the international competitiveness of UK banks. The ICB impliedly acknowledges that the principle of ring-fencing would not apply to incoming branches of EEA banks, although incoming branches of non-EEA banks are now generally required to establish a UK subsidiary if wishing to carry out mandated services in the UK. The ICB also does not recommend that UK subsidiaries of non-UK G-SIBs should hold the proposed primary loss-absorbing capacity (unless they are themselves UK ring-fenced banks). More generally, the ICB's proposals go significantly beyond current international standards.

### Interaction with CRD 4 package

Some of the ICB's proposals are subject to legal uncertainty as a result of regulatory developments at EU level. In its draft legislative proposals for a CRD 4 package, the European Commission adopts a "maximum harmonisation" approach to prudential regulatory requirements, subject only to very limited discretions for Member States. The ICB's recommendations on additional and more loss-absorbent capital conflict with this proposed EU approach. Indeed, the ICB argues that countries should be able to set higher capital requirements than required under the CRD 4 package. It remains to be seen how much freedom the CRD 4 package, once finalised, will give to Member States in this regard.

## Recommendations to enhance competition

### Market structure

The ICB considers that the acquisition of HBOS by Lloyds Banking Group (LBG) at the height of the financial crisis impaired competition in retail banking. Concentration is certainly high, with the largest four banks providing 77% of personal current accounts and 85% of SME current accounts, and barriers to entry and problems with consumer choice are significant.

The European Commission's approval of LBG's receipt of a state recapitalisation at the height of the financial crisis was conditional on a commitment by LBG to divest a retail banking business with, among other things, at least 4.6% of the personal current account market and a network of at least 600 branches. The ICB recommends that this divestiture be enhanced. The aim should be for the divested entity to achieve a funding position comparable to that of its peers (including in terms of its loan-to-deposit ratio) and to obtain at least 6% of the personal current account market.

### Facilitating current account switching and enhancing transparency

Difficulties associated with switching current accounts present an obstacle to competition in the retail banking sectors. The ICB therefore recommends the introduction by September 2013 of a redirection service for credits and debits linked to personal and SME current accounts to facilitate switching. This should be coupled with greater transparency about the costs of retail banking services offered by different firms and hence, the potential benefits from switching.

### Commentary

The ICB focuses on two central competition issues in the UK retail banking sector. Obstacles to retail current account switching are a feature of the market that has long affected – and known to have affected – competition. And LBG's acquisition of HBOS was challenged by the competition authorities already when it was proposed and for good reasons. The recommendations of the ICB lend support to efforts to achieve change in these areas.

Consistent with its broad mandate, the ICB has chosen to leave other questions about competition in the UK retail banking sector and, quite possibly, related sectors to the financial regulatory and competition authorities. Indeed, the ICB recommends ensuring, as part of the reform of the financial regulatory authorities in the UK, that competition issues receive greater attention in financial regulation. The ICB also refers to the OFT's proposed review of the personal current account market in 2012 and a potential market investigation reference to the Competition Commission.

## Implementation and timeline

The ICB envisages complete implementation of its recommendation on retail ring-fencing and additional and more loss-absorbent capital instruments by 2019. In addition, the ICB would favour a market investigation reference to the Competition Commission if the substance of its competition recommendations cannot be successfully implemented by 2015.

George Osborne, the Chancellor of the Exchequer, has already indicated that the government plans to legislate in this Parliament, with a view to ensuring that any changes to the British banking system are completed by 2019. However, as mentioned, the UK's legislative discretion in respect of capital requirements may be limited by the CRD IV package once it comes into effect.