ICB Independent Commission on Banking

Interim Report

Consultation on Reform Options

EXECUTIVE SUMMARY

April 2011

Executive summary

This *Interim Report* sets out the Commission's current and provisional views on possible reforms to improve stability and competition in UK banking, and seeks responses to those views.

The need for reform

The financial crisis that began in 2007 exposed fundamental weaknesses in the global financial system and has had enormous economic costs in terms of lost output, higher unemployment and weakened public finances.

In the build-up to the crisis lenders and borrowers took on excessive and ill-understood risks, and banks operated with excessive leverage and inadequate liquidity. Regulation permitted the ratio of their assets to their capital base to grow far too high – to twice normal levels – and they could not access market funding when they needed it. When the crisis hit, bank balance sheets proved poor at absorbing losses, and the complexity of many failing institutions made it impossible efficiently to 'resolve' them – i.e. sort out which parts of them should fail and which should continue and how. To avert panic and ensure continuous provision of the basic banking services upon which the economy and society depends, governments and central banks injected vast amounts of capital and liquidity into the financial system.

The crisis was global, and the UK, with its large financial sector, was badly affected. National output in 2010 was 4.5% below its level in 2007 and 10% lower than if growth had continued on its pre-crisis trend. Unemployment has risen by more than 800,000 since 2007. The public finances have deteriorated sharply, and the 2010 deficit exceeded 10% of GDP. Despite recent de-leveraging, the total balance sheet of UK banks is more than four times annual GDP. More than 80% of RBS and more than 40% of Lloyds are in state ownership. Competition in UK banking has been seriously weakened as rivals to the largest retail banks have left the market or been absorbed into others.

Beyond the immediate task of repairing bank balance sheets while restoring the normal flow of credit to the economy at large, the challenge is to make the UK banking system more stable, and markets for banking services more competitive. The options discussed in this *Interim Report* are directed to those ends.

Reform options for stability

How to make the system safer for the future? An important part of the answer is better macroeconomic – including 'macro-prudential' – policy so that there are fewer and smaller shocks to the system. Work by others internationally and in the UK aims to address this. But these shocks cannot be eliminated, and the UK will always be subject to global events.

Making the banking system safer requires a combined approach that:

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

These goals are inter-related. The more that banks' owners and creditors (other than ordinary depositors) stand to lose when things go badly, the stronger are their incentives to monitor risks in the first place, and the greater is their capacity to shoulder losses without damage to others when risks go bad. Banks ought to face market disciplines without any prospect of taxpayer support, but systemically important banks have had and still enjoy some degree of implicit government guarantee. This is the 'too big to fail' problem. Unless contained, it gives the banks concerned an unwarranted competitive advantage over other institutions, and will encourage too much risk taking once market conditions normalise. It also puts the UK's public finances at further risk, especially given the size of the banks in relation to the UK economy. On top of the taxpayer risk from bank bail-outs, banking crises damage the public finances because of their effects on output and employment. Indeed the problem could arise in future that the banks are 'too big to save'.

Banks must have greater loss-absorbing capacity and/or simpler and safer structures. One policy approach would be structural radicalism – for example to require retail banking and wholesale and investment banking to be in wholly separate firms. Another would be to be *laisser-faire* about structure and to seek to achieve stability by very high capital requirements across the board. The Commission, however, believes that the most effective approach is likely to be a complementary combination of more moderate measures towards loss-absorbency and structure.

Achieving greater loss-absorbency requires, first, that banks hold more equity relative to their assets and, second, that creditors, not taxpayers, take losses if necessary. On equity capital, an important step is the 7% baseline ratio of equity to risk-weighted assets in the Basel III agreement. The international community is considering augmenting this for systemically important banks. In the Commission's view, the available evidence and analysis suggests that all such banks should hold equity of at least 10%, together with genuinely loss-absorbent debt. That would strike a better balance between increasing the cost of lending and reducing the frequency and/or impact of financial crises.

The Commission's view is that the 10% equity baseline should become the international standard for systemically important banks, and that it should apply to large UK retail banking operations in any event. Subject to that safeguard for UK retail banking, and recognising that wholesale and investment banking markets are international, the Commission believes that the capital standards applying to the wholesale and investment banking businesses of UK banks need not exceed international standards provided that those businesses have credible resolution plans (including effective loss-absorbing debt) so that they can fail without risk to the UK taxpayer.

On remedying the failure of debt to absorb losses in the crisis, contingent capital and debt capable of so-called 'bail-in' might be able to contribute to improved loss-absorbency in the future. Loss-absorbency and stability might also be improved by ranking the claims of ordinary depositors higher than those of other unsecured creditors.

Greater loss-absorbing capacity has the further advantage that it may enable loss-sharing without requiring bankruptcy and thereby facilitate more orderly and efficient resolution of failing banks, limiting collateral damage. This may be of particular importance for wholesale and investment banking operations, which tend to be highly complex and span several countries with differing insolvency regimes. Disorderly failure of such banks is dangerous for the wider financial system, and international agreement on means of allowing them to fail more safely is essential.

Turning to the structural aspect of reform, a focus of the Commission's work is the question of whether there should be a form of separation between UK retail banking and wholesale and investment banking.

Ring-fencing a bank's UK retail banking activities could have several advantages. It would make it easier and less costly to sort out banks if they got into trouble, by allowing different parts of the bank to be treated in different ways. Vital retail operations could be kept running while commercial solutions – reorganisation or wind-down – were found for other operations. It would help shield UK retail activities from risks arising elsewhere within the bank or wider system, while preserving the possibility that they could be saved by the rest of the bank. And in combination with higher capital standards it could curtail taxpayer exposure and thereby sharpen commercial disciplines on risk taking.

Separation between retail banking and wholesale and investment banking could take various forms, depending on where and how sharply the line is drawn. While mindful of regulatory arbitrage possibilities at the boundary, the Commission believes that there are practicable ways of distinguishing between retail banking and wholesale and investment banking. Both sorts of banking are risky and both are important, but they present somewhat different policy challenges. For the most part, retail customers have no effective alternatives to their banks for vital financial services; hence the imperative to avert disruption to the system for their continuous provision. Customers of wholesale and investment banking services, on the other hand, generally have greater choice and capacity to look after themselves. But it is vital to find ways for the providers of these services to fail safely (strengthening market infrastructure and limiting banks' exposures to each other will help). Markets for wholesale and investment banking services – including their provision by 'shadow banks' – are also more international, as must be policy towards them, whereas national policies can bear more directly on retail banking.

As to the form that separation might take, a balance must be struck between the benefits to society of making banks safer and the costs that this necessarily entails. Full separation – i.e. into separate entities with restrictions on cross-ownership – might provide the strongest firewall to protect retail banking services from contagion effects of external shocks. But it would lose some benefits of universal banking. On the other hand, it is doubtful that separability of operational systems, though desirable for effective resolvability, would itself be enough.

The Commission is therefore considering forms of retail ring-fencing under which retail banking operations would be carried out by a separate subsidiary within a wider group. This would require universal banks to maintain minimum capital ratios and loss-absorbing debt (as indicated above) for their UK retail banking operations, as well as for their businesses as a whole. Subject to that, the banks could transfer capital between their UK retail and other banking activities.

It is open to debate whether a retail ring-fence would give more or less banking stability than full separation between retail banking and wholesale and investment banking. It would be less costly to banks because they would retain significant freedom to transfer capital. The required UK retail capital level would constrain banks only when they wanted to go below it to shift capital elsewhere, say to their wholesale and investment banking operations. But at times of overall stress it would not be desirable for the leverage of UK retail banking operations to increase in this way.

Rather than pursuing more radical policies towards capital or structure, the approach outlined above is a combination of more moderate measures. They nevertheless entail costs to banks, some of which fall on the wider economy, but these appear to the Commission to be outweighed by the benefits of materially reducing the probability and impact of financial crises. The approach is also designed with a view to UK competitiveness, and to the UK's international obligations. In particular, so long as there are appropriate measures in place to protect UK retail banking, the Commission is not proposing that UK banks' wholesale and investment banking activities should have to meet higher capital standards than are agreed internationally, provided that they can fail without risk to the taxpayer.

Reform options for competition

Measures to curtail the implicit government guarantee enjoyed by systemically important banks and to ensure that they face the consequences of their risk taking activity are good for competition as well as for stability.

But more than that is needed to remedy the weakening of competition in UK retail banking as a result of the crisis. Challengers to the large incumbents have mostly disappeared, and following its acquisition of HBOS, Lloyds currently has around 30% of current accounts in the UK. This *Interim Report* discusses three initiatives (beyond the continued application of general competition and merger law) that could improve competition.

The first concerns structural measures to improve competition. Although Lloyds is required to divest a package of assets and liabilities to satisfy conditions for state aid approval set by the European Commission, this divestiture will have a limited effect on competition unless it is substantially enhanced.

Second, competition among incumbent banks, and between them and challengers, is blunted by the actual and perceived difficulties for customers switching accounts, by poor conditions for consumer choice more generally, and by barriers to entry. This *Interim Report* suggests that it may be possible to introduce greatly improved means of switching at reasonable cost, in which case the industry should be required to do this within a short timescale, and that barriers to entry may be able to be reduced.

Third, the Commission regards the Financial Conduct Authority proposed as part of the Government's reforms of the regulatory architecture as potentially a vital spur to competition in banking. The Authority will have regulatory tools not available to the general competition and consumer authorities, and, in line with an earlier recommendation by the Commission, the Authority should have a clear primary duty to promote effective competition.

The international context

The Commission's remit is well-aligned with the international reform agenda for financial stability, which is being led by, among others, the Basel Committee on Banking Supervision and the European Commission. The current work on systemically important financial institutions by the Financial Stability Board for the G20 is of particular relevance for the Commission. The UK authorities are centrally involved in these international initiatives, and one intention of this *Interim Report* is to contribute to the international debate.

An important consideration for the Commission is how reforms to UK banking could affect the competitiveness of UK financial services and the wider economy. The Commission's current view is that the reforms of the kind contemplated in this *Interim Report* would support the competitiveness of the economy and would be likely to have a broadly neutral effect on financial services.

First, they would affect a relatively small proportion of the international financial services industry based in the UK. Second, improved financial stability should be good, not bad, for the competitiveness both of the financial and non-financial sectors. The costs and consequences (including for taxation) of financial crises make countries that suffer them less attractive places for international businesses to locate. More resilient banks are therefore central to maintaining London's position as a leading global financial centre, not a threat to it. So while a further domestic taxpayer guarantee might be to the advantage of some UK banks in international competition, it would be a fiscally risky subsidy without justification. In any case, the location decisions of banks are affected by a wide range of factors that go well beyond the issues that the Commission has been asked to consider.

Consultation

The purpose of this *Interim Report* is to focus the next stage of debate on reform options which, in the current and provisional view of the Commission, appear to have most merit. The Commission welcomes views and analysis in response to it. The Commission's final report will be published in September.