# AN OVERVIEW OF THE INDEPENDENT COMMISSION ON BANKING REFORMS – MOTIVATIONS, MEASURES AND LIKELY IMPACT

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## 1 Introduction

### 1.1 THE BANKING SECTOR AND THE CRISIS

The economic crisis that has gripped the world is now about to enter its sixth year. The scale and depth of disruption to economic activity has been widespread and rapidly evolving.

Government support to the financial sector helped to avoid a systemic collapse but also contributed to a rapid deterioration in public finances, exacerbating a cyclical decline and drawing attention to underlying spendthrift policies, resulting in sovereign debt crises in some eurozone countries.

Against a backdrop of deteriorating economic activity, continued liquidity stress and regulatory changes, banks have found it increasingly difficult to fulfil financial intermediation roles. Deteriorating asset quality (both public and private) and regulatory pressures, have constrained banks' ability to provide crucial credit needed to support the economic recovery.

The challenge facing policymakers is therefore threefold:

i) How to ensure the banking sector does not contribute to the build-up of unsustainable economic bubbles, which could precipitate a future crisis?

ii) How to avoid the need for future taxpayer support to the banking sector?

iii) How to solve the above two challenges without inhibiting banks' vital financial intermediation role and prolonging the recovery from the current crisis?

The objective of this article is to provide: an overview of the background and motivations for the UK's Independent Commission on Banking (ICB); an explanation of the key recommendations; a high-level evaluation of its likely impact.

Section 2 of this article sets the ICB within the overall perspective of wider international and national developments. Section 3 explains the UK-specific motivations for the ICB reforms and provides an overview of the overall approach. Section 4 sets out in detail the specific proposals of the ICB measures with regard to financial stability. Section 5 provides an overall evaluation of the likely impact of the ICB measures considering both theoretical and practical implementation challenges. The final section provides a summary of the key messages.

## 2 International and regional regulatory developments

### 2.1 THE INTERNATIONAL RESPONSE

The international response to these challenges has been led by the G-20 through the Basel Committee on Banking Supervision (BCBS), the Financial Stability Board (FSB) and the International Monetary Fund (IMF).

Most of the international regulatory effort to date has focussed on trying to address the first two challenges i.e. putting in place regulation to avoid a future crisis. However, there is increasing recognition that more needs to be done to secure the recovery from the current crisis.

The key elements of the international response include:

— *Enhancing prudential regulation* via the Basel III agreement to increase banks' buffers of capital and liquidity. Such regulation is primarily designed to

counter-balance the build-up of unsustainable leveraging and to increase banks' ability to weather periods of heightened stress.

— *Addressing the underlying moral hazard problem* by introducing crisis management frameworks designed to facilitate the failure of any bank without the need for recourse to public funds and the spreading of systemic risk.

— *Improving micro and macro supervision* to better foresee emerging risks in the financial sector and to be able to take early measures to address them.

The response to date has primarily focussed on enhancing regulation and supervision of the traditional banking sector. However, there is also a need for regulators to take a wider view of risks emanating from non-traditional banking sources, such as the so-called shadow banking sector (loosely defined by the FSB as "credit intermediation involving entities and activities outside the regular banking system"[1]). As regulation of the banking sector increases so do incentives for arbitrage and it is therefore important that these risks are appropriately addressed.

This overall approach can broadly be described as an attempt to address market failures by adapting regulation to the existing system. The objective is to better identify and measure the build-up of risks, ensure that appropriate regulatory measures are taken to penalise risky behaviour and make those responsible for taking systemic risks bear the consequences of their actions.

So far there has been significant activity and many standards have now been defined at an international level. However, some crucial elements are still to be released (most notably the European Commission's Crisis Management framework) and some aspects still need further enhancement (such as a harmonisation of risk-weighted assets). A particular challenge for the banking sector is to correctly assess the implications of the various different changes in the regulatory environment and make clear decisions about future business strategy.

The process of transposing these international standards into regional and national legislation is now starting to take place, though progress has been disjointed with some countries advancing further than others. Some countries (or regions) – where the impact on the banking sector has been especially pronounced – have also introduced their own additional national initiatives. One of the key challenges is to ensure that implementation is even-paced and geographically consistent and that individual national initiatives do not lead to the creation of an unlevel-playing field, which could complicate the activity of cross-border banks and create potential incentives for arbitrage.

To date these additional national measures can de divided into two groups.

*By far the most common, are regional/national initiatives that broadly follow the overall shape of the international regulatory approach. These measures typically extend certain elements of the existing framework or include specific additions to take account of national and regional circumstances.*

1 http://www.financialstabilityboard.org/publications/r_110412a.pdf.

In the *United States,* the Dodd-Frank Reform will introduce 243 rules over the coming years and represents a major overhaul of the US financial sector. A number of the proposed changes follow the broad elements of the international reform but with US specific applications. Some elements also go much further, such as the Volcker Rule (see below).

Similarly in *Europe,* whilst the European Commission is aiming for a consistent implementation of Basel III, requests are being made to introduce EU-specific nuances. The European Commission is also developing its version of a crisis management framework. This framework is likely to closely follow the standards set out by the FSB but with some European-specific additions, such as a proposal for a voluntary ex-ante agreement for intra-group support or additional mechanisms for early intervention (such as the appointment of a special manager). The European Union is also considering the application of an EU-wide Financial Transactions Tax (FTT), which has not yet received the full support of the international community. An FTT would be aimed at disincentivising high-frequency transactions and recuperating some of the fiscal costs of bank rescues.

Individual European countries have also implemented their own initiatives. For example, in 2010, Germany, France and the UK publically committed to introducing direct bank taxes with flexibility to differ on specific design elements. In *Spain,* measures were introduced in 2011 to increase the capital requirements for Spanish banks. The law required that listed Spanish banks hold core capital of 8% of risk-weighted assets (RWAs), increasing to 10% for banks that have less than 20% of their capital listed and have a wholesale funding dependency of over 20%. Meanwhile in 2011, *Germany* introduced the Bank Restructuring Act, which amongst other things introduced two new voluntary restructuring proceedings and amendments to the existing German Banking Act, which significantly broaden the powers of BaFin to execute a rapid bridge bank resolution.

*However, a small number of jurisdictions have opted to take an alternative approach. Instead of attempting to address market failures within the current system, these jurisdictions have instead looked to reform the structure of the system itself.*

This is true for certain elements of the United States' Dodd-Frank reform, which contains the proposal to introduce the Volcker Rule. In simple terms the rule would prevent US-headquartered banks (and those non-US banks that trade with them) from engaging in proprietary trading and would therefore introduce a structural change in the operation of some US banks. It would aim to reduce speculative trading, which it regards as non-economically viable and volatility enhancing.

More recently, the European Commissioner for Internal Markets and Services Michel Barnier has announced the creation of a High-level Expert Group on reforming the structure of the European banking sector. The Expert Group been tasked to consider the need for further structural reform in Europe and will evaluate measures taken by the United States and the United Kingdom's Independent Commission on Banking.

### 2.2 FINANCIAL REGULATORY REFORM IN THE UK

The United Kingdom is the country that has perhaps gone furthest in undertaking its own national measures that are independent of the wider international agenda. To some extent this is unsurprising. The UK's financial sector was one of the worst affected by the crisis. Furthermore, together with the US, the UK has long been regarded as being something of a trendsetter in the financial regulation sphere.

Aside from the recommendations of the ICB, which will be discussed in more detail in the following sections, the UK has introduced a wide range of measures seeking to address the particularly pronounced banking crisis that it experienced.

These measures include:

— *Reform of the previous "tri-partite" regulatory system* (introduced in 1997), where supervision was divided between the Bank of England, Financial Services Authority (FSA) and HM Treasury. The reforms will see the dismantling of the FSA, the transfer of day-to-day macro-supervisory responsibilities to the Bank of England through the Financial Policy Committee, the creation of a Prudential Regulatory Authority responsible for the prudential regulation of banks, and the establishment of a Financial Conduct Authority to cover markets and consumer protection. In the case of taxpayer funds being required, increased powers will also be given to the Chancellor. The reform recognises failures in the UK financial regulatory approach prior to the crisis. The objective is to better integrate supervision, making clearer the lines of responsibility and increasing the focus on identifying the development of macro-fiscal risks.

— *The creation of a Special Resolution Regime* through the 2009 Banking Act. The Special Resolution Regime sets out specific statutory objectives for resolution of banks, as well as establishing a toolkit of powers for authorities to use in resolution. Tools include the ability to accelerate property transfers to private purchasers, the power to establish a bridge bank, the power to take an institution into temporary public ownership, as well as a modified bank insolvency procedure to close a failing bank and facilitate payment or transfer of insured depositor claims.

— *The introduction of a bank levy* on banks' total liabilities. The levy is designed to recuperate some of the fiscal costs of the crisis and to encourage banks to choose less risky forms of borrowing by excluding protected retail deposits and halving the tax rate for long-term debts. The first £20bn of taxable liabilities are excluded from the levy, in part to recognise the lower systemic risk posed by smaller financial institutions.

## 3 The ICB Proposal

However, the Independent Commission on Banking's recommendations are without doubt the clearest example of how the UK has adopted an approach that goes beyond and in a different direction to the current international consensus on financial regulation.

### 3.1 THE "BRITISH DILEMMA"

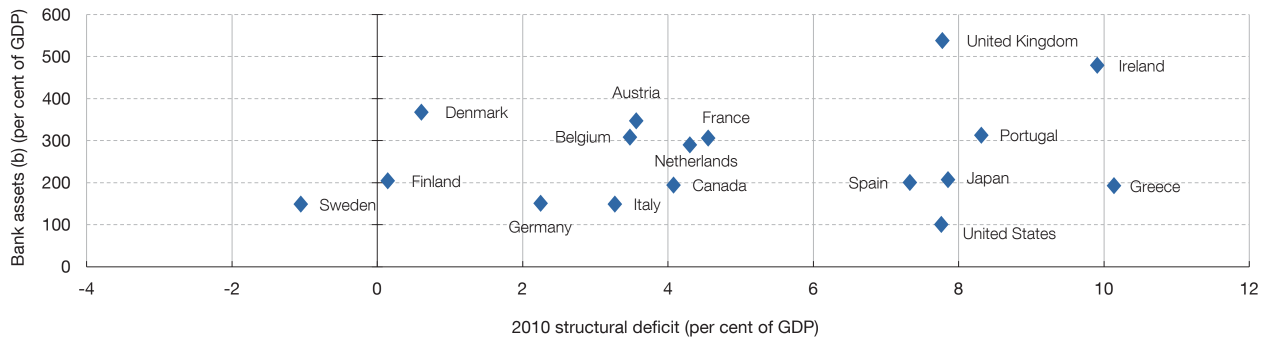
The rationale for establishing the ICB was to address what the Chancellor of the Exchequer, George Osborne, describes as the "British dilemma".

On the one hand it is vital for the UK that it does not lose its strength in financial services. The UK financial sector makes an important contribution to the UK economy's growth and job creation, as well as to fiscal revenue. In 2010, the financial sector accounted for approximately 10% of UK GDP and employed approximately 1 million people. Meanwhile some 11% of fiscal revenues in year 2009/10 were collected from the financial sector.[2]

2 http://www.thecityuk.com/assets/Reports/Economic-Trends-Series/Key-facts-about-UK-FS.pdf.

RELATIVE SIZE OF NATIONAL BANKING SECTORS AND FISCAL POSITION (a)

CHART 1




SOURCES: *World Economic Outlook,* IMF, April 2012 and *Global Financial Stability Report,* IMF, September 2011.

a Page 28: http://cdn.hm-treasury.gov.uk/budget2012_complete.pdf.
b Total assets of commercial banks, including subsidiaries. For Austria, the data is from Austria National Bank. For Ireland, the data are from Central Bank of Ireland. For Portugal, the data are from Bank of Portugal.

On the other hand, as the crisis has shown, the financial sector is a major risk factor for the UK economy and as much as the financial sector has been a significant plus for public finances in normal economic times, it has the potential to be a significant negative in crisis.

A recent report by the National Audit Office[3] estimates that at its peak, total explicit Government support to the UK banking system amounted to £1.2 trillion including taxpayer support to specific banks and support to the financial sector as a whole. Whilst some of this support may yet be recouped through sale of Government stakes in publically-owned banks it is clear that this scale of public sector support is highly undesirable both in terms of its long-term impact on public finances and its moral hazard implications.

Furthermore, the financial crisis starkly called into question the availability and stability of essential banking services in the UK. This was most graphically illustrated by the queues that formed outside branches of Northern Rock in September 2007 and the problems that confronted customers in accessing bank accounts.

In straightforward terms the challenge that the Chancellor tasked the ICB to resolve was, *"how Britain can be home to one of the world's leading financial centres, without exposing British taxpayers to the massive costs of those banks failing"?*[4]

## 3.2 THE INDEPENDENT COMMISSION ON BANKING

In June 2010, the British Government established the Independent Commission on Banking headed by Sir John Vickers, a former Chief Economist of the Bank of England, to answer this question.[5]

The Government set the formal terms of reference[6] for the Commission as being to consider structural and non-structural measures to reform the banking sector and promote competition with a view to: reducing systemic risk; mitigating moral hazard; reducing the likelihood and impact of firm failure; and ensuring effective competition across sectors and sizes of firms.

3 The Comptroller and Auditor General's Report on Accounts to the House of Commons: The financial stability interventions, National Audit Office, July 2011. http://www.nao.org.uk/publications/1012/hmt_accounts_2010-2011.
4 Banking Reform Statement of the Chancellor of the Exchequer, 19 December 2011. http://www.hm-treasury.gov.uk/statement_chx_191211.htm aspx.
5 The other ICB panel members were: Claire Spottiswoode, Martin Taylor, Bill Winters and Martin Wolf.
6 http://bankingcommission.independent.gov.uk/terms-of-reference/.

In April 2011, the ICB published its first draft proposals.[7] Following several months of further consultation and consideration, the Commission published its final report in September 2011.[8]

The final report made two sets of recommendation: a first set aimed at addressing the financial stability issues identified earlier; and a second set aimed at boosting competition in the UK financial sector. The remainder of this article will focus on the recommendations related to financial stability and will not refer to those on competition, although this is not to underplay the importance of the latter.

The measures proposed by the ICB to improve financial stability are organised around two pillars:

1) *Increasing the ability of banks that provide critical retail services to absorb losses:* aimed at increasing the resilience of such banks in times of heightened stress.

2) *Separating critical retail banking activities from other banking operations – through the creation of a ring-fence:* aimed at insulating critical retail services from possible contagion, whilst permitting non-critical banking activities to fail without the need for public support.

These two pillars constitute two routes to addressing the same problem:

— The increase in loss-absorbing requirements essentially extends existing international agreements by increasing some minimum standards (e.g. capital, which other countries have also done) and by bringing forward certain measures (e.g. proposals to bail-in bondholders). In this regard, the measures are not qualitatively different from the approach being pursued elsewhere.

— By contrast, the proposal for a ring-fence is a radically different approach to the above. Instead of attempting to apply regulation to the existing system, the ring-fence is an attempt to reform the system itself. The nearest precedent is the Glass-Steagall Act established in 1933 following the Great Depression (see text box 1).

In December 2011, the UK Government announced its official support for the measures proposed by the ICB.[9] It published some initial reactions about how the Government would seek to implement the recommendations and identified specific areas that would need further analysis. The Government also committed to publishing a White Paper in spring 2012 which will set out how the Government would practically put the recommendations into legislation during the course of the current Parliament.

7 http://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/10/Interim-Report-publication-JV-opening-remarks-check-against-delivery.pdf.

8 http://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/07/ICB-Final-Report.pdf.

9 http://cdn.hm-treasury.gov.uk/govt_response_to_icb_191211.pdf.

Ever since the ICB first hinted at recommending some form of separation between banks' retail and investment banking activities, commentators have been quick to draw comparisons with the Glass-Steagall Act that was introduced in the United States in 1933 and finally repealed in 1999.

The Glass-Steagall Act refers to the 1933 Banking Act which was sponsored by US Senator Carter Glass and Congressman Henry B. Steagall. In particular, it is commonly used to describe the specific provisions that introduced a separation between commercial and investment banking in the United States:

— *A prohibition on national banks from purchasing, selling, underwriting or distributing securities.* Except when: acting on behalf of customers; dealing with US Government securities; or purchasing permitted "investment securities". (Section 16)

— *A prohibition on any person or company taking deposits if it was involved in issuing, underwriting, selling, or distributing securities.* (Section 21)

— *A prohibition on any member of the Federal Reserve System from being affiliated or sharing common directors/officers with a company engaged primarily in issuance, flotation, underwriting, sale, or distribution of securities.* (Sections 20 and 32)

The Glass-Steagall Act is comparable to the ICB recommendations insofar as the ICB recommends that banks' retail and investment operations be separated from one another. However, unlike the Glass-Steagall Act, the ICB only requires operational separation whereas Glass-Steagall imposed institutional separation. Under the ICB recommendations the same banking group can still own both retail and investment operating units. Furthermore banking groups will be able to move capital between retail and investment units provided both are meeting minimum capital requirements and to share common services, such as branding and technology.

## 4 Design of the ICB Recommendations

This section explains in more detail the main elements of the recommendations made by the ICB on financial stability.

### 4.1 RETAIL RING-FENCE

In its simplest form, the ring-fence consists in the separation of retail activity from wholesale activity. Retail activity includes those functions that are typically regarded as being vital to the economy, such as deposit-taking, the payments system and the provision of credit to families and firms.

The ICB argues that the creation of a ring-fence for retail activity has three main objectives.

Firstly, to increase the ease by which banks in difficulty can be resolved, minimising the impact on the financial sector without the need for recourse to taxpayers.

Secondly, to isolate vital banking services for households and SMEs from other financial sector activities that have a greater probability of entering into difficulties. By establishing limits on the activities that can exist on the balance sheet of ring-fenced banks, the ring-fence creates a form of firewall against possible contagion, reducing financial interconnections and therefore systemic risk.

Finally, to reduce the incentives for banks to take excessive risks, making it easier to apply resolution tools, placing the burden of loss absorption on creditors ("bail-in") and avoiding the need to intervene to protect vital banking services, which are already isolated and protected.

The ring-fencing requirements will apply to 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 nor to UK branches of banking groups from outside the UK.

The ICB make a series of high-level recommendations regarding the separation of activities, along two axes: the location and the height of the ring-fence.

Location of the ring-fence

The ICB make a distinction between the various types of services that can and cannot be provided by ring-fenced and non-ring-fenced banks. Activities that do not fall into the following categories are permitted activities, which can be provided by both ring-fenced and non-ring-fenced banks.

The UK Government has indicated that it favours a flexible approach to setting the ring-fence with only a limited amount of prescription regarding what ring-fenced banks can and cannot do.

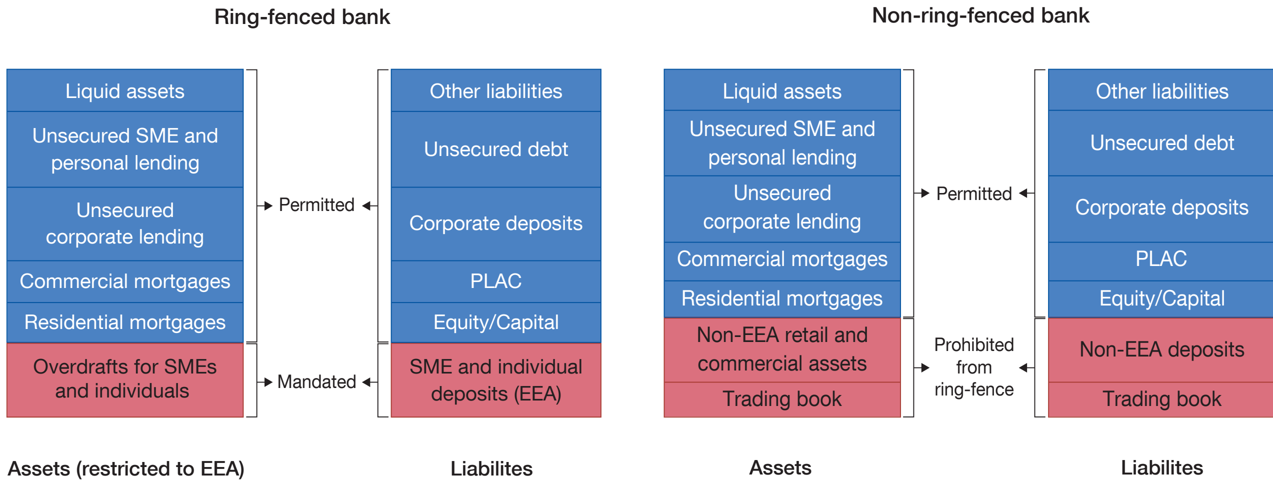
— *Mandated activities* can only be undertaken within the ring-fence. The ICB defines mandated activities as services for which even a temporary interruption would impose a significant economic cost and for which it is typically difficult for customers to plan ahead. At a minimum this would include deposit-taking from individuals and SMEs and providing overdrafts to individuals and SMEs. The UK Government will evaluate whether provision of credit to households and/or SMEs should also be mandated within the ring-fence. It will also provide guidance on the definition of SMEs to be included in the ring-fence and how to treat private banking services.

— *Prohibited activities* cannot be undertaken within the ring-fence. Prohibited activities include services, which: make it significantly more difficult or costly to resolve the ring-fenced bank; directly increase the exposure of the ring-fenced bank to global financial markets; are not integral to the provision of payments services or the direct intermediation function; in any other way threaten the objectives of the ring-fenced bank. The ICB recommends that prohibited activities include: 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 require capital to be held against counterparty risk.

— *Ancillary activities* can be undertaken if necessary for the efficient provision of mandated and permitted services e.g. for the purposes of risk management, liquidity management, or funding of non-prohibited services. The ICB also recommends that limits be placed on the proportion of wholesale funding permitted for a ring-fenced bank. The UK Government agrees that ancillary activities may be necessary for the efficient provision of services, but it is concerned that these activities should not dilute the ring-fence. It has also committed to consider how to prevent ring-fenced banks from becoming over-reliant on wholesale funding.

— The UK Government will evaluate the characteristics of financial institutions that may be permitted as counter-parties to ring-fence banks. It will also analyse the characteristics of prohibited products by reference to their function and investigate the potential scope for including simple derivatives and investment products within the ring-fence – for example, products which provide insurance against interest or exchange rate risk. Finally, the Government will look at ways to define the geographic scope of permitted

WHAT THE BALANCE SHEET OF A RING-FENCED AND NON-RING-FENCED BANK MIGHT LOOK LIKE (a) CHART 2




**a** Page 22: http://cdn.hm-treasury.gov.uk/govt_response_to_icb_191211.pdf.

services. The guiding principle will be that services should be assumed to be prohibited, unless it can be shown that they do not jeopardise the objectives of the ring-fence.

Height of the ring-fence

The height of the ring-fence refers to the degree of separation that the ring-fenced bank should have from other entities within the same corporate group.

During its deliberations the ICB gave serious consideration to recommending full separation of retail entities from wholesale entities (along the line of the Glass-Steagall Act). In the end, the ICB concluded that full separation would involve a number of additional costs with relatively limited additional benefits compared to an effectively imposed ring-fence. In particular, the ICB noted that full separation could result in the possible loss of diversification benefits as well as various benefits from economies of scale, such as shared infrastructure, branding and information. Furthermore, in the case of an entity entering into difficulties, a ring-fence approach would permit the sharing of *surplus* capital and liquidity between entities in the same group. Finally, the ICB also noted potential legal impediments to full separation from European law.

As a result of these deliberations, the ICB plumped for the ring-fence approach, advocating a high degree of separation in legal, operational and economic terms between the ring-fenced entity and the rest of the group.

— In terms of *legal and operational separation,* the ICB emphasises that authorities should be able to isolate a ring-fenced bank from the rest of the group in a matter of days. To this end they recommend that ring-fenced banks be separate legal entities and that ring-fenced banks only be able to own financial institutions conducting ring-fence activities. Regarding operational separation, the ICB emphasises the importance of ensuring that the ring-fenced bank be able to have an uninterrupted supply of essential operational services even when other parts of the group face insolvency. The Government recommends that firms consider use of service level agreements for provision of essential services and provide services via operational subsidiaries on an arm's length basis.

— In terms of *economic separation,* the ICB recommends *inter alia* that ring-fenced banks be subject to regulatory requirements on a solo basis and that intra-group transactions be conducted on a third party basis. In order to ensure effective independence in decision making, the board of the ring-fenced bank should be made up of mainly independent non-executives tasked with maintaining the integrity of the ring-fence and that no more than one member of the board of the ring-fenced bank may also sit on the board of the parent or another member of the group.

The UK Government has signalled its agreement with the broad thrust of the recommendations and will consider in detail how to practically implement them. In particular, it will review the case for *de minimis* exemptions. This could permit certain entities, which already have a high degree of resolvability and pose minimal systemic risk, to be exempt from the ring-fencing requirements. The Government has indicated that this may be the case for small entities. It will analyse the case for *de minimis* exemptions for entities that undertake a small amount of either mandated or prohibited services and for which the implementation of a ring-fence would pose a significant additional cost. However, the Government is cautious of taking any measure that could water down the ring-fence.

### 4.2 INCREASED LOSS ABSORBING CAPACITY

The second main pillar of the ICB recommendations is the proposal to significantly increase the capacity of entities to absorb losses. The ICB propose a range of measures to achieve this.

#### Capital requirements

The ICB recommends that ring-fenced banks should be subject to capital requirements that are greater than the international standards established by Basel III. They propose an additional layer of Tier-1 capital, referred to as the “ring-fence buffer”. The buffer will not apply to non-ring-fenced banks, to avoid harming the international competitiveness of the UK’s investment banks.

— For large ring-fenced banks with a ratio of risk-weighted assets to UK GDP in excess of 3%, they propose a ring-fence buffer of 3% of RWAs. Adding the buffer to Basel III criteria, means that large ring-fenced banks in the UK should have a total minimum common equity of 10% of RWAs.

— For smaller retail ring-fence banks (ratio of RWAs to GDP of between 1% and 3%), the ICB propose a ring-fence buffer of between 0% and 3%. This means that small ring-fenced banks could have a total minimum common equity of between 7% and 10% of RWAs.

These additional capital requirements are aimed at increasing ring-fenced banks’ ability to weather periods of heightened stress and reduce their cost of resolution, therefore providing greater insulation to vital banking functions. However, the ICB also note that increased capital requirements could increase regulatory arbitrage incentives and potentially encourage deleveraging, which will be discussed in more detail later.

Some industry participants have expressed concern that the ICB’s recommendations would interfere with the operation of the various equity buffers. These buffers (Basel II capital conversation buffer, counter-cyclical capital buffer, G-SIB surcharge) are intended to run in addition to the hard regulatory minimum of 4.5% established by the Basel Committee. They would provide a cushion that can be built up in normal times but also be

temporarily run down in times of stress. Some industry participants expressed concern that the ICB criteria would introduce a higher hard regulatory minimum and therefore limit the operation of the buffers. The ICB has clarified that the ring-fence *buffer* is exactly that and should not be seen as raising the hard regulatory minimum.

Leverage ratio

In line with Basel III, the ICB also favours the introduction of a leverage ratio. The leverage ratio is designed to avoid some of the difficulties associated with risk-weighting of assets, which can suffer from inaccuracies. Basel III established a binding minimum ratio of Tier 1 capital to total exposures of 3% to be in place by 2018.

The ICB proposes that:

— All UK-headquartered banks should maintain a Tier 1 leverage ratio of a least 3%. This should be met on a solo basis by ring-fenced banks.

— All ring-fenced banks with a ratio of RWAs-to-UK GDP of between 1% and 3% should have a minimum leverage ratio that increases on a sliding scale to a maximum of 4.06%.

Bail-in

In accordance with wider international developments, the ICB proposes that UK regulatory authorities be given statutory bail-in powers, allowing them to impose losses on the creditors of a failing bank and reducing taxpayer exposure.

The ICB recommends that:

— Authorities are given a "primary" bail-in power allowing them to bail-in long-term unsecured debt, either by write down or conversion into equity. The power would be primary insofar as the ICB view this type of debt as being the most practicable for resolution authorities to impose losses.

— Authorities are given 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. The ICB propose that this power be secondary, recognising that imposing losses on certain types of short-term funding and derivatives could increase disruption in financial markets.

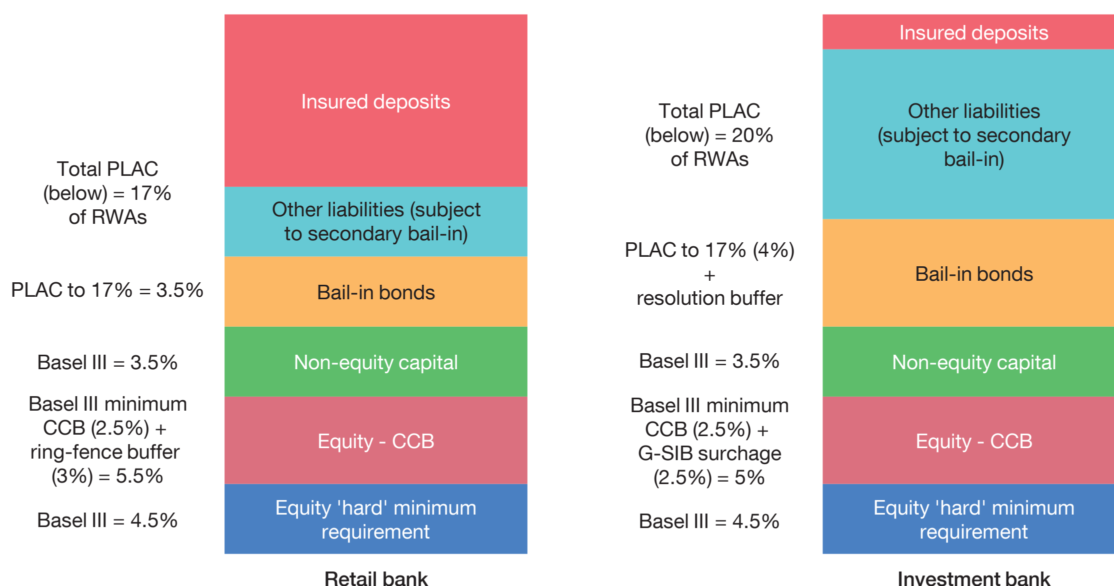
— The existing creditor hierarchy should be maintained as far as possible and bail-in should be applied retroactively to existing debt already issued.

— Bail-in powers should extend to non-deposit taking entities within banking groups.

Depositor preference

The ICB recommends that all insured deposits (regardless of whether they are in the ring-fenced or non-ring-fenced bank) should rank ahead of other creditors in resolution. The ICB argue that this approach would reflect the limited capacity and ability of insured depositors to exert market discipline on banks and would increase the incentives of other unsecured creditors (who would normally rank *pari passu* with insured depositors in liquidation) to be more effective in exerting discipline. Such an approach would also reduce the potential losses to the Financial Services Compensation Scheme (FSCS) and further limit the possibility of recourse to the taxpayer in the case of a systemic event in which banks were temporarily unable to fund the scheme.

LOSS ABSORBENCY CAPACITY IN RESOLUTION FOR A RING-FENCED AND NON-RING-FENCED BANK (a) CHART 3




**a** Page 120: http://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/07/ICB-Final-Report.pdf.

Primary loss-absorbing capacity

The ICB's proposal to introduce a bail-in regime that prioritises certain liabilities over others has the potential to increase incentives for banks to concentrate on issuing liabilities that would not be affected by bail-in (e.g. secured debt or protected deposits or short-term funding). These liabilities would presumably be relatively cheaper to issue as investors would not be affected by a possible bail-in.

In anticipation of this problem, and to avoid a situation in which the bail-in tool would be blunted by a lack of bail-inable liabilities, the ICB recommends that banks be required to hold a minimum amount of "primary loss absorbing capacity" (PLAC). This is defined as either regulatory capital or long-term unsecured debt that is capable of being subject to the primary bail-in power. The ICB suggests that for the biggest G-SIBs and large ring-fenced banks, the minimum level of PLAC should be set at 17% of RWAs. According to the ICB's analysis, this would constitute a level of loss-absorbency capable of covering losses suffered by banks in the majority of previous crises. In particular, the ICB recommends that:

— UK-headquartered banks that are subject to a 2.5% G-SIB surcharge,[10] and all ring-fenced banks with a ratio of RWAs to UK GDP of 3% or more, should be required to have PLAC of at least 17% of RWAs

— UK-headquartered banks that qualify as G-SIBs but have a G-SIB surcharge of below 2.5%, and all ring-fenced banks with a ratio of RWAs to UK GDP of between 1% and 3%, should be required to have PLAC on a sliding scale of between 10.5% and 17% of RWAs.

Furthermore, the ICB recommends that these requirements apply to UK-headquartered G-SIBs at the consolidated group level and to UK-domiciled banks on a solo basis.

10 In November 2011, the Basel Committee on Banking Supervision (BCBS) approved measures to apply a common equity surcharge on certain global systemically important banks ("G-SIBs"). The surcharge ranges from an additional 1% to 3.5% to be applied on top of the Basel III 7% requirement in proportion to the degree of systemic risk posed by banks, determined according to an indicator-based methodology.

Imposing PLAC against group wide assets would aim to reduce the impact of the failure of non-UK operations on UK financial stability and taxpayers.

Resolution buffer

In addition to the PLAC requirements, the ICB also propose that supervisors of UK-headquartered G-SIBs and ring-fenced banks should have the discretion to impose an additional loss absorbing capacity of up to 3% of RWAs. Supervisors could apply this "resolution buffer" if they have concerns about the resolvability of a particular institution and would be free to choose whether the buffer should take the form of capital or long-term unsecured debt.

The UK Government's initial response

The UK Government has expressed its support for the loss absorbency proposals as a whole. In certain areas the Government makes specific observations or commitments to further work:

— *On the ring-fence buffer,* the Government believes that capital requirements should not be regarded as additional to any G-SIB surcharge (only the higher of the ring-fence buffer or the surcharge should apply) and that internationally-agreed G-SIB/L-SIB criteria could be used to calibrate the appropriate size of the buffer.

— *On the leverage ratio,* the Government will analyse whether different minimum leverage ratios are needed for banks with different business models and whether a buffer approach should be taken towards the application of the leverage ratio.

— *On bail-in,* the Government will undertake further analysis to determine which liabilities should fall under the primary and secondary bail-in power. It will review potential perverse incentives of providing a more favourable treatment to short-term funding and will analyse whether bail-in should apply retroactivity.

— *On depositor preference,* the Government will analyse related issues including the potential for arbitrage, the possibility of flights of certain types of creditors and potential cost and supply implications for non-protected instruments. It will also analyse different scopes of depositor preference, which may be wider or narrower than the ICB's proposal for an insured depositor preference.

— *On primary loss absorbing capacity,* the Government will analyse whether 17% is the appropriate number for the largest institutions. The Government agrees that PLAC should be applied on UK-headquartered G-SIBs' global operations, but will consider exemptions for non-UK operations that can be shown not to pose a risk to UK financial stability. The Government also believes that PLAC requirements should function on a buffer basis rather than as a hard regulatory minimum.

## 5 Evaluation

The following section looks at the likely impact of the ICB recommendations in addressing the three challenges defined by this article at the beginning of this paper:

i) How to ensure the banking sector does not contribute to the build-up of unsustainable economic bubbles, which could precipitate a future crisis?

ii) How to avoid the need for future taxpayer support to the banking sector?

iii) How to solve the above two challenges without inhibiting banks' vital financial intermediation role and prolonging the recovery from the current crisis?

The section is divided into two parts: a first part, which highlights some of the challenges facing the UK Government and the banking sector in implementing the ICB recommendations; a second part, which draws out some high-level conclusions about the extent to which the recommendations will deliver on their objectives.

The ICB reforms have already generated a significant amount of discussion. This article seeks to draw the reader's attention to some of the key issues that have been raised.

## 5.1 PRACTICAL IMPLEMENTATION CHALLENGES

In evidence sessions conducted by the UK Parliament, senior banking figures acknowledged that the reforms proposed by the ICB were essentially a "done deal".[11] However, they also emphasised that the implementation of the recommendations was likely to prove complex and have a significant bearing on the cost and effectiveness of the ICB's measures.[12]

This section identifies some of the challenges that the UK Government will need to get right over the coming years as it attempts to put the ICB recommendations into legislation.

### Location of the ring-fence

The challenge for the UK Government is to decide which activities should be mandated, permitted or prohibited, so as to ensure both ring-fenced and non-ring-fenced entities are economically efficient and viable. The UK Government will need to strike the right balance to ensure that entities on both sides of the fence have:

— *Balance sheets that make sense.* Assets and liabilities need to be able to be balanced effectively. For example, if mandated liabilities are insufficient to match mandated assets, then the ring-fenced bank will either need to reduce its mandated assets (which are presumably useful activities), or fund itself through other non-mandated liabilities, which could increase its exposure to wholesale market volatility.

— *The ability to provide a range of cost efficient services to customers.* SMEs may find themselves in a situation where they need to visit a ring-fenced bank for vital basic banking services (i.e. to deposit money) and a non-ring-fenced bank to access important hedging facilities such as exchange rate and interest rate hedges. There is therefore a potential opportunity cost between permitting the retail-ring fence bank to engage in certain activities, such as client hedging, which would involve exposure to small amounts of market volatility and being able to provide a cost-efficient, low hassle range of services to the client.

— *A sufficient degree of diversification.* The range of activities that ring-fenced banks are allowed to engage in should not be so limited that they are exposed to concentration risks from certain sectors.

The UK Government has indicated that it intends to take a flexible approach, defining only a small number of mandated and prohibited services for ring-fenced banks. This would seem to be the most sensible approach for ensuring that the entities are economically viable.

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11 Pages 20 & 24: http://www.parliament.uk/documents/lords-committees/economic-affairs/reporticb/ResponseICBReport.pdf.

12 See for example pages 20 & 26, Ibid.

Height of the ring-fence

Another related challenge for the UK Government is to determine how high to place the ring-fence. The difficulty is to achieve the right balance between allowing some degree of intra-group connection so groups are able to benefit from economies of scale and the possibility of sharing excess capital and liquidity in times of stress, whilst ensuring that the ring-fenced bank is sufficiently separable and resolvable. In this regard one of the key practical issues that still needs clarification is *what to do with shared infrastructure* such as branches and ATM machines.

A more intangible problem is how to bring about *changes in culture within the governance of the ring-fenced bank.* One of the key conclusions from the crisis is the need to introduce a more prudent management culture, focussed on the identification and careful control of risk. The ICB recommends that as a starting point the board of the ring-fenced bank should have a majority of independent non-executives and that a maximum of one board member from the parent or another entity within group may be allowed to sit on the board of the ring-fenced bank.

On a practical basis, this could present several challenges:

- *Ensuring that non-executive directors are sufficiently well-qualified.* If non-executives are to impose a culture of prudence in the ring-fenced bank they need to be able to effectively carry out their challenge function. This means that they need to have a deep understanding of how the bank works and confidence to challenge its management. There is also a question as to whether there are currently a sufficient number of non-executives well placed to carry out the function.

- *Ensuring that there is congruence between the ring-fenced bank and the rest of the group.* The proposal to limit participation of other group members on the board of the ring-fenced bank is designed to reduce influences from the group, which may be more focussed on maximising returns. However, limiting group involvement also comes with potential costs. It may make the integration of shared group services and policies more complicated. Furthermore, if majority shareholders see that they will be deprived of their ability to control investee banks, this could serve as a barrier to entry for new investors in the UK banking sector.

Loss-Absorbency

Although a number of the ICB's loss absorbency proposals broadly follow the standards set out at an international level, there are some specific elements that are likely to complicate practical implementation:

- *Proposal for a minimum-level of Primary Loss Absorbing Capacity* – unlike the FSB, the ICB proposes that banks should hold a minimum level of capital and primary bail-inable debt. The objective is to avoid incentives for banks to issue secured debt or other forms of debt that would not be affected by bail-in. However, for banks which are primarily deposit-funded, the proposal could have the perverse effect of requiring such banks to increase their financing from wholesale markets so as to meet the minimum requirements.

- *Depositor preference.* The proposal to introduce a depositor preference also raises implementation challenges. On the one hand depositor preference may provide increased reassurance to depositors, reducing the probability of a

sudden loss of liquidity resulting from depositor runs in resolution. However, it also increases monitoring incentives for senior debt classes and this in turn may lead investors in senior debt to look to reduce their potential exposures in a resolution by moving into deposits or secured debt not affected by bail-in. This could have the perverse effect of increasing depositors' potential exposure to losses in resolution, as there could be less of a cushion of senior debt to absorb losses ahead of them. A depositor preference could also reduce depositors' incentives to make prudent choices between financial institutions of varying solvency.

International consistency

As was highlighted at the start of this article, the ring-fence proposal is fundamentally different in approach to international regulatory reform to date. However, ring-fenced and non-ring-fenced entities will continue to operate in a financial sector which is intrinsically international and will continue to be subject to international regulatory agreements. This has the potential to present significant implementation challenges in a number of areas:

— *Bail-in:* Although the proposal for bail-in has been endorsed at an international level by the FSB, many of the technical details have not been finalised (for example on retroactivity, scope of depositor preference). The ICB's proposals are more detailed and include elements such as a minimum quantity of bail-inable debt and retrospective application, which go beyond international standards. This could raise potential funding costs for UK banks, in particular if the UK bail-in regime is either more advanced, more complicated or seen to expose investors to higher risks than the rest of the international sector.

— *Crisis Management:* UK systemically important financial institutions (SIFIs) will be subject to the same crisis management requirements established by the FSB as other global SIFIs. This means that in October 2012 the UK authorities will need to conduct assessments of the resolvability of UK SIFIs and may be required to make recommendations on structural changes to improve their resolvability. This could present potential difficulties given that such changes would also need to be consistent with the direction of the ICB reform.

## 5.2 WILL IT WORK?

The ICB recommendations are a mix of two different solutions to the same problem.

The *proposals for increased loss-absorbency* broadly follow the international approach to regulation taken to date. That approach is to identify risk, measure it and take action to counter it, so that banks better take into account and address the risks of their activities. It is essentially a market-based solution, focussed on the identification of negative externalities and the creation of tailored responses, which maintain the overall efficiency of the system and ensure consistency across the financial sector (both banking and non-banking sectors). In this sense, the ICB recommendations regarding loss-absorbency are *quantitatively* but not substantially qualitatively different from the international approach.

Therefore when evaluating the effectiveness of the loss-absorbency elements of the ICB reforms, the issue that needs to be considered is whether the ICB chose the right level. The key question is whether the benefits associated with an increased capacity to withstand future crises are commensurate to the incremental cost imposed on banks' funding from having to hold additional capital, more longer-term funding and bail-inable debt and the possible loss of competitiveness that this may entail.

The *proposal to establish a ring-fence* is fundamentally a different approach. It is a structural reform, which instead of adapting regulation to emerging risks, attempts to change the system itself to avoid the emergence of risks. It is essentially an interventionist solution based on prohibition rather than the creation of incentives to avoid certain activities. By significantly inhibiting or totally prohibiting certain risky activities in certain organisations, it is possible that such an approach is more effective in limiting any residual risk posed by certain activities. However, it also interferes with the efficiency of the existing system and may disrupt the provision of associated socially useful activities. It is therefore *qualitatively* different from the international approach to regulation to date.

Therefore when evaluating the effectiveness of the ICB's ring-fencing proposals, the relevant question is not whether the ICB chose the right level, but whether the approach itself makes a substantial improvement to addressing the underlying problems given the implementation and operating costs that will be incurred in implementing the reform.

The UK Government believes that the reforms will deliver significant benefits to the UK economy. The Government's analysis assumes that the ICB reforms could reduce the probability of a future crisis by 10% (by moderating financial sector risk and increasing bank resilience) and reduce the GDP cost of a crisis by 25% (by protecting vital banking services and enhancing bank resolution powers). This would yield an incremental economic benefit of £9.5bn[13] p.a., which is roughly five to ten times higher than their estimate of the GDP costs of the ICB's recommendations (see below).

This section now briefly evaluates the likely benefits offered by the two pillars of the ICB reform. It considers the extent to which each approach contributes to addressing the three questions identified at the start of the article:

*How to ensure the banking sector does not contribute to the build-up of unsustainable economic bubbles, which could precipitate a future crisis?*

*Loss-absorbency measures:* Additional capital and leverage ratios proposed by the ICB will help to limit future crises. By requiring ring-fenced banks to hold more capital against their activity, the ICB recommendations act as a counterweight against unsustainable lending. Furthermore, the bail-in proposals increase incentives for banks' creditors (especially in the non-ring-fenced banks) to be more prudent in their approach to management of risk as they will no longer be excluded from the costs of failure.

The point, however, is whether the ICB have balanced the marginal benefit of requiring additional capital to the marginal costs of holding more capital. In particular, it is not clear that retail activity should be penalised through higher capital requirements than non-retail activity. Retail activity, like all banking activity, carries a degree of risk. However, this risk is typically low reflecting the straightforward and transparent nature of the activity and slow deterioration rates of retail bank's balance sheets even in deep and sudden financial crises such as in 2008.

*Ring-fence measures:* The main way in which ring-fence proposals contribute to reducing the probability of a future crisis is by making clearer the separation between ring-fenced and non-ring-fenced banks and therefore further reinforcing the removal of the Government guarantee for those banks outside of the ring-fence. However, on the

13 Chapter 5: http://cdn.hm-treasury.gov.uk/govt_response_to_icb_191211.pdf.

flipside, the recommendations also increase moral hazard within the ring-fenced bank. The concentration of economically critical functions within the ring-fence makes it unthinkable that a ring-fenced bank would be allowed to fail.

Furthermore, whilst ring-fenced banks are limited in some of the risky activities that they can undertake; the ring-fencing solution does little to address the potential for non-ring-fenced banks to continue taking significant risks. In order to maintain the competitiveness of UK wholesale banking the ICB proposals permit non-ring-fenced banks to have lower levels of capital than ring-fenced banks. It is true the creditors of such institutions will be vulnerable to pay the price for excessive risks, but this is a result of the loss-absorbency measures and not the structural reform itself.

*How to avoid the need for future taxpayer support to the banking sector?*

*Loss-absorbency measures:* Loss-absorbency measures proposed by the ICB will reduce the need for taxpayer support to the banking sector. Increased levels of capital and the possibility to bail-in creditors create additional layers, protecting taxpayers from having to take a share in the losses. The size of these additional layers will depend on the scope of the depositor preference chosen by the Government. A wider depositor preference would reduce the liabilities capable of being bailed-in and may create arbitrage incentives for senior debt-holders to move to protected classes.

*Ring-fence measures:* The ICB argue that the ring-fence reduces future taxpayer support by significantly simplifying the disentanglement of vital economic functions from non-vital functions and therefore underlying the ease with which a non-ring-fenced bank would be allowed to fall without taxpayer support.

The potential flaw in the ICB's analysis is to assume that the ring-fenced bank can be fully isolated from the potential failure of a non-ring-fenced bank. Although the ring-fence creates a barrier between ring-fenced and non-ring-fenced banks, both entities share a common link to the real economy. The failure of a non-ring-fenced bank could have an important impact on the real economy, which in turn could affect the ring-fenced banks' assets and costs of financing. Furthermore, both banks will depend on the same capital and debt markets. Any disruption to these markets created by the activity of non-ring-fenced banks would also have a direct impact on ring-fenced banks' funding. Thus by failing to fully rein in the risky activity of non-ring-fenced banks, the ring-fence proposals may do relatively little to reduce the probability of contagion to ring-fenced banks.

Some commentators also argue that the ring-fence will lead to a concentration of particular assets in the ring-fenced bank. This means the ring-fenced bank could be more vulnerable to risks in certain key sectors than might otherwise have been the case if it were able to have a more diversified approach. Furthermore, in the UK certain retail banks proved vulnerable to the crisis as a result of high loan-to-value ratios, poor underlying analysis of credit risks and lending at high income multiples – all of which are not fully addressed by the ICB reforms.

*How to avoid inhibiting banks' vital intermediation role and prolonging the current crisis?*

Aside from the risks that the financial sector can pose to the real economy, banks also have a vital role in providing credit to support growth and the economic recovery. There is significant debate about the extent to which current economic conditions and financial regulation may be impacting on the cost and supply of credit by banks.

The ICB recommendations will impose costs on banks. These costs are likely to be substantial, especially in the short-run and depending on banks' ability to absorb them, could have an additional impact on the price and supply of credit.

The size of any potential impact will depend to a large extent on the timing of implementation. Whilst implementation is officially scheduled for full completion by 2019, the Government has indicated that it will look to implement certain elements more rapidly. Furthermore, market expectations often lead to a more rapid implementation than set out by official timelines.

*Loss-absorbency measures:* The loss absorbency measures are likely to have a very significant ongoing impact on banks' balance sheets through an increase in funding costs. Funding costs could increase as a result of several factors:

— The requirement to hold increased capital of a higher quality;

— The requirement to hold larger proportions of more expensive, long-term financing to satisfy minimum loss-absorbency requirements;

— The loss of the Government guarantee, which is likely to be most significant for non-ring-fenced banks.

More indirectly, increased loss absorbency measures may also have a detrimental impact on the international competitiveness of UK banks. This could have a long-term impact on UK banks' profitability and therefore lending.

*Ring-fence measures:* The costs of ring-fencing measures are likely to be most pronounced in the short-run. They will include:

— *Implementation costs* associated with moving to new structures (for example, the possible need to create a new wholesale entity or establish separate arrangements for the use of branches and ATMs),

— *Legal costs* (for example, associated with the rewriting of contracts, counterparty documentation)

— *Tax costs and possible pensions implications.*

There may also be additional effects on lending – as highlighted earlier – if the balance sheets of ring-fenced and non-ring-fenced banks cannot be easily matched.

Overall, the ICB estimate that the annual pre-tax costs to UK banks of the reforms could be between £4bn and £7bn. The UK Government believes that the range may be slightly larger at between £3.5bn and £8bn. Industry estimates are even higher. Based on its own calculations, the UK Government estimates that the additional bank costs would translate into a gross reduction in GDP or around £0.8 to £1.8bn p.a. in the long-term.

Ultimately the overall costs of the reform are extremely uncertain and will likely be significantly higher in the short-run. Much will depend on how the Government resolves some of the implementation challenges set out earlier in the article, as yet unknown market conditions in the future and the extent to which the reforms have a longer term impact on UK banks' competitiveness.

## 6 Conclusion

The UK financial sector has been both a major source of growth, employment and fiscal revenue as well as a significant risk factor to the UK economy.

The ICB recommendations are an attempt to address the financial sector's role in the origins of the crisis and to reduce the need for taxpayer involvement in future crises, while at the same time maintaining the UK's position as a leading financial centre.

This article has argued that the ICB recommendations are a combination of two different routes to tackling the same problem. The loss-absorbency measures are an extension of the international regulatory reform undertaken to date – they are quantitatively but not significantly qualitatively different. By contrast, the ring fencing proposal is fundamentally a different route, based not on adjusting regulation to the existing system but in attempting to reform the structure of the system itself.

Attempting to implement these two distinct approaches at the same time, as well as navigating amongst various other regulatory reform developments and a still fragile economy, is likely to prove a challenging task for UK authorities and the financial sector itself. There are important practical decisions to be made that will have an impact on the likely cost.

The additional loss-absorbency measures should help to reduce the likelihood of future crises and reduce the probability of future taxpayer support. However, these measures will have a significant impact on banks' funding costs and spillover effects for short-term lending cannot be ruled out. Furthermore, requiring retail banks to hold more capital does not reflect the low risk posed by retail activity and as a result harms the efficiency of retail banks.

This article has also questioned whether the marginal benefits from the artificial separation of retail and wholesale activities are commensurate with the likely additional costs. The approach is based on the assumption that ring-fenced banks can be isolated from potential contagion risks posed by wholesale banking. However, this fails to recognise that both banks are linked via the shared economy and therefore it will never be fully possible to eliminate contagion risks.