12 September 2011

Alert

International Financial Regulation

UK Independent Commission on Banking - Final Report

Not good news but could be worse....

By Elaine O'Donnell

Early this morning, the UK's Independent Commission on Banking ("ICB"), chaired by Sir John Vickers, issued its final report on the reform of British banking. The ICB largely reiterated the measures first outlined in its interim report in April and summarized in a previous Alert. Whilst banks may not be initially rushing to relocate overseas, there is no doubt implementation of the ICB's conclusions will be expensive (estimated at around £6 billion annually). The ICB believes that incremental benefits will exceed costs by "a very large margin," a view perhaps not widely held as London's FTSE 100 reportedly fell by over 2.3% in early trading following the report's release, with bank shares the biggest fallers.

The ICB's challenge was twofold. As well as creating a more stable and competitive basis for UK banking, it was also tasked with ensuring an "effective and efficient" banking service to safeguard retail deposits. The report notes the global events and goals to which the UK is subject and recognizes that part of the challenge is reconciling the UK's position as an international financial centre with stable banking in the UK. It remains to be seen whether the report will lead to enhancement or divestment of the UK's reputation as a pre-eminent financial centre.

Financial Stability

The report proposes a combination of measures requiring structural reform and greater capital/other loss-absorbing capacity. The ICB intends risks associated with banking should not be carried by UK taxpayers, who do not have the practical ability or incentive to monitor or bear those risks.

Structural Reform

In a move reportedly supported by the majority of the British public the ICB has, as foreshadowed in its interim report in April, proposed "retail ring-fencing" under which retail banking operations would be carried out by a separate subsidiary within a wider group. Banks would no longer be able to combine domestic retail services with global wholesale and investment banking operations. The UK retail subsidiary must be legally, economically and operationally separate from the rest of the banking group. This final proposal is less radical than the complete break-up of the banks initially feared when the report was commissioned last year, but, as mentioned above, will still involve considerable cost to British banks.

The ICB maintains that there are important differences between the ring-fence and complete separation which should mean significantly lower economic cost to the industry. For example, capital could be injected into the retail subsidiary from the wider group if necessary; agency arrangements within the group could provide "one-stop" services to customers for both retail and investment banking; and expertise, information, operational infrastructure and branding could be shared across the group.

Separation is intended to:

- allow better-targeted policies for banks in difficulty, making it easier, for example for creditors to bear losses instead of taxpayers;

- insulate retail banking from any tumult from global investment banking shocks; and

- safeguard the future of British banking and the status of the City of London as a premier financial services centre by, for example, allowing UK retail banking to have safer capital safeguards.

Importantly, an element of flexibility has been introduced in relation to determining those operations that may be within the ring-fence. Deposit taking and provision of overdrafts to individuals and small and medium-sized enterprises ("SMEs") fall within the ring-fence. Other activities such as taking deposits from customers other than individuals and SMEs and lending to large companies outside the financial sector are permitted (but not required) within the ring-fence. Whilst a large raft of services, which are considered not to be integral to activities within the ring-fence and may increase the banks exposure to global financial markets or threaten its resolution, are not permitted, such as services to non-EEA customers, or which relate to secondary markets activity and derivatives trading.

Greater capital and loss-absorption capacity

In relation to making banks better able to absorb losses, the ICB advocates that internationally systemically important banks, and large UK retail banks, be required to:

- hold equity of at least 10%. This exceeds international recommendations. International standards can still apply to UK banks outside their UK retail subsidiaries provided that they have "credible resolution plans" together with genuinely loss-absorbent debt; and

- have a primary loss-absorbing capacity of at least 17-20%. As well as equity and other capital, this capacity can include long term unsecured debt that regulators could require to bear losses, 'bail-in bonds' and contingent capital 'cocos'.

The ICB also recommends depositor preference for deposits insured by the Financial Services Compensation Scheme which would rank higher than other unsecured debt on insolvency, again protecting the UK taxpayer.

Competition

In relation to making UK banks more competitive, the report suggests a few measures to improve competition: enhancing divestitures required of Lloyds by the European Commission to ensure the emergence of a "strong challenger bank"; helping customers switch accounts more easily; and the Financial Conduct Authority having a duty to promote competition. If one or more of these measures is not achieved by 2015, the report recommends a market investigation reference to the Competition Commission be considered if the OFT has not already made one, following its proposed review next year of the personal current account market.

What next?

The ICB advocates implementation as soon as possible with a long-stop date of 2019. A long implementation period is hoped will minimize any transition risks and take into account the current economic situation. The report strikes a remarkably similar note to that reported in the market last week in anticipation of its publication, noting that "Postponement of reform would be a mistake, as would failure to provide certainty about its path". The UK chancellor, George Osborne welcomed the report and agreed that the government should legislate "in this parliament ... and then it will take some time for the full rules to come in." It is not yet known whether reforms will be introduced into the current Financial Services Bill.

We will continue to update you on the status of the proposed changes to regulation of the UK's banks, and the likely impact on the UK's financial services sector, over the coming months.