The voice of banking
& financial services

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Dear Sir John

Interim report: consultation on reform options

The BBA welcomes the opportunity to provide comments on the recommendations made in the interim report issued by the Independent Commission on Banking. As explained in response to the preceding issues paper, we see it as essential that the Commission positions its recommendation firmly within the comprehensive series of banking reform measures currently being pursued under the aegis of G20 governments and the international regulatory community.

We are in agreement that the reform programme needs a dual focus of reducing the probability of failure of systemically important banks by improving their resilience and reducing the impact of failure by providing for orderly resolution and strengthening the financial system as a whole. We also agree that we should continue to work towards further improvements in the loss absorbency of banks and that the objective in this regard should be to ensure that 'bail-in' should be available as part of a resolution process in preference to 'bail-out' by government and the taxpayer. This is part of an international programme of work which is coming to its conclusion. We are therefore pleased to see the Commission acknowledge this.

Further work is needed by the international standard setters to agree the remaining requirements around recovery and resolution plans and those aimed at increasing loss absorbency. Therefore, in concluding its report, it is essential that the Commission puts its weight behind achieving the right outcome for the key measures under discussion by embedding its final recommendations more firmly within these fundamental proposals set in train in the G20, with thought leadership from the UK. Further, as the UK is an international and open market with many non-UK players, ensuring that the final recommendations recognise both that internationality and the role of the many other policy makers would add to the prospect of the right outcomes being achieved.

We were pleased to see that the Commission recognised that any proposals must also be mindful of the impact on the ability of banks to lend to households and businesses in support of economic recovery, on international competitiveness and on the Government's fiscal position. As can be seen from overseas as well as here in the UK, a strong and competitive banking industry is a prerequisite to achieving economic growth and we need to make sure that all

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measures introduced in order to achieve financial stability are consistent not only with good risk management, but with ensuring that the capacity to lend is maintained at a level compatible with a return to economic well-being.

There is widespread concern across much more than just the financial service industry at the lack of sufficient analysis of the possible outcomes of the many proposals for change already underway or shortly to be agreed. The nature of and consequence of the international programme of change is huge and will inevitably have an impact on the ability of banks to perform their essential functions of supplying credit to the market. It is therefore vital that before coming to its final recommendations the Commission undertakes a full analysis to determine the impact of its proposals on different banking models, on the economy and on the ability of business of all sizes to access the finance they need. Further, as the Commission's interim proposals for ring fencing do not accord with the considered views of other countries, analysis is also required to demonstrate the effect of such a proposal on financial stability under different economic scenarios, and the consequences for the internationality of the UK as a financial centre should such a proposal proceed.

Turning to the report's principal recommendations:

- **Increasing the capital of major banks**

As the Commission is aware, we will see in the next few weeks the publication of a consultation paper by the Financial Stability Board (FSB) on the question of surcharges for global systemically important banks (G-SIBs). If international agreement is reached on this, then we believe the UK should align itself with the global regime that results. This is likely to recommend a surcharge of up to 2.5% for the largest G-SIBs as matters stand and to include provision for the possible addition of a further 1% charge. It needs further to be borne in mind that individual banks will in all cases be keen to manage their capital levels some way above the minimum; we therefore do not see a case for the Commission recommending a divergence from the internationally agreed levels. Should it do so then this would in effect mean that the UK would not be willing to stand by the more comprehensive impact analysis being undertaken by the FSB and the Basel Committee and would weaken the UK's advocacy for seeking agreement on banking reform on a global basis.

- **Retail Ring Fencing**

We are supportive of the objectives to improve the resolution of universal banks, to improve their resilience and to curtailing the implicit government guarantee by ensuring 'bail-in' rather than 'bail-out'. But we are concerned about the level of prescription proposed by the Commission for its ring fence. The balance sheet and business model of some financial institutions may be better suited to a retail ring-fence than others. We are not therefore opposed to the concept as a matter of principle, but see practical difficulties which would need to be resolved and believe that the Commission should be open to other mechanisms for delivering the objectives set for the retail ring fence.

- **Competition in the retail market**

We do not agree that international comparison shows the UK banking market to be unduly concentrated, and view it as competitive, but accept that more can be done in respect of specific initiatives identified in the interim report. We are heavily engaged in a wide ranging programme of improvements including a platform to enable more efficient account switching from one bank to another and better clarity and transparency of the products and services offered.

Key aspects of the Commission's eventual recommendations are likely to overlap, contradict or provide additions to the international regulatory reform programme. When the Government comes to consider the final recommendations, it will need to:

a) Take that international programme into account;
b) Consider the economic and other considerations;
c) Think through timing and implementation issues carefully, not least as the Commission and the international programme are not running to the same timetable;
d) Determine the further coordinating work to be undertaken by the Treasury, in consultation with the Bank of England and the FSA; and
e) Assess the additional stability proposals in light of the macro-prudential work and the responsibilities of the interim Financial Policy Committee.

The banking industry as always stands ready to engage and assist with this work.

We have copied this letter to HM Treasury and the Treasury Select Committee and would be happy to meet with you or your team to discuss the points raised and the way forward.

Yours sincerely

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Independent Commission on Banking interim report: consultation on reform options

- Comments by the British Bankers' Association -

Introduction & Executive Summary

The BBA welcomes the opportunity to provide industry-wide comments on the reform options set out in the Commission's interim report. This submission:

- Sets out our broad support for the Commission's analysis of the overall objectives for the reform of the banking and financial system, with measures needed on both resilience and resolution, and the need for this to be balanced with the ability of banks to lend to households and businesses in support of economic recovery. International competitiveness and the government's fiscal position also need to be borne in mind.

- Counters the suggestion that the UK banking market is unduly concentrated and that this has a bearing on competition since this is not supported by a comparative analysis of the bank market place in economies equivalent to the UK. The analysis confirms that concentration is not a proxy indicator of propensity to banking crises.

- Supports the Commission aiming to place its recommendations into the context of the broader regulatory reform programme being developed internationally and implemented in the UK and provides further information on aspects of this which may be of interest to the Commission.

- Explains the reasons why we believe the capital recommendations of the Commission should be progressed in a manner consistent with the outcome of the Financial Stability Board's (FSB) forthcoming consultation on global systemically important banks (G-SIBs), in particular the need for a graduated approach enabling allowance to be made for the assurance that can be placed on recovery and resolution plans.

- Supports the Commission's recommendation that bank debt should be made more loss-absorbing using some or all of contingent capital, bail-in debt and depositor preference and provides further information on the dialogue within the UK banking industry in this regard.

- Sets out our support for the Commission's overarching objectives of: improving the resilience of universal banks, their orderly resolution, and curtailing the implicit government guarantee by ensuring 'bail-in' in preference to government injecting funds into failing institutions.

- Notwithstanding our support for the Commission's objectives for resilience, resolution and the removal of the implicit guarantee, explains the reasons why we believe an overly prescriptive approach, such as a structural ring fence, may impede the normal operation of a universal bank and its compliance with measures aimed at strengthening its resilience. We urge the Commission to focus on setting out more fully its objectives; this would allow banks and their supervisors to agree responses that are appropriate to the balance sheets and business models of individual banks and could contribute to the development of recovery and resolution plans tailored for each bank which could be effectively and efficiently implemented.

- Explains potential challenges that would arise from placing retail activity in a separate legal entity including compliance with new funding obligations under Basel III, the question of whether group treasury should be within or outside the ring-fence, the treatment of hedges and general considerations relating to pension obligations and potential VAT consequences.

- Identifies other ways for meeting the objectives, including the tailoring of recovery and resolution plans, the international adoption of the Basel III capital reforms, including counter-cyclical elements, the completion of measures contributing to depositor protection and the use of the business model to provide a separation between retail/commercial and investment banking or trading activity.

- Explains initiatives underway within the industry to enhance significantly the accounts switching process and improve price transparency.

- Underlines the need for a proper cost/benefit analysis to be undertaken before determining precisely how to proceed and the need for this to consider not only the nature of the reforms but issues concerning transition and timing. This needs to take into account the broader economic environment and the effect that any additional measures may have on banks' capacity to lend to households and business particularly as we emerge from recession and demand grows.

Chapter 2: The need for reform in the UK banking sector

Chapter 2 outlines the role of the financial system and the sources of financial instability before looking at the recent crisis from a UK perspective and measures aimed at making the banking system safer. It then turns to competition issues before setting out the Commission's analytical framework. It asks respondents to comment specifically on whether they agree with the analysis set out in the chapter and the analytical framework adopted by the Commission.

2.1 Do you agree with the analysis set out in this chapter?

The analysis provides the springboard from which the Commission proceeds to make its recommendations. We would agree with the observations concerning the purpose of the financial system and the sources of instability in banking. As the report identifies, the Basel III reforms aim to make the capital structure of banks less brittle and further work is in progress, both in terms of SIFIs and in terms of making banks' liability structures more loss absorbing. These are important aspects of the regulatory reform programme and are explored in our comments on the third chapter of the report.

We also agree with the analysis that in addition to banks becoming better able to withstand losses, we need to ensure that bank failure can be orderly so as to minimise the cost to others and avoid the need for government to inject funds into failing institutions. We agree entirely with the assessment that reforms are needed that:

- Reduce the probability of failure of systemically important banks by improving their resilience; and

- Reduce the impact of failure of systemically important banks, both by providing for the orderly resolution of any institutions that fail, and by reducing the levels of risk in the financial system as a whole.

These complementary objectives have underpinned much of the work undertaken on the reform programme since the crisis broke and continue to provide an appropriate direction for the various overlapping initiatives underway.

The analysis further identifies ways in which a bank failure may have a negative impact on the financial system and the wider economy as including:

- disruption to the payments system;
- depositors being unable to access funds;
- poorer availability and/or the pricing of credit;
- disruption to a client's ability to access assets placed within a failed bank, and to the provision of investment banking trading and advisory services; and
- contagion to other financial institutions and to the wholesale funding markets, both through direct exposure to the failed firm and through a generalised collapse in confidence in financial institutions.

These potential consequences of failure also feature within the objectives for the reform programme and some are relevant to the Commission's proposal for a retail ring-fence, which we discuss later. As the analysis identifies, the migration of activities between banks and non-banks can also have a bearing on financial stability and, as recognised when it met on an interim basis for the first time last month, this is a real risk and will be a factor to be monitored closely by the Financial Policy Committee of the Bank of England (FPC). As the FPC's first recommendations show, its establishment will provide the Bank with a sharp focus on financial stability and the FPC will have at its disposal a significant set of regulatory policy tools.

It is difficult to see from the analysis whether the Commission accepts that the financial crisis resulted not only from failures in bank judgement and risk management, and shortcomings in both the regulatory framework and conduct of banking supervision, but also from broader fiscal and monetary policies. Imbalances in the broader economic environment clearly had a part to play and as the relevant authorities struggle to contain the sovereign debt position within certain euro-zone countries it is clear that financial stability can no longer be seen as a metric dependent purely upon bank behaviour and the height of the regulatory wall. It is important that we fully appreciate this if we are to ensure that the new approach to financial regulation planned for the UK is underpinned by the right statutory objectives, responsibilities and accountability mechanisms. Many of these issues were explored by the BBA in its response to the second Treasury paper on the new financial structure[1]

Chapter 2 next turns to competition and makes the point that the UK appears to be similar to many other developed countries in having a concentrated retail banking market. It names the Netherlands, Sweden, Australia and Canada and we would add France and Germany to this list. By one measure of the Herfindahl-Hirschman Index the UK can be said to be less concentrated than the vast majority of other European Union member states[2]. The index shows that the top five banks in the UK account for 40.8% of total assets in comparison to a European

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[1] BBA response to the Treasury consultation 'A new approach to financial regulation: building a stronger system' April 2011.

[2] 'EU Banking Structures, European Central Bank', European Central Bank, September 2010; Table 3, Herfindahl-Hirschman Index (HHI) for credit institutions and share of total assets of the five largest credit institutions, page 36.

Union average of 44.3% and according to this the UK banking market is 23rd on the list of concentration of the 27 Member States. It should also be noted that in any case concentration is not a reliable proxy measure for potential financial system instability – the Canadian experience of the financial crisis was quite different from the UK experience.

We also explained that the position also looks different if you base the comparison – as the IMF had chosen to do in its November 2010 report on the impact of regulatory reforms on large and complex financial institutions[3] – on the number of banks owning 65% of banking assets. By this measure the UK is less concentrated than France, where three banks account for 65% of banking assets. The measure is also interesting in that it shows a considerable increase in concentration in the German market, where the number of banks accounting for 65% of banking assets reduced from nine in 2001 to five in 2008.

We also drew to the attention of the Commission the view strongly held by the European Central Bank that universal banks are better placed than less diversified banks to maintain the supply of credit during systemic banking crises and that they provide a stabilising factor during financial turmoil[4]. This is also highly relevant to the Commission's analysis. Universal banks and those which provide a full range of 'through the cycle' relationship-based services are also ideally placed to provide the full range of support to exporters, which include a growing number of SMEs, and therefore have a vital contribution to make to the economic recovery.

We view the UK retail banking market as competitive in comparison to its overseas equivalents and see the divestments on the part of RBS and LBG, and the sale of Northern Rock, as providing significant market-changing opportunities. We also accept that accounting switching and transparency have a valuable contribution to make and have said more on this in response to chapter 5.

2.2 Do you agree with the analytical framework?

Paragraph 2.91 onwards explains that the analytical framework which the Commission has adopted is one in which it aims to promote:

- financial stability; and
- competition in banking (including consumer choice)

While also considering:

- lending and the pace of economic recovery;
- the competitiveness of UK financial services and the wider economy; and
- risk to the Government's fiscal position.

It also explains that the Commission's recommendations aim to:

1) reduce the probability and impact of systemic financial crises in the future;
2) maintain the efficient flow of credit to the real economy and the ability of households and businesses to manage their risks and financial needs over time; and

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[3] IMF Staff Position Note 'Impact of Regulatory Reforms on Large and Complex Financial Institutions', 3 November 2010, Figure 2.
[4] 'EU Banking Structures, European Central Bank', European Central Bank, September 2010; section 2.1.1 on diversified versus specialised business models.

3) preserve the functioning of the payments system and guaranteed capital certainty and liquidity for small savers including SMEs.

It is then explained that the Commission is seeking to achieve these aims in the context of the wider regulatory reform agenda both in the UK and abroad by:

a) curbing incentives for excessive risk taking by neutralising subsidies and the unpriced risk of triggering financial crises, and by enabling the market to function more effectively;
b) reducing the costs of systemic financial crises through increased resilience of institutions and the financial system as a whole, and through improved resolvability of institutions;
c) promoting effective competition in the provision of banking services in the UK;
d) having regard any impact on GDP through the cycle, any fiscal implications, and the competitiveness of the UK and professional service sectors and the wider UK economy; and
e) having regard to the possible impact of recommendations on non-bank parts of the financial system, and to the effects of wider regulatory reforms in the financial sector.

We support this analytical framework and believe that in the main part it provides an appropriate focus for the Commission's work against an appropriate set of criteria against which to measure its recommendations. It provides a useful reminder that the banking industry is an essential component of economic recovery and that we must take care to calibrate any additional regulatory requirements according to the effect that they will have on banks' ability to lend to households and businesses particularly as we emerge from the economic downturn. It also reminds us of the contribution that financial services, whether in terms of domestic banking or the international business hosted here, make to the UK's economic activity, export earnings and exchequer revenues. This contribution is highly significant and financial services – and the professional services which support them – are therefore an industry which the authorities should be seeking to foster and not drive overseas.

Chapter 3: Current reform initiatives

Chapter 3 acknowledges the considerable progress made since the crisis in enhancing the regulation of banks and that some important reform initiatives remain under development, including: the development and use of macro-prudential monitoring and supervision; increased capital under Basel III, tougher requirements in Switzerland and the FSB's review of global SIFIs; recovery and resolution plans including an FSA consultation paper due Q3 2011; work by the Bank and FSA on liquidity; the international task force on shadow banking due to report to the FSB; work on market infrastructure, including central clearing; the reform of the UK's regulatory regime to move to a more intrusive and judgement-focused regulatory approach; recent work by the competition authorities on transparency and improvements to the account switching process; and planned divestments.

3.1 Are there other reform initiatives, beyond those set out in this chapter and annex 5, which you consider it essential for the Commission to examine further?

The Commission identifies a broad range of reform measures and acknowledges that considerable progress has been made since the crisis in enhancing the regulation of banks and that a number of important reform initiatives continue to be developed. It makes the point – and we would support this - that the Commission's remit is broadly aligned with these initiatives including work by the Basel Committee on Banking Supervision and the FSB on capital requirements for SIFIs (G-SIBs in the first instance) and improving their resolvability and the European Commission's proposals for a framework for bank recovery and resolution.

Chapter 3 comments briefly on key financial stability initiatives. We have commented specifically on these below and have additionally included as appendix 1 a brief outline illustrating the broad nature of the reform programme:

- ***Macro-prudential regulation***: as the report observes, the FPC has now been established (on an interim basis) and will have a broad range of tools at its disposal to reduce systemic risk and inform micro-prudential supervision. This is a major development in itself and the BBA has previously undertaken research drawing together information on the exercise of such tools in other parts of the world, notably the Far East, based on the experience of member banks[5]. We have also updated members on the advent of the Financial Policy Committee and its interrelationship with the European Financial Stability Board (ESRB) and have attached this as appendix 2 in case of interest to the Commission.

- ***Capital***: international agreement on the Basel III capital accord is close to be made a statutory requirement in the European Union in the form of the Capital Requirements Directive IV. It requires Core Tier 1 capital to be raised to 7%; the standard set by Basel II was 2% common equity supplemented by other capital which when under stress provided only partial loss absorbance. As part of this, risk weights applied to instruments within the trading book have increased substantially. It is accepted in Europe, but not necessarily in the United States, that there should be an additional countercyclical capital buffer up to 2.5% at the top of the cycle; discussion is advanced on a potential G-SIB surcharge of up to 2.5%, with provision for the possible addition of a further 1% charge. Discussions are also taking place on the loss absorbency of debt. UK banks have also been subjected to rigorous stress testing and the FPC has announced the improved disclosure of sovereign and banking sector exposures in support of this. We would add that simply piling requirements one on top of another does not reduce risk or increase loss absorbency on a going concern basis if banks are not allowed to 'draw down' against these capital holdings in times of stress. It is important therefore that we continue to bear in mind why we are increasing capital limits overall and adding different component parts.

- ***Resolution***: the Banking Act 2009 put in place the special resolution regime (SRR) to provide the authorities with a legal framework and range of tools to resolve a failing institution in a manner which minimises the impact on financial stability, protects depositors and protects public funds; attention has since turned to individual institutions preparing recovery and resolution plans and the FSA is expected shortly to publish a consultation paper on these.

- ***Liquidity:*** the need for higher liquidity requirements was a key learning point of the crisis and the volume of instruments held for liquidity purposes has increased at least fivefold. This will be formalised in a new Liquidity Coverage Ratio to apply from 1 January 2015.

- ***Market infrastructure:*** changes are being made to require OTC derivatives to be cleared through central counterparties supported by higher collateral arrangements in effect building stronger firewalls into the financial system; payment and settlement systems overall are also to be more closely supervised.

[5] BBA paper 'A Possible Macro-prudential Approach' September 2010.

- ***Reform of regulatory institutions****:* reforms have been, or are being made, to strengthen the institutional framework of financial regulation at an international, European and national level. As the Commission is no doubt aware, the latest step in this was last month's publication of a white paper by HM Treasury 'A new approach to financial regulation: the blueprint for reform'. This involves a further landmark change in the regulation of financial service companies operating in the UK and will build on the earlier adoption of a process of enhanced supervision.

The remainder of the chapter briefly summarises initiatives relevant to competition in the UK market.

The Commission clearly has a good appreciation of the breath of measures that have either been introduced or are in the process of development, including those which fall within the remit of the interim FPC. We are not aware of there being further measures which the Commission needs to examine and would instead suggest that priority should be given to completing the measures in hand. Progress on many of the individual areas of reform has involved a need to overcome considerable statutory, regulatory and other technical barriers and the need as we see it is for these changes to be embedded. Improvements have also been seen in governance and risk management in individual institutions, and improvements in banking supervision, which provide stronger foundations in the first place.

It is also the case that the UK is at the forefront of the development and implementation of the international reform programme and careful consideration needs to be given to the consequences of adding to this already substantial set of requirements. It is however understood as appropriate for the Commission to put its weight behind a call for developments in train to be brought to a satisfactory conclusion.

Chapter 4: Reform options – financial stability

Chapter 4 examines ways to reduce the probability and impact of bank failures by increasing the loss-absorbing capacity of banks and by structural reform to create some degree of separation between retail banking and wholesale and investment banking, both aimed at reducing banks' contribution to systemic risk. The Commission currently sees a combination of approaches as the best way forward incorporating:

- Internal ring-fencing within universal banks to isolate UK retail banking services; and
- Higher 'but not very high' capital requirements, together with measures to make bank debt effectively loss-absorbing.

It asks specific questions relating to individual aspects of the Commission's thinking and concludes by asking whether respondents agree with the Commission's intention to consider a package of measures and whether some elements could be relaxed if others were strengthened and also for views on the timeframe over which any reforms should be implemented.

The report explains that the Commission believes that:

- SIFIs should hold equity of at least 10% supplemented by genuinely loss absorbing debt – which it sees as striking the right balance between increasing the cost of lending and reducing the frequency and/or impact of financial crises - but that it sees this as a matter for international agreement *providing* relevant UK banks have credible recovery and resolution plans.

- UK retail activity should be supported by a minimum 10% core Tier 1 holding as a matter of UK government policy predicated on a bail-in regime for debt.

- Pre-resolution ‘contingent capital’ and subordinated debt which absorb losses at the point of non-viability bring the prospect of being able to contribute to improved loss-absorbency and should be supported by the claims of ordinary depositors being ranked above other unsecured creditors.

4.1 Should systemically important banks be required to hold more equity than Basel III requirements? If so, how much?

As the Commission appreciates, the FSB is at an advanced stage in its deliberations concerning SIFIs and is expected to publish its conclusions later this month on the amount of the surcharge and the methodology for defining a SIFI. This will clearly be an important paper. In determining its precise recommendations we would expect the FSB to take into account the interrelationship between the capital regime and other measures that can be taken to strengthen reliance and resolution. This will involve a thorough analysis of the position of key individual firms and we believe the UK authorities should be fully guided by this.

4.2 Should UK retail banks be required to hold more equity than Basel III requirements? If so, how much?

While there will need to be a further period of consultation and consideration, it is clear that the UK should be bound by the capital surcharge which the Basel Committee ultimately decides to recommend but only from the point at which Europe makes this a statutory requirement. This leaves the question of whether it is right that the UK should act to make retail activity subject to a higher capital charge irrespective of the outcome of discussions around the Basel and European table. This is more difficult since the arguments for following international standards apply equally in respect of retail activity as they do for any other banking activity.

We are not in favour of the UK hard-coding any limits above the Basel limits and believe that this is in any case unnecessary. The dynamic of the market is such that banks will inevitably – other than at times of stress when drawdown is utilised – build capital reserves to a level above the regulatory minimum to ensure that they do not need to draw down on their buffer. The Pillar 2 process will also be used by supervisors to set capital levels above the minimum. There is broad acceptance that banks’ management will exercise discretion about the amount of capital retained which is above regulatory minimums; a backstop for this management discretions is, of course, supervisory judgement. What we would not wish to see would be a specific UK minimum that would set a regulatory minimum benchmark at an even higher level than internationally agreed.

We do not see any analysis within the report to underpin such a recommendation. We do however note that some external analysts have commented extensively on the various behavioural and other consequences of such a proposal. These include an increase in the cost of finance to the consumer and the issues that arise should the retail bank require wholesale funding or where the retail bank has a surplus of deposits when demand for borrowing is low.

The requirement for increased capital is very significant indeed. Should investors not be forthcoming, then the higher capital ratios can only be met by de-leveraging. This is contrary to the express desire of all to finance economic recovery.

4.3 Do you agree that bank debt should be made more loss-absorbing using some or all of contingent capital, bail-inable debt and/or depositor preference? If so, which of these tools do you support and how should they be designed?

As the report observes, greater use of pre-resolution 'contingent capital' and the introduction of point of non-viability 'bail-in' debt are seen as potentially providing the means by which banks could increase their loss absorbing capacity and thereby make the potential need to call upon the taxpayer in the event of failure highly remote.

Contingent capital is a going concern recovery tool which acts to either enhance an institution's capital position or absorb losses when a predetermined trigger has been met; it thus contributes to reducing the probability of bank failure. It can take several forms and discussions are taking place with institutional investors and other market participants to understand preferences on the demand side. We should add that while contingent capital, for instance, may have a valuable role to play in the overall capital structure, it would be unhelpful for the Commission to be too prescriptive on this as the dialogue is on-going in this area and market forces and other influences will need to be considered.

Basel III, once implemented, will require all subordinated debt to absorb losses at the point of non-viability, enhancing loss absorbency. To us bail-in should be seen as a statutory power for a competent authority to either convert or write down an entity's liabilities following its entry to resolution to avoid rapid loss of value, provide time to allow for orderly resolution and prevent systemic contagion, ultimately protecting the taxpayer[6]. Given its implications, it should be the subject of a secondary trigger process, following the institution's entry to resolution.

It should be noted that the UK already has the powers to require 'bail-in' on the part of senior creditors as part of the special resolution regime introduced under the Banking Act 2009; discussions are advancing in the European Union on this being replicated across the EU which this may require some refinements to the UK regime. The FSB is also expected to publish recommendations later in the month.

4.4 In relation to structural reforms to promote stability, do you agree that the Commission should focus its work on a UK retail ring-fence?

The interim report proposes the isolation of UK retail banking activities within a universal bank and placing them into a separately capitalised subsidiary. This would enable additional restrictions to be placed on the subsidiary as appropriate including limitations on its financial links to the rest of the group. The Commission sees the retail ring-fence as helping to tackle three key problems:

- Making it easier and less costly to sort out universal banks that get into trouble by improving the separability of retail and wholesale/investment banking.

- Making the UK system better able to absorb shocks by ensuring minimum levels of capital for retail services in times of stress while preserving the ability of different parts of the universal bank to support each other in less stressed times.

[6] The European Commission is considering the development of a new EU framework for bank recovery and resolution. The BBA response 3 March 2011 comments upon this in full. We discuss our thoughts on bail-in further in appendix 3 and provide a glossary of commonly used terms in this area in appendix 4.

- Curtailing perceived government guarantees by making it clearer to shareholders, management and creditors that they will not be bailed out by the taxpayer.

Looked at through the perspective of these three objectives, we would say that there is a high degree of commonality between the rationale behind the UK retail ring-fence proposal and key measures either being put in place or under serious discussion:

- The major UK banks are at an advanced stage in developing their recovery and resolution plans and the FSA will be publishing a consultation paper on their general applicability based on this pilot project shortly. The exercise has a dual focus in which attention is given to a) putting in place contingency arrangements aimed at providing a plan by which banks in financial difficulty could recover on a going concern basis and b) organising the group in such a way as to support an orderly resolution at the point of non-viability, including the ability to hive off the retail part of the business together with key infrastructure needed to ensure a continuation of service.

- The various changes to the capital (and liquidity) regimes are designed to place banks on a surer footing and to reduce their exposure to risk through a) increasing the quantum and quality of capital held, b) putting more sustainable limits on the assets-to-equity ratio c) ensuring a more appropriate liquidity resource and d) ensuring a more stable funding structure.

- The banking reform programme is being undertaken on a basis to address the 'too big to fail' position and the discussion on contingent capital and bail-in debt is specifically about ensuring that subordinated debt can be called upon to contribute to the recovery or resolution of a bank. The implication of this is understood in the market and as the measures are put in place it is expected that the implicit guarantee will fall away. It is evidence of the market's understanding that the legal structure is in place in the UK for subordinated debt that rating agencies have already announced that they will need to factor this in as part of their review process[7].

- Substantial measures have already been introduced to strengthen deposit protection. In addition to deposit insurance limits rising from 90% coverage of £33,000 to 100% of £85,000 under the FSCS scheme funded by financial institutions, UK banks lead the field in the establishment of a 'single customer view' designed to facilitate the continuity of essential banking services in the event of failure and 7 day payout as a backstop. The development of proposals for 'bail-in' debt will further protect depositors as this will in effect provide preference over debt holders.

We would question the need for compelling the introduction of a retail ring-fence based on a separate legal structure and we believe that the Commission's objectives can be met without requiring this:

- A key aspect of recovery and resolution plans is that they should enable a bank to separate the retail part of the business from wholesale/investment activity and the infrastructure needed in support. The major UK banks have invested considerable time and resource in order to achieve this and have completed their single customer view exercises. It seems reasonable to suggest that a bank may be able to present a well-working RRP without resort to a legal entity ring-fence.

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[7] See for instance 'UK lenders face rating downgrades', Financial Times, 24 May 2011.

- Capital requirements are based on individual asset classes and the Basel Committee is undertaking further work on the trading book. It is also intended that the interim FPC should be able to build up the counter-cyclical provision. It is clear therefore that the ring-fencing of a particular level of capital in support of retail activity is not dependent upon there being a separate legal entity.

- There is a growing understanding within the market of the expectation that subordinated debt will shoulder the cost of failure in place of the taxpayer. The UK has already put in place the legal powers for this though there may be a need for some technical amendment to clarify that depositors will be given creditor preference in the event of a bail-in being triggered as part of a resolution. This is an issue which we have given specific consideration to in discussion with members and we believe that a more telling measure than the legal separation of retail activity would be the provision of clear creditor preference to all deposits at this stage.

This is not to say that a retail ring-fence will not suit the balance sheet and business model of some financial institutions. The question, however, is whether it is necessary to compel this approach.

4.5 What are the costs and/or benefits of a UK retail ring-fence, and what approaches could be taken to analysing them (noting Annex 3)?

The cost-benefit analysis is struck in fairly general terms and would need substantially more work if it were to support the more specific recommendations set out in the interim report or indeed another model. It would seem improbable to expect this to be undertaken during the remaining life of the Commission and so this is something that the authorities will need to complete in determining how to act upon the Commission's recommendations. In terms of the macro-economic element of the cost side, we have previously outlined the reasons why we believe it is important to isolate the impact of the financial crisis from the impact of the more general economic cycle downturn. While others have undertaken more detailed work on this the Commission can see the analysis that we have provided previously in our response to the Turner Review Conference Paper[8].

The analysis also stops short of seeking to assess the effect of its proposals on the ability of banks to lend into the economy, which must be taken into account in determining the precise way forward. The UK banks are already on a path to making substantial increases to their capital bases, with Basel III and CRD 4 including a 7% minimum for core Tier 1, face a possible G-SIB surcharge under proposals to be published by the FSB later this month and have been informed by the FPC that they should expect to start building a 2.5% countercyclical capital buffer as and when their financial position allows. This is in addition to the potential use of contingent capital and 'bail-in' debt. Each of these will have a significant bearing on the cost of capital, whether from a perspective of supply and demand or risk, and we therefore believe that careful consideration should be given in the consideration whether further capital requirements should be put in place. We are aware that analysts are already beginning to signal that it should not be assumed that there will be demand for bank equity.

The cost-benefit analysis also makes the point that a ring-fenced bank may be easier for the authorities to resolve in the event of distress. While we fully agree with this as a prime objective, there are a range of potential options in addition to a specifically mandated ring-fence. The

[8] BBA reponse to the Turner Review Discussion Paper, February 2010, pp13-16 on assessing the cumulative impact.

prudential and accounting regimes are both much more tightly defined than previously was the case and this should be taken into account in the Commission's analysis.

The analysis also makes the point that a large part of the cost will relate to the loss of the inefficient public guarantee. As previously stated, we agree with the objectives for increased resilience, orderly resolution and the removal of the implicit guarantee, but as this is in the process of being delivered – as confirmed by recent statements from credit rating agencies - we would suggest that this may be achieved without the Commission proposing a specific model for the subsidiarisation of UK retail activity.

4.6 How should a UK ring-fence be designed (noting Annex 7)?

As explained above, we see strong grounds for the final report not seeking to be as prescriptive in its recommendations as implied by the interim report. Seeking to define what should be in and out of a retail-ring fence will be very difficult regardless of the model. We would also see a 'one size fits all' approach as being flawed given the diversity of bank balance sheets and business models. This diversity is widely seen as adding to the resilience of the financial system and is the first line of defence against the next financial crisis.

Annex 7 raises the question of whether a broad or a narrow view be taken on what may or may not be permitted in the retail ring-fence and shows some of the difficulties. Is it right, as suggested in the paper, that client hedging services and risk management can only be conducted from outside the ring-fence? Where would essential treasury management in support of interest rate and foreign currency exposures be positioned? Might a retail ring-fence necessitate a division of treasury management and, if so, what might the effect of this be on efficiency and the institution's overall risk profile? Would it make sense, as seemingly suggested, for the hedging of risk arising from everyday business such as fixed rate mortgages and trade finance to be positioned outside the ring-fence? Should wealth management be on the inside – on the grounds that the client relationship is likely to include an eligible deposit – or on the outside since in most cases the eligible deposit is likely to be a less important part of the wealth management service and the customer's portfolio? Where would banks place other activity in support of commercial lending such as leasing and factoring and what might be the regulatory consequences of that positioning?

Funding and liquidity requirements as a result of Basel III will be amongst the issues which a bank considering whether to place their retail operations into a separate legal entity will need to resolve. One concern is that under these a pure retail business that only includes retail deposits and retail loans may not satisfy the Liquidity Coverage Ratio and Net Stable Funding Ratio requirements. In order to cover the deposit outflow assumed under the Liquidity Cover Ratio stress (5-10% depending on how stable the deposit base is deemed) the retail business would need to hold a stock of liquid assets and this might not be achievable if the retail business could only draw upon retail lending for this. It is likely that they would have to access the wholesale funding markets too.

In relation to the Net Stable Funding Ratio the loans to retail customers would require a stable funding of 85% (or 65% in the case of mortgages) and while deposits will qualify as stable funding for 80-90%, depending on the stability of the deposit base, this could mean that additional stable funding with long term liabilities may be required for the retail business. This will be a further requirement to manage if a banking group determines that it should place retail activity into a separate legal entity.

Another impact of the separation of retail and wholesale business on funding is likely to relate to secured funding. First, there is a question mark over where funding secured on retail lending, via securitisations and covered bonds, should sit within the bank – the retail business (given origination) or the wholesale business (given the type of market that is accessed). Our expectation is that secured funding would still need to be obtained by the wholesale business even if the deposits were required to reside in a separate retail business. It would seem clear that as a result of this securing funding on retail assets would become more expensive for the wholesale business as it would need to compensate the retail business for making the assets available. This may act as a disincentive for the use of secured funding and increase reliance on other sources of wholesale funding available in the markets.

Thought also needs to be given specifically to the treasury function of the retail bank. Will this be able to enter into derivatives contracts and act as a market-maker for the group's own securities? If so, will the group require separate master netting agreements for different business units and what impact would this have on the exposure that counterparts would consider having towards the group? What impact would this have on the effectiveness and cost of hedging?

The interim report appears dismissive of operational subsidiarisation. It needs to be appreciated however that the business model of any bank, including those with retail activity, is predicated upon being able to rely upon shared services. Any retail ring-fencing proposal should consider this context.

Other unintended consequences may include:

- The impact of the fiduciary duties of the board of the entity housing the retail ring-fence on its ability to engage in intra-group transactions in support of the group's compliance with regulatory requirements and the putting in place of suitably robust recovery and resolution arrangements. Might also the commitment of the board of entities housing non-retail activity to supporting other group functions in times of stress be weakened?

- The effect on covenants relating to employee pension schemes, many of which are in deficit and subject to agreements to fill that deficit over a period of time. Should that commitment be broken in any way then the result would be an immediate funding requirement amounting to several billions GBP.

- A VAT consequence for intra-group business of the type that would be necessitated by legal separation.

- Cutting across accounting changes agreed at an international level with the intention of removing some of the complexity through better reflection of the business model.

Changing the legal structure of banks could also add a further layer of complexity to the restructuring of banks that in some cases already constitutes a hugely complex exercise.

We therefore urge strongly that the parallels between the proposal for a retail ring-fence and the objectives of the banking reform programme underway be further explored. While these can only be said to be met if further progress is made on key aspects, including contingent capital and bail-in debt, we would suggest that the Commission should conclude that legal separation constitutes only one form of delivering its objectives. There are other approaches that may be made to work under recovery and resolution plans and these should be viewed as equally acceptable providing they deliver the commonly agreed outcome.

To reiterate, this is not to say that there will not be some banks for which it will suit their balance sheet and business model to place their UK retail operations into a separate legal entity. The question is whether it is necessary to compel this approach and whether the additional complexity and cost can be justified given that it would appear that the objectives for the retail ring-fence may be achieved through other means.

4.7 Should the Commission pursue any other structural reforms to promote stability?

As commented upon elsewhere, the government and regulatory authorities are already pursuing a vast array of measures aimed at strengthening the resilience of the banking and financial system - based around banks having strengthened capital and liquidity, improved risk management, and other reforms aimed at making the financial system more resilient generally - and have put in place a resolution regime providing a framework for the orderly winding down of failing banks. We therefore see the need as being for these measures to be completed and given effect.

4.8 Do you agree with the Commission's assessment of the impact on the competitiveness of the City and the UK economy of the reforms it is considering? Can you provide further data and analysis in this area?

We are pleased to see that the Commission recognises that the banking system matters for UK productive potential, potentially affects UK competitiveness through enabling lower taxation elsewhere in the economy and through the additional employment and tax revenues, including through the UK providing a world-class centre for international financial services (and related professional services). While we are aware of the case being made that financial services are disproportionate to the size of the UK economy, we see financial services, and the professional services upon which they rely, as champion brands that should be seen as integral to the UK's long-run productive potential and economic well-being.

We are aware of anecdotal evidence that it is proving difficult to attract new high value added services to the UK and believe the moment has come for the UK government to signal that with the delivery of the Commission's report, and the delivery of relevant measures, we can look forward to a period of regulatory pause to allow industry consolidation and adjustment.

4.9 Do you agree with the Commission's intention to consider a package of measures, and do you think that some elements could be relaxed if others were strengthened?

As explained above, we anticipate that the FSB's G-SIBs proposals will adopt a graduated approach to the recommended surcharge based on a variety of factors, including the supervisory authorities' assessment of the plans made for recovery and resolution. We therefore see grounds for the recommendation for additional capital to be held against retail activity to be similarly graduated. We also believe that the recommendation on the retail ring-fence should be less prescriptive but would not see this as a weakening of the original proposition.

A specific factor for the Commission to take into account is the ongoing work on contingent capital and 'bail-in' debt. While the legal powers for subordinated debt are already in place in the UK, work remains in respect of other aspects. Support from the Commission in the form of recognition of the part that they have to play in contributing to achieving an appropriate level of assurance on capital and ring-fencing would provide suitable encouragement.

4.10 Over what timeframe should any reforms be implemented?

We believe that any agreed measures should be introduced over a time period, with appropriate transitional arrangements, consistent with the implementation periods agreed for the application of Basel III as transcribed into European law by CRD IV. This means a rolling period of implementation over a number of years in order to ensure that the substantial increase in minimum requirements, and compliance with other metrics, is consistent with preparing for the next economic downturn without unduly impeding the economic recovery which we would need to see in order for such measures to be relevant.

Ultimately, the timetable for reform will be set by the Government and we look forward to further consultation on possible measures and timetabling.

Chapter 5: Reform options: competition

5.1 Do you agree with the three broad measures proposed in this chapter (structural change, improvements to switching and barriers to entry and pro-competitive financial regulation)?

We do not agree that the UK market is unduly concentrated in comparison to other developed economies of a similar size and nature and believe that market developments in course will add further to its competitive nature.

Turning to the improvements in the accounts switching process we would comment as follows:

- While our members believe the UK experience on current account switching stands up favourably in comparison with the current position in other EU Member States, they are focused on what further practical arrangements can be made to overcome remaining difficulties, both in terms of accessibility and known problems relating to direct debits. We see this as a pragmatic way forward and preferable in public policy terms to full account portability which falls down when judged on cost/benefit and risk criteria.

- As the Commission acknowledges, significant improvements in account transparency are in the process of being introduced. We clearly need these arrangements to be put in place before yet further steps are contemplated.

- We are unaware of there being problems in practice arising from access to the payments system and have no difficulty with the regulatory authorities taking an interest in their operation. We are unsure, however, whether this should fall within the remit of the Financial Conduct Authority (FCA) rather than the Bank.

On current account switching, we can add that we work closely with the Payments Council and fully support their initiative to ensure the switching process is made simpler and more straightforward for customers by the introduction of a switching hub. The commitments made by Payments Council members are as follows:

1. Introduction of a “Switching Contract” including a guaranteed switching time of no more than 7 working days for the customer (unless the customer asks for a transfer date more than 7 working days in advance), underpinned by a Switching Scheme to which all Payments Council members subscribe.

2. Introduction of new switching tools (e.g. central redirection of all Bacs and Faster Payments transactions and a daily sweep facility) that will ensure all transactions are made through the customer's new account from working day 7.

3. Introduction of robust processes to ensure originators of transactions amend records to send these transactions to the new account.

4. Significantly enhanced automation of messages to support the new 'switching contract', including the removal of the need for physical 'pen on paper' signatures.

5. Mandatory exchange and automation of bill payment information.

The switching hub is viewed as a practical means of overcoming the main difficulties known to arise from accounts switching and is seen as a proposition that would be deliverable without the cost and disruption for all that would arise from the introduction of portable account numbers. It is based on best practice overseas.

5.2 Should the Commission pursue any other measures to promote competition?

No. The Government has acted upon the Commission's recommendation that the FCA be given a duty to promote competition and has published revised proposals in its White Paper 'A new approach to financial regulation; the blueprint for reform'. We see this as a further stage in the continuing dialogue about the appropriate regulatory regime for the UK industry and consumers; we will continue to engage in this dialogue which has moved on from principles to more detailed and technical considerations.

5.3 What factors make smaller banks more likely to exert competitive pressure on larger incumbents?

We understand the Government's rationale for the regulatory authorities being placed under a statutory duty to ensure that their requirements are proportionate and in keeping with the maintenance of a competitive regime. This would appear to have been accepted by the Government through its proposed application of the competition scrutiny regime to the Prudential Regulatory Authority and the FCA in the draft Financial Services Bill published last month.

5.4 What are the limitations on customers' abilities to understand banking costs, compare different accounts, and switch between them?

The banking industry commented in detail on this during the OFT Market study on personal current accounts. The package of changes which the industry agreed to implement has increased transparency and so made it easier for customer to compare accounts. The September 2010 progress update acknowledges that this increased transparency may result in customer changing their behaviour or switching accounts and that the transparency initiatives will help customers make better decisions [9].

[9] OFT report 'Personal accounts in the UK: progress update', September 2010; see paragraphs 3.10 and 3.11 in particular.

5.5 What costs might an improved switching process impose on banks and direct debit originators?

Cost is a consideration built into the switching hub proposal being worked upon by the Payments Council.

5.6 How could the cost of meeting prudential requirements be mitigated for small banks and new entrants, while ensuring safe practices in all banks?

We do not see proportionality in prudential requirements as necessarily conflicting with safe practice and believe that a proportionality test should be applied to supervisory approaches and new requirements.

We see good grounds for suggesting that the regulatory authorities should be placed under a statutory duty to maintain an internationally competitive regime which is attractive to investors.

5.7 How could small banks' ability to offer a national network of cash handling services be improved?

Experience shows that the availability of conveniently located cash handling services is a significant factor for some small business and the decisions they make about which bank will best meet their needs. We see nothing unusual in this and would have no difficulty in cash handling sevices being made available through the Post Office if it was thought that would be something that the Post Office could make available as part of its commercial offering.

5.8 How should the Financial Conduct Authority discharge its duty to promote competition?

We shared the concern of others over the characterisation of the FCA as a 'consumer champion', and welcome the clarification that:

- The Government recognises that, as impartial regulator, the role of the FCA should not be confused with that of consumer advocate organisations;
- The FCA's regulatory focus on achieving better consumer outcomes should recognise not only the limitations of regulation, but also the potentially negative effects of excessive regulation on market efficiency and consumer choice; and
- The concept of consumer responsibility for their choices will also be important.

We are generally supportive within this context of the FCA fulfilling its role in a way which is consistent with the promotion of competition but would see a need for a clear understanding of the division of responsibility between the planned new competition authority and the financial regulator.

For further information on this submission please contact Paul Chisnall, Executive Director, BBA
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British Bankers' Association
4th July 2011

Appendix 1: The banking reform programme

The stability of individual banks, and the system as a whole, has been improved radically by the reforms that have been agreed over the past two years and will be strengthened further by measures in hand. Taken together, these will ultimately place banks on a very different footing to where they stood pre-crisis. The measures predominantly include:

- **Core Tier 1 capital:** international agreement has been reached on the Basel III capital accord and is close to being made a statutory requirement in the European Union in the form of the Capital Requirements Directive IV. It requires Core Tier 1 capital to be raised to 7; the standard set by Basel II was 2% common equity supplemented by other capital which under stress provided only partial loss absorbance. As part of this, risk weights applied to instruments within the trading book have increased substantially. Notwithstanding losses, based on the definitions used by the Bank of England for its Financial Stability Report, Core Tier 1 capital held by UK banks has risen from £100bn in 2000 to £300bn at the end of last year.

- **Additional capital requirements:** it is accepted in Europe, but not necessarily in the United States, that there should be an additional countercyclical capital buffer up to 2.5% at the top of the cycle; discussion is advanced on a potential SIFI surcharge of up to 3%. The Basel Committee will release further proposals on the trading book this Autumn.

- **Further loss absorbency:** work is also being undertaken to ensure that subordinated debt is truly loss absorbing at the point of non-viability. Consideration is also being given to whether under 'bail-in' arrangements creditors should bear the cost of failure if the tools and powers available under resolution regimes are not sufficient to resolve a failed institution.

- **Leverage:** discussions are at an advanced stage in the Basel Committee on the introduction of formal leverage ratios; in the meantime leverage in UK banking has almost halved since the period directly before the financial crisis.

- **Liquidity:** the need for higher liquidity requirements was a key learning point of the crisis and the volume of instruments held for liquidity purposes has increased at least fivefold. This will be formalised in a new Liquidity Coverage Ratio to apply from 1 January 2015.

- **Funding:** discussions are at an advanced stage in the Basel Committee on the introduction of ratios limiting the reliance that banks and other financial institutions can place on short-term wholesale funding. This will restore the relationship between deposit-taking and lending. While further work needs to be undertaken e.g. on the underlying accounting rules a new 'Net Stable Funding Ratio' will apply from 1 January 2018.

- **Taxation:** the annual £2.5bn UK banking levy – which is at the top end of levies introduced within the EU and elsewhere – taxes short term funding at a higher rate than long-term funding and so adds to the incentive to rely less on short-term wholesale funding.

- **Infrastructure:** changes are being made to require OTC derivatives to be cleared through central counterparties supported by higher collateral arrangements in effect building stronger firewalls into the financial system; payment and settlement systems overall are also to be more closely supervised.

- **Recovery & resolution:** the Banking Act 2009 established a Special Resolution Regime in order to provide the authorities with a legal framework and range of tools to resolve a failing institution in a manner which minimises the impact on financial stability, protects depositors and protects public funds; attention has since turned to individual institutions preparing Recovery & Resolution Plans intended to strengthen their contingency planning and to underpin the resolution regime.

- **Depositor protection:** in addition to deposit insurance limits rising from 90% coverage of £33,000 to 100% of £85,000 under the FSCS scheme funded by financial institutions, UK banks lead the field in the establishment of a 'single customer view' designed to facilitate the continuity of essential banking services in the event of failure and 7 day payout as a backstop.

- **Customer confidence:** UK banks are seeking to overcome the loss of trust and confidence in which they are held and as part of this have committed to making available lending capacity and under the Business Finance Taskforce skills and resources to assist SMEs access finance.

- **Banking supervision:** the FSA signalled an end to 'light touch regulation' as part of its post-Northern Rock analysis and has since embarked upon a substantial shift in its approach to banking supervision – a process that will be continued by the new Prudential Regulation Authority.

- **Accounting:** the International Accounting Standards Board and the US Financial Accounting Standards Board are working together on a convergence programme aimed strengthening the key accounting standards that apply to banks and other financial institutions; this work will largely be completed by the end of the year. Key changes include simplified measurement and classification aimed at making a clearer distinction between traditional banking and trading activity and the introduction of expected loss provisioning.

- **Corporate governance:** the Walker Review into the corporate governance of British-owned financial institutions made 38 recommendations spanning the size, composition, qualification, functioning and performance evaluation of boards of directors, the role of institutional investors, risk governance and remuneration. Many of these recommendations have fed into the Financial Reporting Council's Corporate Governance Code; others have been acted upon by the FSA and banks themselves.

- **Macro-prudential supervision:** as part of the changes in the UK regulatory arrangements the Bank of England has established its Financial Policy Committee on a shadow basis and this will start work on overseeing financial stability and macroeconomic risk within the financial system. The FPC for instance will be responsible for assessing whether counter-cyclical capital weights need to be applied to particular asset classes as we work through the economic cycle.

While there are instances where the UK authorities have adopted a leadership position on reform – notably in signalling a changed approach to banking supervision, front-running liquidity requirements and putting in place the statutory framework needed for the resolution regime – they have largely worked through international bodies such as the Financial Stability Board and the Basel Committee to reach agreement to reform measures on a global basis. This is important given the global nature of financial services and the fact that some of the seeds of the financial crisis can be said to have lain in key regulatory differences between different jurisdictions.

A global approach reduces the prospect of regulatory arbitrage, thereby strengthening financial stability and, importantly, ensures a level playing field. This gives the market confidence in reforms being capable of implementation without damaging international competitiveness. It also reduces complexity since it provides a global regulatory framework that has a good level of coherence and common understanding.

The Basel Committee is currently undertaking a comprehensive cost/benefit analysis to understand better the impact of these changes overall on banks including their lending capacity. It will clearly be important for the UK authorities to adopt a similar approach in assessing the form of any potential supplementary measures.

Appendix 2: Macro-prudential update

This note provides an update on the current status of work to develop macro-prudential regimes in the UK, EU and US.

Background

A common theme in both the reform of the EU and UK regulatory architecture, as well as each of the key analyses of the financial turmoil issued since the crisis, has been an emphasis on the importance of a 'system-wide macro-prudential perspective[10]', to supervision. The Turner Review, for example, laments the absence of such a perspective arguing that 'the failure to specify and to use levers to offset systemic risks were far more important to the origins of the crisis than any specific failure in supervisory process relating to individual firms'[11].

For this reason the July 2010 HM Treasury paper setting out the Coalition Government's proposed changes to the UK's regulatory structure argued: 'there must be a dedicated focus on macro-prudential analysis and action, to ensure that risks developing across the financial system as a whole are identified and responded to'. It proposed 'a new Financial Policy Committee (FPC) in the Bank of England, with primary statutory responsibility for maintaining financial stability. Unlike in the current system, which provides the Bank with responsibility but no tools for financial stability, the Government will provide the FPC with control of macro-prudential tools to ensure that systemic risks to financial stability are dealt with'[12].

The development of the FPC is mirrored in the EU by the establishment of the European Systemic Risk Board (ESRB) to monitor risks in the European financial system and provide early warnings of those risks to the European System of Financial Supervisors. The EU is not alone in identifying the need for macro-prudential oversight. In the US, for example, the Dodd-Frank Act created a new Financial Stability Oversight Committee (FSOC) to perform an equivalent function. The Council has met bi-monthly since its inaugural session on 1 October 2010.

Current status

Financial Policy Committee

The Government has now subjected its proposals for the FPC to two consultations and has produced draft legislation proposing how it should be framed in terms of its objectives, functions and structure. The draft legislation sets the FPC's objective as being to contribute to the achievement of the Bank's financial stability objective via the 'identification of, monitoring of, and taking of action to remove or reduce, systemic risks with a view to protecting and enhancing the resilience of the UK financial system'. It identifies these systemic risks as including in particular risks attributable to structural features of financial markets or to the distribution of risk within the financial sector and unsustainable levels of leverage, debt or credit growth. The Committee's mandate is qualified, however, by a clause which states the objective does 'not require or authorise the Committee to exercise its functions in a way that would in its opinion be likely to have a significant effect on the capacity of the financial sector to contribute to the growth of the

[10] Turner, A (2009) "A regulatory response to the global banking crisis" *FSA*, pp83
[11] Ibid
[12] HM Treasury: "A new approach to financial regulation: judgement, focus and stability" (July 2010) pp4

UK economy in the medium or long term'; a formation which industry commentators have described as unduly subjective. It is envisaged that the FPC will have access to the following levers to achieve its mandate[13]:

- Public pronouncements and warnings;
- Influencing macro-prudential policy in Europe and internationally;
- Making recommendations to bodies other than the PRA and the FCA, including perimeter recommendations to the Treasury;
- The ability to make recommendations to the PRA and FCA, supported where appropriate by a comply-or-explain mechanism; and
- The power to direct the two regulators where explicitly provided for by macro-prudential tools set out by the Treasury in secondary legislation and subject to Parliamentary approval via the affirmative procedure.

In reflection of the potentially far reaching nature of these proposed powers, much of the discussion of the FPC to date has focused on its democratic accountability and the concentration of responsibilities within the Bank. For example, many of the responses to the Treasury's second consultation emphasised the need for clear checks and balances to be built around the use of the FPC's powers, for the Treasury to have a stronger oversight role and for external members to form a greater core of the FPC. In response, the Treasury Select Committee has launched an inquiry into the accountability of the Bank; the Government has undertaken to consider the TSC's findings in detail.

Whilst the legislative underpinning is being set in place, the Court of the Bank of England has formed an interim FPC to undertake, as far as possible, the future statutory FPC's macro-prudential role. During this interim period, the FPC is tasked with contributing to the maintenance of financial stability by 'identifying, monitoring and publicising risks to the stability of the financial system and advising action to reduce and mitigate them'[14]. It made its first contribution in this regard with the publication of the June 2011 *Financial Stability Review* which followed its first meeting on 16 June 2011. The FSR considered the risks to the financial system and the prospects for financial stability, delivering six policy recommendations:

- The Committee advises the Financial Services Authority (FSA) to ensure that improved disclosure of sovereign and banking sector exposures by major UK banks becomes a permanent part of their reporting framework, and to work with the FPC to consider further extensions of disclosure in the future.
- The Committee advises the FSA to compile data on the current sovereign and banking sector exposures of other UK banks not subject to the EBA stress tests. If these exposures are significant, then the FSA should publish an aggregate estimate.
- The Committee advises the FSA to extend its review of forbearance and associated provisioning practices across UK banks' household and corporate sector exposures on a global basis.
- The Committee advises the FSA that its bank supervisors should monitor closely the risks associated with opaque funding structures, such as collateral swaps or similar transactions employed by exchange-traded funds.
- The Committee advises UK banks that, during the transition to the new Basel III capital requirements, they should take the opportunity of periods of strong earnings to build capital so that credit availability is not constrained in periods of stress.

[13] HM Treasury: "A new approach to financial regulation: the blueprint for reform" (June 2011)
[14] Bank of England: Financial Stability Report (June 2011)

- The Committee advises the FSA, as part of its regular supervisory dialogue with banks, to ensure that the proportion of earning retained is consistent with the advice in the preceding recommendation.

ESRB

The General Board of the ESRB held its inaugural meeting on 20 January 2011. At its second meeting on 20 June 2011, the General Board reviewed the systemic risks facing the EU, including the efforts of Member States to return their finances to a sustainable footing and the risks posed by the uniquely interconnected EU financial system. Looking forward, the General Board called on the EU authorities and Member States to deliver on the commitments they have made in regard to the EU-wide stress testing regime and the measures which will need to be put in place to deal with the consequences of the assessments. The ESRB reported it was monitoring a number of issues which collectively or individually could impact the stability of the EU financial system[15]:

- The ability of banks to reduce maturity, and where relevant currency, mis-matches in their funding structures and to absorb losses arising out of the ongoing credit cycle.
- The risk of potential asset price imbalances (in particular in property markets but also in financial and commodities markets).
- And the external risks posed to the system from current international capital flows, asset growth in emerging countries and a re-emergence of economic imbalances at a global level.

FSOC

The mandate of the FSOC gives it collective accountability for the identification of risks and threats to financial stability. Its composition and remit is subtly different to that of the FPC in that it draws together the universe of Federal financial sector regulators and is intended to facilitate coordination between these different regulators as much as it is a macro-prudential oversight body. Interestingly, it has the power to require additional supervision of non-bank financial companies whose failure could pose systemic consequences for the US economy. Discussion of potential threats to US financial stability has identified a similar list of concerns as the reviews conducted by the FPC and ESRB. The minutes of the Council's 17 March 2011 meeting record concern over the current macro-economic environment, including the oil price, the threats posed by European sovereign fiscal positions and banking sectors and risks inherent in the structure of Money Market Mutual Funds.

[15] http://www.esrb.europa.eu/news/pr/2011/html/is110622.en.html

Appendix 3: BBA position on bail-in

This note summarises the developing position of the British Bankers' Association on the concept of bail-in. It outlines in broad terms our view of the key aspects of a bail-in regime and how it might be utilised. It expands our thinking on when bail-in might be utilised and how it could be triggered.

Purpose

We believe that bail-in could be an important enhancement to the powers available to resolution authorities to manage the failure of a financial institution without recourse to the taxpayer. To us bail-in should be seen as a statutory power for a competent authority to either convert or write down an entity's liabilities following its entry to resolution to avoid rapid loss of value, provide time to allow for orderly resolution and prevent systemic contagion.

Bail-in is therefore distinct from contingent capital which is a going concern recovery tool whose form and trigger are contractual and determined by management. It should also not be confused with the write-down of subordinated debt which takes place at the point of non-viability before the application of the resolution tools.

Trigger

We favour a statutory approach under which bail-in is exercised by the resolution authority once a firm is judged to have met the trigger for resolution. To reassure creditors and markets it is essential, however, that the discretion of the resolution authority be limited by further requirements for the triggering of a bail-in and that there be a well defined and understood process around how any decision will be made. A Code of Conduct, agreed with the industry and market participants, should be used for this purpose and set out that:

- no creditor will be left worse off by the use of the bail-in power than they would have been under liquidation;
- the bail-in power should only be used if the resolution authority determines that there are no other tools available to resolve the firm in an orderly manner and prevent systemic contagion; and
- the use of the bail-in power will be approved by the finance minister, supervisor and resolution authority.

Characteristics

We are yet to reach a consensus view on whether bail-in should be implemented under the comprehensive or targeted approach. However, whichever approach is followed, we believe that there are certain classes of liabilities which should be excluded from the regime in the interests of financial stability. We would argue that this list should include: swap repo and derivative counterparties and other trade creditors, retail and wholesale deposits and secured debt and collateral. Views differ on whether short-term debt should be included; some take the view that it should be included to mitigate a migration to short-term funding and reduce the prospect of structuring. Others, however, are concerned that doing so would exacerbate funding difficulties during a stress scenario and point to the different use of short-term finance in the funding of the firm (i.e. as liquidity management instruments that might also be used as collateral for derivative transactions).

We accept that exclusions from the regime establish a new creditor hierarchy by definition and therefore believe that consideration should be given to compensation mechanisms to assure that debt is not subordinated to equity. It goes without saying that we believe senior debt should only be subject to bail-in if absolutely needed to restore the bank's financial heath, and if so, should always be treated better than subordinated instruments. Subordinated instruments should likewise always receive better treatment than equity.

In cross-border situations, we believe a hybrid approach may be necessary under which the contracts of liabilities issued by the firm outside of the home country include an agreement that the purchasers affected by the bail-in decision will agree to be bound by the decision of the resolution authority in the home country but have access to the resolution authorities and to judicial review. A transition period may be required to allow adjustment of contractual provisions to align with the applicable resolution regime and to assure that bailing in does not trigger early termination and cross-default clauses. A transition period would also allow for international harmonisation to assure a level playing field.

Impact

We believe it is too early to quantify the impact the introduction of a bail-in regime would have on senior funding markets. We note that the pricing of bank debt spiked with the publication of the European Commission's consultation paper but it is uncertain whether a move to a bail-in regime has been fully priced in at this stage. Funding costs are evolving due to a number of regulatory changes and the move away from the notion of an implicit state guarantee. It is therefore important to assess the bail-in regime in a 'new world' without any further bail-outs of senior creditors.

The structure of the bail-in regime will have a bearing on the impact on senior debt. If bail-in is only imposed on the basis that creditors will be left no worse off than they would have been under insolvency then bail-in could lead to a slight increase in PD but a significant decrease in LGD; hence bail-ins could moderate the effect of the removal of an implicit state guarantee.

Conclusion

In summary, we support the concept of bail-in and believe it could be an important means of addressing the perception that some institutions are too big to fail. We look forward to the opportunity to work with the authorities to solve the legal and technical issues outstanding to make this a viable solution.

Appendix 4: Contingent capital and bail-in glossary

This note provides definitions of terms commonly used to describe aspects of measures under consideration to enhance the loss absorbency of financial institutions. It seeks to clarify the differences between instruments designed to be utilised as recovery measures once an institution has encountered a stress situation from those designed to absorb losses and protect the taxpayer in the event of failure.

Contingent capital	A debt instrument which converts to equity or is written down either temporarily or permanently whilst an entity is a going concern when certain predetermined triggers are met. The trigger and form of the instrument are determined by management. The instrument may count towards an entity's regulatory capital requirement, classified as 'Tier 2' under Basel III.
Gone concern contingent capital	A synonym for a bail-in instrument under the targeted approach discussed below.
Subordinated debt	All non-common Tier 1 and Tier 2 instruments. Under Basel III any such instruments issued by a bank must have a provision that requires them, at the option of the relevant supervisory authority, to be written off or converted into common equity at the earlier of a decision that a write-off is necessary as determined by the relevant authority or the decision to make a public sector injection of capital, or equivalent support, without which the entity would become non-viable, as determined by the relevant authority.
Bail-in	A statutory power for a competent authority to either convert or write down an entity's liabilities following its entry to resolution. Bail-in is a resolution tool that should be triggered after the firm has met the conditions for resolution; it should be based on a statutory regime (with some contractual elements to support the statutory rules in a cross-border context); it would be used to provide time to allow for orderly resolution of a failed/failing institution and prevent systemic contagion. Bail-ins should only be used in the context of a resolution and if it will leave no creditors worse off than they would have been under insolvency (although this may be via an equity stake). Before instigating a bail-in, the resolution authority should demonstrate that it has considered all other resolution tools and that a bail-in is the only option left to avoid disorderly liquidation and is therefore essential to managing an orderly wind-down of the firm (out of which parts of the old firm may emerge as new going concern entity/ies following the application of the other resolution tools).

Going concern	Used to describe an entity up until the point of non-viability.
Gone concern	Used to describe an entity after the point of non-viability.
Point of non-viability	The point at which an entity enters resolution. In the UK, defined by Section 7 of the Banking Act 2009 as the point at which an entity fails, or is likely to fail in the opinion of the supervisor, to meet its threshold conditions for authorisation (as stipulated in FSMA) and at which there is no prospect that any other steps will return it to viability.
Resolution	A pre-insolvency framework granting the regulatory authorities statutory tools and powers to resolve a distressed financial institution in pursuit of set public policy goals. Under the Special Resolution Regime in the UK these are: • to protect and enhance the stability of the financial systems of the UK; • to protect and enhance public confidence in the stability of the banking systems of the UK; • to protect depositors; • to protect public funds; and • to avoid interfering with property rights in contravention with the Human Rights Act 1998. The SRR powers allow the authorities to: • transfer all or part of a bank to a private sector purchaser • transfer all or part of a bank to a bridge bank - a subsidiary of the Bank of England – pending a future sale • place a bank into temporary public ownership (the Treasury's decision) • apply to put a bank into the Bank Insolvency Procedure (BIP) which is designed to allow for rapid payments to Financial Services Compensation Scheme (FSCS) insured depositors • apply for the use of the Bank Administration Procedure (BAP) to deal with a part of a bank that is not transferred and is instead put into administration
Targeted approach	A proposal to require entities to issue a fixed volume of ‘bail-inable’ debt or defined typologies of ‘bail-inable’ debt (permitting the determination of specific issues which are ‘bail-inable’) which, in addition to the power to write off all equity, and either write off existing subordinated debt or convert it into an equity claim, could be written down or converted into equity on a statutory trigger. Such debt would need to include a contractual term which it would specify that the relevant resolution authority could use a statutory power to write down the debt when the institution meets the trigger conditions for entry into resolution.
Comprehensive approach	An alternative to the targeted approach under which the resolution authority would be given a statutory power, exercisable in

	conjunction with the core power when an entity meets the trigger conditions for entry into resolution, to write down by a discretionary amount or convert to an equity claim, all senior debt deemed necessary to ensure the credit institution is returned to solvency. The resolution authority would have the discretion over which classes of debt would be affected in a particular case, the extent of the haircut and where relevant the rate of conversion. To ensure the proper functioning of credit markets, it might be necessary to exclude certain classes of liabilities from the regime. Under the comprehensive approach, supervisors may still require minimum levels of bail-inable debt as part of the recovery and resolution plan process.
Statutory regime	A bail-in regime under which the resolution authority has the statutory power to alter the claims of creditors to an entity in resolution with the objective of returning it to viability.
Contractual regime	A regime under which the terms of certain debt instruments include a clause specifying that the claim of the holder will be either written down or converted into equity if specific conditions are met.
Hybrid regime	A method of applying a bail-in regime to a cross-border group. Under this regime the relevant authority in the issuing entity's jurisdiction would have a statutory bail-in power. However, in recognition that the holders of the entity's liabilities may not be within the legal remit of that authority the entity would be required to include within the terms of each of its contracts a clause to the effect that the holder undertook to be bound by the decision of the home state authority.

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