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ICB Interim Report on UK Banking Reform.

12 April 2011

The UK Independent Commission on Banking (the "**ICB**"), chaired by Sir John Vickers, yesterday published its interim report on reforms to the UK banking industry. Although the final ICB report is not expected to be published until September of this year, yesterday's interim report provides a clear picture of the direction that the ICB's thinking is moving in. The proposals made by the ICB will not pass directly into law, but, when finalised in September, are recommendations that are likely to form the backbone of the Government's next phase of banking reform.

Key proposals in ICB's interim report

UK retail ring-fencing

The ICB proposes the creation of a firewall between retail banking and investment/wholesale banking, by requiring all retail banking operations to be ring-fenced and carried out in separately capitalised subsidiaries.

Increased capital requirements

> The new UK retail banking subsidiaries would be required to hold equity capital equivalent to at least 10% of risk weighted assets.

> Wholesale and investment banking operations would not be subject to increased capital requirements beyond those agreed internationally (although the ICB suggests that, in its view, it would be appropriate for the 10% level referred to above to be applied internationally to all operations of systemically important financial institutions ("**SIFIs**")).

Competition reforms

> To promote greater competition, the ICB suggests that the Government should seek agreement with Lloyds to "substantially enhance" the retail banking divestiture programme agreed in November 2009.

> The ICB also notes that there are actual and perceived difficulties for retail customers in switching banks and recommends the implementation of measures to make it easier and less costly for retail customers to do this.

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Structural reform – UK retail ring-fencing

The scope of structural changes to be recommended by the ICB is the issue that has attracted the most debate and controversy in the lead-up to yesterday's interim report. In a conference speech in January of this year Sir John Vickers appeared to rule out recommending an extreme form of narrow banking in which deposits would be required to be fully backed by government bonds. However, short of such extreme measures, the ICB has been deliberating and consulting at length over the scope and magnitude of structural reform that it should propose.

In the interim report, the ICB recommends that "UK retail ring-fencing" should be the main plank of structural reform. In terms of severity, this recommendation is towards the middle of those that were being considered by the ICB - the more severe option of requiring retail banking and investment/wholesale banking to be carried out in completely separate corporate groups has effectively been dismissed.

The key elements of the recommendation are as follows:

> "UK retail ring-fencing" would involve restructuring banks' operations so that all UK retail banking operations would be carried out by separate subsidiaries within the banking group that do not carry out any investment or wholesale banking business.

> The ring-fenced subsidiaries would be required to maintain increased capital to protect against losses, as described in paragraph 2 below.

> The ring-fencing requirement would apply to any bank which conducts UK retail banking activities, regardless of the location of its headquarters.

> Precise details as to how the ring-fencing would operate are not fully developed in the interim report and will form a large part of the further work and consultation undertaken by the ICB prior to its final report in September of this year. The key issues that will need to be decided upon are:

- the activities which should fall within the scope of the retail bank – clearly these will include retail deposit taking, but which other activities must, and must not, take place in the retail bank will need to be decided upon; and
- the nature and scope of the segregation rules – the ICB suggests that some of the rules which they will be considering include prohibiting the retail subsidiary from holding equity in other parts of the bank group, limiting intra-group exposures and cross-defaults, requiring the retail subsidiary and the rest of the bank group to enter into separate master netting agreements, imposing further constraints on the level of wholesale funding allowed in the retail bank and/or requiring regulatory approval for transfers of capital out of the retail bank.

The ICB's final recommendation on these matters and, in particular, the severity of the segregation rules (including, for instance, whether the retail subsidiary will be required to maintain a separate minimum liquidity level) will be key.

As well as cost issues, there are likely to be concerns that UK banks may be put at a competitive disadvantage if the ICB's recommendations set out above are adopted. In order to judge this we will have to wait to see the detail of the reforms that are proposed and ultimately adopted in other jurisdictions and, in this regard, it will be interesting to gauge the international reaction to yesterday's interim report. It is perhaps unlikely that regulators in continental jurisdictions such as Germany and France will implement structural reforms of the type suggested by the ICB due to the historical belief held by regulators in such jurisdictions that a fully universal and diversified bank model is actually the best way of reducing risk. In the United States, by contrast, insured deposit-taking banks have long been subject to ring-fencing in several important respects. Not only are they prohibited from engaging in investment banking activities (any securities business must broadly speaking be conducted through separately capitalised affiliates), they are also limited in their ability to provide any funding to their affiliates.

In addition to the main recommendation described above, the ICB also states in the interim report that it is strongly supportive of "operational subsidiarisation" (under which the key infrastructure needed for a bank to keep operating should be placed in a separate subsidiary with sufficient funds to ensure that it would be able to continue to operate if other parts of the bank group go into insolvency), and that it should be best practice for banks to be organised in this way going forward. However, the ICB stresses that such measures in themselves are not sufficient, which is why it is suggesting the retail ring-fencing described above.

Increased capital requirements

The ICB proposes that the minimum equity capital requirement for the new UK ring-fenced retail banking subsidiaries should be set at 10% of risk weighted assets – this is 3% higher than the level set by Basel III.

However, the ICB does not propose any increase above the Basel III capital levels for wholesale or investment banking operations (it suggests that 10% would be an appropriate level for SIFIs, but that this is ultimately a decision that should be made, and then consistently implemented, at an international level).

In addition to the higher minimum equity requirement described above, the ICB also stresses that methods of generally improving the loss absorption of banks' debt instruments must be considered. It suggests three possible tools:

> debt instruments that absorb loss at a point while the bank is still viable ("**contingent capital**");

> liabilities that absorb loss at the point of non-viability ("**bail-in debt**"); and

> depositor preference, i.e. ranking depositors above other unsecured creditors in a bank insolvency.

The ICB does not give any further detail in the interim report as to how any requirements relating to these tools might be structured, and acknowledges that there are likely to be a number of cost and market issues that would need to be overcome. However, more work will undoubtedly be carried out by the ICB in investigating the options around these tools, and it is very likely that the ICB's final report will include requirements in this regard.

The increase recommended by the ICB over the Basel III equity capital levels for retail operations and the probable additional debt loss absorption requirements are likely to lead to fears that UK banks may be put at a competitive disadvantage compared with banks in other jurisdictions. Whether this proves to be the case will depend on how the European Commission and other home regulators implement Basel III:

> At present, only Switzerland has announced a specific minimum capital level (which, at 19% for all operations of Credit Suisse and UBS, to be made up of 10% common equity and 9% convertible notes, is more stringent than the level recommended by the ICB).

> Although no formal announcements have been made, regulators in Sweden, Spain and Ireland have indicated that they are likely to impose minimum capital requirements above the standard requirements set by Basel III (although it is worth noting that regulators in France and Germany have increasingly asked for a flexible approach to Basel III implementation, implying that they may ultimately adopt lower levels).

Competition reforms

Lloyds Banking Group divestiture

In November 2009, the UK Government, the European Commission and Lloyds Banking Group agreed to a divestiture programme to create greater competition in the retail banking market. Lloyds committed to divest a retail banking business consisting of at least 600 branches and at least 4.6% of the UK personal current account market, together with 19.2% of Lloyds' retail mortgage assets.

The ICB believes that the scope of this divestment programme does not go far enough – on the assumption that the divestment is a stand alone business, in its view the scale of the divestment and the overall balance sheet of the divested assets would not give rise to a strong enough challenger to the current market participants. The ICB also says that in its view the divestment programme should go further in reducing Lloyds' current share of the personal current account market.

The ICB therefore suggests that the Government should seek agreement with Lloyds to substantially enhance the divestiture programme.

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General competition reforms

In the interim report, the ICB states that it believes that competition among incumbent banks, and between them and challengers, is blunted by the actual and perceived difficulties for customers switching accounts, by poor conditions for consumer choice more generally, and by barriers to entry.

Overall, the ICB says that a key aim of banking reform should be for customers to have the ability to move accounts more easily and at a more reasonable cost. In particular, the ICB proposes several reforms, including:

> The implicit charges and costs to customers of current accounts should be described in a much clearer way, and there should be a short deadline imposed on banks for transferring over customer information when someone moves a current account to a new bank.

> The new Financial Conduct Authority being created by the Government to protect consumers of financial services should have "a clear primary duty to promote effective competition".

> A new automated system for moving a current account from one bank to another should be created, and it should be possible for current account customers to keep their account numbers when they move banks.

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