The Independent Commission on Banking: The Vickers Report

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Ever since the Northern Rock Bank failed in September 2007, the UK financial regulatory authorities have looked at how they operate and whether changes were needed to the existing system. The deepening crisis in 2008 and 2009 expanded the breadth of this review both in the UK and across the world.

New legislation in the form of the *Financial Services Act 2012* has been passed. This established the new regulatory framework for the financial services industry. In parallel with the passage of that legislation was the publication of the Report of the Independent Commission on Banking headed by Sir John Vickers. Vickers looked at solutions to the 'too big to fail' banking conundrum, as well as at issues connected with competition in banking. The main features proposed by the Vickers Commission were intended, with government approval to go forward to form the basis of a further financial services Bill. However, following revelations about serious irregularities by high profile banking organisations in connection with LIBOR and related indexes, the Government established a further body - the Parliamentary Commission on Banking Standards, to look at banking in its broadest economic, regulatory, cultural (moral) and social context and to make recommendations.

This note summarises 'Vickers' and outlines the new observations and recommendations of the Parliamentary Commission.

Many of the recommendations of Vickers and of the Commission, were given effect by provisions in the *Financial Services (Banking Reform) Act 2013*.

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1 Review of bank structure: the Vickers Commission

1.1 The Interim Report

Alongside the decision to produce proposals for reform to the supervisory structure of UK financial services, at his Mansion House Speech, the Chancellor announced a review of the banking industry –

> the new Government is establishing an independent commission on the banking industry. It will look at the structure of banking in the UK, the state of competition in the industry and how customers and taxpayers can be sure of the best deal. The Commission will come to a view. And the Government will decide on the right course of action. Sir John Vickers has agreed to chair the Commission.[1]

In September 2010, it published an issues Paper which outlined its preliminary thinking.[2] The issues it was minded to think about included:

- Financial stability
- Competition
- Interaction of financial stability and competition
- Lending and the pace of economic recovery
- Competitiveness of UK financial services and the wider economy
- Risks to the Government's fiscal position

In April 2011, it published its Interim Report.[3] The response focussed largely on the proposals surrounding the ring-fencing of British retail banks; i.e. separating deposit and lending functions from investment banking. Sir John Vickers summarised his proposals in the following way:

> Structural reform, in sharp form, would end universal banking and require retail banking and wholesale and investment banking to be carried out by separate banks.
>
> This would aim to isolate retail banking services and taxpayers from the risks of global wholesale and investment banking.
>
> The Commission's focus is on a *combination* of these capital and structural approaches, in moderate form.
>
> First, we estimate that systemically important banks should have an equity ratio of at least 10% provided that they also have genuinely loss-absorbing debt. We believe this should be agreed internationally. But whether or not it is, we believe that it should apply to UK retail banking. Then international standards would apply to the wholesale and investment banking activities of UK banks, so long as the taxpayer is not on the hook if they fail.
>
> Second, and in structural support of that approach to capital, the Commission sees merit in a UK retail 'ring-fence'. This would require universal banks to maintain the UK retail capital ratio – that is, not to run down the capital supporting UK retail activities below the required level in order to shift it, say, to global wholesale and investment banking. Our current view is that such a limit on banks' freedom to deplete capital would be proportionate and in the public interest, and would preserve benefits of

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1 Speech by Chancellor of the Exchequer, Royal Mansion House, 16 June 2010
2 Independent Commission on Banking, *Issues Paper call for evidence*, September 2010
3 Independent Commission on Banking, *Interim Report*, April 2010

universal banking while reducing risks. Without it, capital requirements higher than 10% across the board might well be called for.[4]

The Report said this on the issue of competition:

Reform options for competition

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

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

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

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

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

1.2 The Final Report

The Vickers Commission produced its final Report in September 2011.[5] It included a summary of responses to its interim proposals. In general, there was complete disagreement between parties on virtually all of the issues.

Financial stability: structure
Responses included all possible combinations of views about the effectiveness of 'ring fencing' and higher capital reserves. There was also a range of views about where the 'fence' should sit. Most thought that basic, transactional banking services were within the fence, but there was little agreement on the spectrum of activities that

Financial stability: loss absorbency

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4 Speech by Sir John Vickers 11April 2011

5 ICB Final Report: recommendations; September 2011

Responses varied from those who thought that the capital proposals for banks were too high to those who thought they were not high enough. There was general acceptance of depositor protection, or preference, as well as support for a mechanism by which bondholders would bear losses in crises.

Competition measures.
Some respondents argued that the Commission's view was wrong and that the Lloyds divestiture went too far. Others argued the precise opposite. There was general support for more micro measures to improve competition, namely easier switching between accounts; more transparent pricing; greater use of comparison websites etc. Views on the competition priority for the new regulator – the Financial Conduct Authority were mixed. Some thought that it should have greater powers whereas others doubted its practical efficacy.

Before listing the Reports final reforms, it is worth looking at the aims of the Commission as it saw them:

> The recommendations in this report aim to create a more stable and competitive basis for UK banking in the longer term. That means much more than greater resilience against future financial crises and removing risks from banks to the public finances. It also means a banking system that is effective and efficient at providing the basic banking services of safeguarding retail deposits, operating secure payments systems, efficiently channelling savings to productive investments, and managing financial risk. To those ends there should be vigorous competition among banks to deliver the services required by well-informed customers.
>
> These goals for UK banking are wholly consistent with maintaining the UK's strength as a pre-eminent centre for banking and finance, and are positive for the competitiveness of the UK economy. They also contribute to financial stability internationally, especially in Europe.[6]

Financial stability: ring fencing

The Commission had to decide two things:

Where would the fence sit (which activities should be within it and which without); and

High how should the fence be – what degree of separation should there be between the activities on different sides of the fence.

Where?
The criteria they chose for what activities should be within the fence are shown below:

- contain all deposits from individuals and SMEs, along with any overdrafts supplied to them;
- not be allowed to engage in trading or other investment banking activities, provide services to financial companies, or services to customers outside the EEA;
- within these constraints, be allowed to take deposits from larger companies and provide non-financial larger companies with other intermediation services such as simple loans; and

6 Ibid p7

- where they form part of a wider corporate group, have independent governance, be legally separate and operationally separable, and have economic links to the rest of the group no more substantial than those with third parties – but be allowed to pay dividends as long as they maintain adequate capital levels, which will preserve diversification benefits.[7]

The Commission articulated their principles in terms of what they called mandated services, prohibited services and ancillary services. It admitted that these principles "are not in a format which would be appropriate for legislation or regulatory rules".[8]

Mandated services

These are services which must be provided by only by ring fenced banks – the regulator would remove permission for other banks to provide the service. The services are defined in terms of:

> **Mandated services**. Only ring-fenced banks should be granted permission by the UK regulator to provide mandated services. Mandated services should be those banking services where:
>
> a) even a temporary interruption10 to the provision of service resulting from the failure of a bank has significant economic costs; and
>
> b) customers are not well equipped to plan for such an interruption.
>
> Mandated services currently comprise the taking of deposits from, and the provision of overdrafts to, individuals11 and small and medium-sized organisations.[9]

Prohibited services

These are the services which the Commission thought that ring fenced banks must not be permitted to provide.

> **Prohibited services**. Ring-fenced banks should be prohibited from providing certain services. Prohibited services should be those banking services which meet **any** of the following criteria:
>
> a) make it significantly harder and/or more costly to resolve the ring-fenced bank;
>
> b) directly increase the exposure of the ring-fenced bank to global financial markets;
>
> c) involve the ring-fenced bank taking risk and are not integral to the provision of payments services to customers, or the direct intermediation of funds between savers and borrowers within the non-financial sector; or
>
> d) in any other way threaten the objectives of the ring-fence.
>
> As a result prohibited services should include (though need not be limited to):
>
> a) any service which is not provided to customers within the EEA;

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7 Ibid p29

8 Ibid p36

9 Ibid p38

> b) any service which results in an exposure to a non-ring-fenced bank or a non-bank financial organisation, except those associated with the provision of payments services where the regulator has deemed this appropriate;
>
> c) any service which would result in a trading book asset;
>
> d) any service which would result in a requirement to hold regulatory capital against market risk;
>
> e) the purchase or origination of derivatives or other contracts which would result in a requirement to hold regulatory capital against counterparty credit risk; and
>
> f) services relating to secondary markets activity including the purchase of loans or securities.[10]

In its discussion the Commission accept that separating functions "involves a balance between the costs associated with losing synergies and the benefits of improving financial stability through separation".[11] It rejects extreme forms of separation – the narrow banking model where banks only lend against deposits – and says that "some risk of failure should be tolerated" provided that transmission services can be protected. Neither does it see the 'Volker rule' as a substitute for ring fencing.[12] Whilst the restricted activities under Volker – proprietary trading and investment in hedge and private equity funds – would be 'prohibited activities' under the ring fence rules, there are other activities which deepen the connectivity between institutions which contributes to the sort of collective failure seen in the banking crisis. The commission did not see benefit in preventing ring fenced banks from either lending to or taking deposits from large, non-financial, institutions sited within the EEA.

The Commission describe the impact of its proposals below:

> Broadly, this principle would mean that the majority of the retail and commercial banking divisions of current UK banks *could* be placed in ring-fenced banks, but the wholesale/investment banking divisions could not. At present most, but not all, financial companies are served out of the wholesale/investment banking divisions.
>
> Some of the lending to large organisations currently performed in the wholesale/ investment banking divisions would be permitted within ring-fenced banks. As shown in Figure 3.5, based on the balance sheets of UK banks at the end of 2010 this construction of a retail ring-fence could lead to around £1.1tn-£2.3tn of assets being held within UK ring-fenced banks, or around 75%-160% of current UK GDP. This is between a sixth and a third of the total assets of the UK banking sector of over £6tn.[13]

Ancillary activities

The Commission recognise that ring fenced banks would need to engage in what are normally collectively called treasury functions. This would cover activities such as interest rate hedging often conducted through the derivatives market. It sees no reason why ring fenced banks should not engage in such activity even if they are at the same time not allowed to provide such a service for customers. This dual model is currently in force for building societies and although some societies failed, this was not directly due to their

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10 Ibid p51-52
11 Ibid p41
12 Ibid p45-46
13 Ibid p52

treasury operations. It also suggests that wholesale funding of institutions should continue albeit within tighter constraints than before. The building societies legislation which sets wholesale funding at a 50% limit might not be appropriate for all ring fenced banks, but might be used as a baseline for calibrated measures. The third principle therefore is described thus:

> **Ancillary activities**. The only activities which a ring-fenced bank should be permitted to engage in are: the provision of services which are not prohibited; and those ancillary activities necessary for the efficient provision of such services. Ancillary activities should be permitted only to the extent they are required for this provision, and not as standalone lines of business.
>
> Ancillary activities would include, for example, employing staff and owning or procuring the necessary operational infrastructure. In particular, a ring-fenced bank should be permitted to conduct financial activities beyond the provision of non-prohibited services to the extent that these are strictly required for the purposes of its treasury function – i.e. for risk management, liquidity management, or in order to raise funding for the provision of non-prohibited services. In conducting ancillary activities a ring-fenced bank may transact with and become exposed to non-ring-fenced banks and non-bank financial organisations.
>
> Backstop limits should be placed on the proportion of a ring-fenced bank's funding which is permitted to be wholesale funding and on its total exposures, secured and unsecured, to non-ring-fenced banks and other non-bank financial companies.[14]

How high?

The next phase of the work on the ring fence was to decide how 'high' it should be; i.e. what degree of separation should there be between banks within the fence and those outside. Should they be completely separate institutions or could they be joint subsidiaries of a parent group for example? As the Commission put it:

- Should a ring-fenced bank be allowed to be in the same corporate group as other companies, including those conducting prohibited activities, at all?
- If so, what legal and operational links should be permitted between a ring-fenced bank and its wider corporate group?
- What economic links should be permitted between a ring-fenced bank and its wider corporate group?[15]

The Commission note two main arguments in favour of full separation:

Reputational contagion – banks above all other industries rely on confidence and reputation is a major component of this. So if part of a banking group collapses it will transmit a fatal reputational loss on the ring fenced bank even though it may be separate.

Simplicity - policing and regulating connected groups is complex and hard to enforce in the face of strong incentives for the group to get around the barriers. Full separation is just simpler.

Whilst accepting some of these points the Commission point out that if retail banking generally is performing badly "more retail banks would fail under full separation than under ring fencing". Alternatively, the risk that general investment banking losses could bring down

[14] Ibid p62
[15] Ibid p62

the ring fenced bank could be countered by “insisting that the ring fenced bank is not dependent for its solvency, liquidity or continued operations on the rest of the group”.[16] The Commission also emphasised the need for independent management of the ring fenced bank, to disassociate itself from group incentives or interests.

The Commission noted three arguments against full separation:

- The cost - largely the cost of holding extra capital which could be in the region of £4 billion annually
- The loss of customer synergies – whilst not outright denying their existence the Commission states that it “has received rather little quantitative evidence on [their] magnitude”.[17]
- Illegality – European law places certain obstacles to the full separation model which are not faced by the ring fenced model.

The Commission rejected full separation and offered the following description of its ring fence principle:

> **Legal and operational links**. Where a ring-fenced bank is part of a wider corporate group, the authorities should have confidence that they can isolate it from the rest of the group in a matter of days and continue the provision of its services without providing solvency support.
>
> As a result:
>
> a) ring-fenced banks should be separate legal entities – i.e. any UK regulated legal entity which offers mandated services should only also provide services which are not prohibited and conduct ancillary activities;
>
> b) any financial organisation owned or partly owned by a ring-fenced bank should conduct only activities permitted within a ring-fenced bank. This organisation’s balance sheet should contain only assets and liabilities arising from these services and activities;
>
> c) the wider corporate group should be required to put in place arrangements to ensure that the ring-fenced bank has continuous access to all of the operations, staff, data and services required to continue its activities, irrespective of the financial health of the rest of the group; and
>
> d) the ring-fenced bank should either be a direct member of all the payments systems that it uses or should use another ring-fenced bank as an agent.[18]

The Commission does not set out how it thinks that this principle should be effected but describes various options (pp 67-68).

The final aspect of ring fencing to be looked at was the question of economic linkages between the ring fenced institution and the rest of the group.

[16] Ibid p63
[17] Ibid p65
[18] Ibid p67

Economic links
The Commission noted that even opponents of ring fencing thought that if there was one, it had to be "relatively high to secure the benefits". The issue, in terms of responses centred on whether transactions between the bank and the parent should be treated as being closer or more distant than normal third party transactions. The Commission opted for a 'no more favourable than third party' principle. It is shown in full below:

> **Economic links**. Where a ring-fenced bank is part of a wider corporate group, its relationships with entities in that group should be conducted on a third party basis and it should not be dependent for its solvency or liquidity on the continued financial health of the rest of the corporate group. This should be ensured through both regulation and sufficiently independent governance.
>
> Thus, where a ring-fenced bank is part of a wider corporate group:
>
> a) its relationships with any entities within the same group which are not ring-fenced banks should be treated for regulatory purposes no more favourably than third party relationships;
>
> b) all transactions (including secured lending and asset sales) with other parts of the group should be conducted on a commercial and arm's length basis in line with sound and appropriate risk management practices;
>
> c) where third party arm's length relationships are not ensured through the application of existing regulation, additional rules should be considered;
>
> d) assets should only be sold to and from the ring-fenced bank and other entities within the group at market value. The ring-fenced bank should not acquire any assets from other entities within the group unless such assets could have resulted from the provision of non-prohibited services;
>
> e) the ring-fenced bank should meet regulatory requirements, including those for capital, large exposures, liquidity and funding, on a solo basis;
>
> f) dividend payments and other capital transfers should only be made after the board of the ring-fenced bank is satisfied that the ring-fenced bank has sufficient financial resources to do so. In addition, any such payments which would cause the ring-fenced bank to breach any kind of capital requirement, including requirements to hold buffers above minimum requirements, should not be permitted without explicit regulatory approval;
>
> g) the board of the ring-fenced bank should be independent. The precise degree of independence appropriate would depend on the proportion of the banking group's assets outside the ring-fenced bank. Except in cases where the vast majority of the group's assets were within the ring-fenced bank, the majority of directors should be independent non-executives of whom:
>
> i. one is the Chair; and
>
> ii. no more than one sits on the board of the parent or another part of the group;
>
> h) a ring-fenced bank should make, on a solo basis, all disclosures which are required by the regulator of the wider corporate group and/or its other relevant substantial subsidiaries, and those which would be required if the ring-fenced bank were independently listed on the London Stock Exchange; and

> i) the boards of the ring-fenced bank and of its parent company should have a duty to maintain the integrity of the ring-fence, and to ensure the ring-fence principles are followed at all times.[19]

If the 'no more favourable than third party' principle is applied then this will mean for example, that the exposures between the bank and its parent (in either direction) could be no more than 25% of its capital resources. The Report includes a description of the exposure controls in operation in the United States for comparison (see p70).

The Commission acknowledge that its proposals would mean an end to the currently unregulated pattern of bank structures which it describes as a "complex web of legal entities and intra group relationships".[20] It argues however, that bank structures would retain some flexibility where this did not impinge upon the broader objectives of having a ring fence in the first place. For example, their proposals do not prevent non-bank lending to corporate nor would it prevent groups from dealing with customers across a range of services. They dismiss the view that their solution is too complex to be enforced and cite "precedents in other and other sectors" in support.

Loss absorbency

Capital reserves

As well as looking at the overall structure of the banking industry, the Commission examined proposals for improving the loss absorbency of individual banks.

It starts by examining the current system and illustrates that the higher is a bank's leverage (the more it borrows for any given asset base) the more volatile is the bank's return on capital, such that "relatively small declines in the value of their assets threatened insolvency".[21] This risk was tempered by the existence of implicit government support (the problem of 'moral hazard') but encouraged by the more favourable tax treatment of debt over equity (debt interest is deducted from profits – dividends are distributions of it). There are governance issues too. If debt holders only bear losses on the insolvency of a bank and governments cannot, or will not let banks become insolvent, then debt holders have no incentive to monitor what is done with their money. Taken together:

> So banks' shareholders (and some employees) have an incentive to economise on equity in a way that is not aligned with the interests of wider society. It follows from the above that this incentive arises in two ways. First, the social costs of bank insolvency are greater than the private costs. Second, as a consequence of this banks benefit from an implicit guarantee; this makes debt cheaper than it should be, further incentivising leverage.[22]

The Commission therefore identified a lack of quantity of equity capital amongst the banks and a narrowness of the range of assets which could absorb losses as two key areas for reform.

It is a truth universally acknowledged, that banks will hold more capital and more in the form of 'hard' equity' in the future than they did in the past. The Basel III capital requirements set

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[19] Ibid pp71-72
[20] Ibid p76
[21] Ibid p79
[22] Ibid p82

the level at 8% of risk weighted assets, with further extrusions for systemically important banks and for counter cyclical buffering.[23]

However, the Commission discusses the pros and cons of extending the capital requirements much higher than this 8% minimum. It focuses on equity capital (as opposed to variants of convertible debts) since, it says, "equity is the only form of loss absorbing capacity which works both pre and post resolution (insolvency)". It dismisses the view that higher equity will have a serious impact on banks' ability to function: "Higher equity requirements simply require banks to use less debt and more equity funding".[24] Banks would point out that because of the more favourable tax treatment of debt (see above) their profits may be lower and these costs would be passed onto borrowers. However, if banks use more equity and hence pay more tax, that revenue is not lost to the economy as a whole, it could be recycled in some way either through lower taxes elsewhere or higher government spending. The Commission conclude:

> Moreover, any increase in banks' funding costs from higher minimum equity requirements would not be borne solely by borrowers – it would be likely to be shared with shareholders and employees. So it is not clear how much a bank's average cost of funding would increase with more equity funding, nor how much of any such increase would be passed on to borrowers.[25]

The Interim Report argued that "all large UK ring fenced banks be required to have a minimum equity to risk weighted assets (RWAs) ratio of at least 10% (plus loss-absorbing debt)."[26] Responses to the proposals covered the entire spectrum of too much to too little. In the final Report, the Commission proposed that:

> large ring fenced banks should be required to have an equity 'ring-fence buffer' of at least 3% of RWAs *above* the Basel III baseline of 7% of RWAs. (A ring-fenced bank is defined to be 'large' if it's RWAs-to-UK GDP ratio is 3% or above.) Smaller ring-fenced banks should have correspondingly smaller ring-fenced buffers.[27]

Arguments against a higher level were:

- The continuing tax distortion between debt and equity meant that a significant redistribution between debt and equity might mean a negative impact on growth
- Any bank in the European Economic area (EEA) could simply 'branch' into the UK and would have a competitive advantage over a UK bank
- High equity requirements might encourage the migration of banking activities away from the mainstream and into 'shadow banking' channels.
- Transitional costs. In the current climate, it would take many years to raise sufficient more new capital to achieve the desired ratios. Banks might therefore look to deleverage (stop lending) as a quicker way to meet the ratio targets. This would be undesirable for the economy as a whole

23 See Report p84 for full Basel rules
24 Ibid p86
25 Ibid p88
26 Ibid
27 Ibid p99

The Commission stress that these are minimum ratios, they would expect ratios to be higher at periods when the counter-cyclical Basel phase reaches a peak. The system proposed is composed of several strands. A common reserve plus ring fence buffers, systemic buffers and counter cyclical buffers. According to the proposals Barclays, HSBC, Lloyds, Nationwide, RBS and Santander banks would face the 10% requirement. The Co-Op, Verde and Clydesdale banks would have 7% plus any other ring fence buffers. All other banks would have a 7% requirement.

Debt bail-ins

As well as banks retaining greater amounts of capital, higher levels of equity could be supplemented by 'loss bearing debt'. Under the current system, equity (shareholders) bears all of the losses whereas bond holders (Greece notwithstanding) bear none of the losses unless the bank becomes insolvent. There is no mechanism by which debt can be turned into supporting capital before insolvency takes place. There has been considerable discussion about how such a mechanism might be introduced and what debt instruments might be needed for it to happen. The currently fashionable term for this process is debt bail-in.

The Commission explain the problems with finding an answer:

- Imposing losses on secured debt would fundamentally undermine the concept of taking security under English law.

- Most ordinary deposits are insured by the Financial Services Compensation Scheme (FSCS), so losses imposed on them would largely fall to the FSCS. The FSCS is funded by other banks, but effectively operates with a taxpayer-funded backstop – so losses either act as a channel for contagion from a failed bank to other banks, or are picked up by the taxpayer.

- Imposing losses on derivatives counterparties would prompt them to close out their contracts (where this is permitted under the terms of their contracts). This process is likely to exacerbate losses for the shareholders and other creditors of the failing bank. More damaging could be the disruption to financial markets, including as a result of indirect losses to other market participants resulting from a fire sale of collateral and consequential adverse market and confidence effects.

- There may also be systemic risks involved in imposing losses on 'central counterparties', or in other circumstances where market participants rely on the use of collateral and 'close-out netting' to control their mutual exposures.

- Similarly, imposing losses on short-term unsecured debt and uninsured deposits may – depending on the extent to which such liabilities are regarded as loss bearing *ex ante* – cause significant disruption to funding markets, and act as a channel for contagion from a failing bank to other, previously healthy financial institutions.

- Imposing losses on long-term unsecured debt is more straightforward. (Indeed Tier 2 capital' mandated by the Basel III rules takes this form – see Box 4.2.)[28]

The responses in the Interim Report from the industry focussed upon the possible impact of convertibility on the pricing of bonds. This would affect contingent capital in particular. The Commission accepted this argument but held that bail-in of debt was different. If a bail in

[28] Ibid p100

was needed the bank was unlikely to be able to continue and that the real value of bail in debt would be to increase the chances of an orderly dissolution of the bank, rather than the more ambitious aim of contingent capital which was to allow the bank to carry on. The Commission therefore recommended two new powers for the regulator:

> First, the authorities should have a 'primary bail-in power' to impose losses in resolution on a set of pre-determined liabilities that are the most readily loss absorbing.
>
> This should include the ability to be able to write down liabilities to recapitalise a bank (or part thereof) in resolution.[46] As described in Paragraph 4.63, the class of (non-capital) liabilities that bears loss most readily is long-term unsecured debt. The Commission's view is therefore that all unsecured debt with a term of at least 12 months *at the time of issue* – 'bail-in bonds'[47] – should be subject to the primary bail-in power. Bail-in bonds should have specific risk disclosure acknowledging this. To the extent possible, the contractual provisions of any foreign law governed bail-in bonds should expressly make such debt subject to the primary bail-in power.
>
> 4.78 It is useful at this stage to introduce the concept of 'primary loss-absorbing capacity', being those liabilities that can be regarded as constituting the best quality loss absorbing capacity. 'Primary loss-absorbing capacity' is made up of (i) equity; (ii) non-equity capital; and (iii) to reflect the fact that short-term liabilities are less reliable as loss-absorbing capacity,[48] those bail-in bonds with a *remaining*[49] term of at least 12 months.[50]
>
> 4.79 Second, the authorities should have a 'secondary bail-in power' that would allow them to impose losses on all unsecured[51] liabilities beyond primary loss-absorbing capacity (again, including the ability to write down liabilities to re-capitalise a bank) in resolution, if such loss-absorbing capacity does not prove sufficient.
>
> 4.80 These bail-in powers should add to the other resolution powers that the authorities have at their disposal. Note in particular that any re-capitalisation of a bank through bail-in would most likely be one aspect of the resolution of a failed bank that may also involve the use of other resolution powers, such as property transfers. Bail-in should not simply be regarded as a tool to be used in isolation to re-capitalise a failed bank without further remedial action.[29]

The Commission used previous historical examples of banking crises to determine the amount of loss-absorbing capacity which it thought was needed. According to this "requiring systemically important banks to hold primary loss-absorbing capacity up to 20% of risk weighted assets (RWA) would come at low social cost...[and] primary loss absorbing capacity of 17% of RWAs would have been sufficient to cover nearly all of the loss making banks {in the current and previous crises]". The Commission expected this to be introduced gradually, to all big banks in the UK, the large ring fenced banks and, on a sliding scale, to some smaller banks too.

A summary of the recommendations in this section of the Report is shown below:[30]

> **Recommendations**
>
> 4.132 Equity
>
> • Ring-fenced banks with a ratio of RWAs to UK GDP of 3% or more should be required to have an equity-to-RWAs ratio of at least 10%.

29 Ibid p104

30 Ibid p121

• Ring-fenced banks with a ratio of RWAs to UK GDP in between 1% and 3% should be required to have a minimum equity-to-RWAs ratio set by a sliding scale from7% to 10%.

4.133 Leverage ratio

• All UK-headquartered banks and all ring-fenced banks should maintain a Tier 1 leverage ratio of at least 3%.

• All ring-fenced banks with a RWAs-to-UK GDP ratio of 1% or more should have their minimum leverage ratio increased on a sliding scale (to a maximum of 4.06% at a RWAs-to-UK GDP ratio of 3%).

4.134 Bail-in

• The resolution authorities should have a primary bail-in power allowing them to impose losses on bail-in bonds in resolution before imposing losses on other non-capital, non-subordinated liabilities.

• The resolution authorities should have a secondary bail-in power to enable them to impose losses on all other unsecured liabilities in resolution, if necessary.

4.135 Depositor preference

• In insolvency (and so also in resolution), all insured depositors should rank ahead of other creditors to the extent that those creditors are either unsecured or only secured with a floating charge.

4.136 Primary loss-absorbing capacity

• UK G-SIBs with a 2.5% G-SIB surcharge, and ring-fenced banks with a ratio of RWAs to UK GDP of 3% or more, should be required to have primary loss absorbing capacity equal to at least 17% of RWAs.

• UK G-SIBs with a G-SIB surcharge below 2.5%, and ring-fenced banks with a ratio of RWAs to UK GDP of in between 1% and 3% , should be required to have primary loss-absorbing capacity set by a sliding scale from 10.5% to 17% of RWAs.

4.137 Resolution buffer

• The supervisor of any (i) UK G-SIB; or (ii) ring-fenced bank with a ratio of RWAs to UK GDP of 1% or more, should be able to require the bank to have additional primary loss-absorbing capacity of up to 3% of RWAs if, among other things, the supervisor has concerns about its ability to be resolved at minimum risk to the public purse.

• The supervisor should determine how much additional primary loss-absorbing capacity (if any) is required, what form it should take, and which entities in a group the requirement should apply to, and whether on a (sub-)consolidated or solo basis.

Competition issues

The Commission set out to examine the distinction between "'good competition' to serve customers well, and 'bad competition' that exploits customer unawareness or for example, creates a race to the bottom on lending standards".[31] The Report paints a gloomy picture:

[31] Ibid p153

- Most of the bad issues highlighted in the 2000 Cruickshank Report remain;
- The competition authorities have had to intervene on several occasions in recent years;
- The industry is more concentrated post crisis than it was before; and
- Consumer satisfaction levels are low and the perceived costs of exercising market choice by switching accounts are ‘remarkably’ low.

The Commission recommended

- That the current divestment of RBS and Lloyds Banking Group should be enhanced to create a major new ‘challenger’ in the market;
- The introduction of an account ‘redirection’ service for personal and small business accounts to ‘boost confidence in the ease of [account] switching’;
- Improved transparency of the costs of an account, including interest foregone indicators;
- Competition should be central to financial regulation.

1.3 The Government response to ‘Vickers’

The Government gave its response to the Report by way of a statement to the House on 19 December 2011.[32] In short the Government accepted all of the recommendations, with one notable exception.

It accepted:

- The principle of ring fencing. It was undecided over whether there should be a de-minimis exemption for small banks;

- Large retail banks will have to hold equity capital of 10% and a loss absorbing capacity of 17% for large banks. There could be adjustments of this figure for banks with a large overseas operation which could be shown to pose no threat to UK stability if it failed.

- The principle of depositor preference

- Improved competition – easier switching of bank accounts, to be done within seven days by September 2013. The government did not accept the recommendation that the divestment of Lloyd’s branches should go beyond that required under EU rules.

The Chancellor announced that changes would be made to the concurrent draft *Financial Services Bill* to give the future Financial Conduct Authority a competition objective; and that the Payments Council (responsible for the proposed phasing out of cheques) would be regulated.

The Chancellor gave an estimate for the cost of the reforms. For the banks the cost would be between £3.5 billion and £8 billion, and the cost to the economy as a whole is estimated at £0.8 billion to £1.8 billion. However, these direct costs were, he said, outweighed by the reduced likelihood of a future crisis, valued at £9.5 billion per year.[33]

Regarding the implementation of the Commission’s Report, in his statement the Chancellor said “I can confirm that primary and secondary legislation relating to the ring fence will be

[32] HC Deb 19 December 2011 cc1069-1092
[33] Ibid c1072

completed by the end of this Parliament in May 2015, and that banks will be expected to comply as soon as practically possible thereafter. The Government will work with the banks to develop a reasonable transition timetable." Previously, during an evidence session to the Joint Committee on the draft Financial Services Bill (see below) the Chancellor said that:

> There may be some features of its recommendations which we are able to put into this Bill, particularly, for example, ensuring that the FCA has a proper regard to competition. We have taken the view—and this is a view shared by John Vickers himself— that to try and shoehorn hastily drafted clauses that would implement the ring-fencing part of the Vickers Report into this very important piece of legislation, which is about the crucial issue of how we as a nation supervise financial services, would have been a mistake and would have risked creating poor legislation. We are absolutely committed to putting the Vickers Report into legislation, but we think it is more appropriate to do that with a separate piece of legislation, which we are also committed to introducing.[34]

2 The Joint Committee on the Financial Services Bill

Although not part of the Bill, the committee set up to provide pre-legislative scrutiny of the *Financial Services Bill* took evidence from a number of witnesses about the Commission's proposals. The Committee's Report can be found here. An extract of some of the evidence given is shown below.

Sir John Vickers, justifying ring fencing as opposed to complete separation of banking and investment arms:

> **Q78 Mr Brown:** In defending the ring fence structure in the House of Commons the Chancellor of the Exchequer, in answer to Michael Meacher, said he thought there were strengths in the investment arm of a bank being able at a time of difficulty in its retail arm to transfer money to support that retail arm. Can you explain how that is compatible with a ring fence?
>
> ***John Vickers***: Let me try. This leads to the question of why we did not recommend a full split. One of the arguments for a full split, some would say, is that it deals emphatically with the risk that problems in the non-retail bit would contaminate the retail arm of the bank despite the greater capital cushions and all the rest of it that go with the retail part of the ring-fence design. The argument in the other direction is the one you have alluded to, which is that, depending on the economic and financial shock at issue, there may be some occasions when the retail side is in trouble and globally things are fine. In that circumstance, with a ring fence as distinct from full split, there would be scope for rest of bank to bring in capital to support the troubled retail operations and see them through it. We took evidence on this. We believed that not only would that possibility exist, but there would be very strong reputational incentives for a wider banking group not to let its retail arm in the UK go in those circumstances. Therefore, there are arguments on both sides as far as that is concerned.
>
> It is not just fanciful to suppose that there might be a UK retail problem and not a global one. As we have seen in some other economies, there may be a domestic property market crash, commercial or residential, given the focus of retail lending, whether it is mortgage lending or business lending secured on commercial property, or companies very much involved in commercial property. You can have domestic shocks. Even with fantastically good macro-prudential regulation, you cannot banish that risk. It seems important to retain the possibility of rest of bank supporting the retail operation.

34 Joint Committee on Draft Financial Services Bill, Evidence Q1005

The other set of reasons we went for ring fence rather than full split was that there are, at least arguably, various kinds of synergy between the different banking operations, some would say a diversification benefit, which a full split would lose. The cost-benefit analysis overall led us to the recommendation here.[35]

Q85 Lord Maples: Was the decision as between total split and ring-fencing a difficult one for the commission to make? Was it a finely balanced decision when you thought of this and that, or in the end were you unanimously and overwhelmingly in favour of the ring fence?

John Vickers: As chair of the past commission, we were wonderfully united in our thought process throughout. A year ago I was not counting any chickens at all on that front. I would not describe it as finely balanced as between full split and ring-fence design; we firmly came down in favour of the latter. Rather than it being a binary decision, in our interim report in April we had spoken in general terms about ring-fencing without fleshing it out, so through the summer a lot of our work was on that. At one extreme, ring-fencing by a matter of degree could end up almost as full split. We thought the right way to go was to have a strong fence, ideally with zero porosity, and yet allow co-ownership of different kinds of activity under the same ultimate corporate umbrella. There is some merit in having the benefit of flexibility about where the line is drawn, and it is not so clear how that would fit with a full split. A final point was that there are some EU law issues that would make a full split more difficult to implement, but that was not the decisive consideration. We had come to the collective view before addressing that legal difficulty that a ring-fence design like this was preferable.

Comments by Sir John Gieve – Deputy Governor of the Bank of England during the financial crisis:

Baroness Wheatcroft: Among all the stable doors that have been crashing, attempts to find a resolution regime had been foremost in people's minds. On top of that, we now have the ICB report and its suggestion about ring fencing. Do you think ring fencing would serve any purpose? Will it work? Do you trust the system proposed by the ICB?

Sir John Gieve: It is a sensible proposal. I do not think it will work in the sense it will make it possible to let Barclays or Barclays Capital go to the wall in a crisis. When there is a real crisis of confidence the main channels of contagion are not the mechanical question of who owes what to whom and uncertainties over that; it operates much more through confidence. We definitely reached the stage in 2008 when we had to save everything—there was really nothing too little to save—in order to prevent a contagious loss of confidence across the system.

If we get into those circumstances again, as we could quite soon, it may well be impossible for the Government or the authorities to step aside, even with these ring fences, and say, "We're saving only this bit and letting this bit go to the wall." It will make it easier to manage the rescue and make creditors pay towards the cost of it than it was in 2008. If it is operated properly it will lead to a greater transparency in the structure of our big banks which are made up of thousands of intertwined companies, mainly for tax and regulatory reasons. If you can create greater correspondence between the businesses and legal structures that will make the handling of a crisis much easier, and would help you to deal with an idiosyncratic failure in a way that put the bills in the right place.[36]

35 Joint Committee on Draft Financial Services Bill, Evidence Q302
36 Ibid 27 October 2011, Q681

Comments by the heads of Barclays, HSBC and Royal Bank of Scotland:

> **David Mowat:** I would like to turn to the ICB report specifically on ring-fencing. Is it your judgment that they have it about right in their proposals?
>
> ***Stuart Gulliver***: It remains to be seen. As has been said at previous Committees, it is obviously a "done deal". The Government wish to introduce this. It would not be our most preferred way of doing it. To my earlier point, there have been several examples in history of narrow ring-fenced institutions also failing. They are happening in Spain at this moment in time. This is what the UK wishes to do; therefore we will implement it.
>
> **David Mowat:** That sounds like a no.
>
> ***Stuart Gulliver***: No. We don't really know what the end impact of this is at this moment in time. For example, the number that is in the ICB report does not contain the cost of moving a pension fund from within your ring-fenced bank into your non-ring-fenced bank and having to crystallise all of the catch-up required for your defined benefits scheme. Those kinds of technical details are not covered and are often not in that cost-benefit analysis, for example. Also, when the cost-benefit analysis was applied across all assets in the banking system, it of course includes our global balance sheet at £2.7 trillion, of which 70% is outside the UK so it has a bit of a dilutive effect on the basis point cost of the whole thing. It will absolutely help solve the issue that the ICB has been asked to solve. It will absolutely be implemented and absolutely we will all implement it, but all I am saying is that it is not as crystal clear cut, and nor will it be, until we see what implementation takes place.
>
> ***Bob Diamond***: We keep being asked if it was the right decision. [...] It certainly would not have been my first choice. It will add costs to banking and, therefore, it will increase the cost of borrowing, but we can live with it and we are going to implement it. The decision has been made and so I want to be as positive as I can and run the best ring-fenced bank that I can. There are a lot of positives. There is flexibility. As banks, we certainly would have liked to have said there is one model of ring fence that fits all of us, so let's implement that, but there is not. The Independent Commission and the Chancellor have given flexibility. They have given a time frame that is supportive of not overreacting in the UK. There are a lot of positives to this and we are going to make it work, but it would not have been my first choice.[37]
>
> **David Mowat:** I want to follow up on your answer. My specific question is whether or not it is feasible for a non-ring-fenced bank of the sort of size that your banks are to be allowed to fail—could you imagine a scenario of that happening and the world carrying on?
>
> ***Bob Diamond***: Yes. It is very important to us. We have asked the FSA to put us right at the front of the queue in terms of a test case, if you will—I don't think it is formally that. We are implementing operational subsidiarisation. We have spent £30 million this year, and we will probably spend half of that again next year, in the hope that, by early next year, at the end of the first quarter, we will have everything in place so that, if there were an issue in some area of the bank, the regulators would be able to provide all that is necessary to allow that to be cauterised and the rest of the bank to operate. There are a lot of moves being implemented around resolution and recovery, bail-in bonds and potential contingent capital which, at the end of the day, we hope very much support that banks can be allowed to fail. So I am saying, yes, I can conceive that.
>
> ***Stuart Gulliver***: I would also say yes. The recovery and resolution work that has taken place with the FSA and the international work that has taken place with the Financial

[37] Ibid 1 November 2011 Q737-8

Stability Board is all aligned to reach a situation where an institution such as HSBC, if it were to get into difficulty, could fail in a way that inflicted losses on its equity holders and bond holders but not taxpayers. That would absolutely be the aim.

[...]

On the wider point, we would absolutely expect to be in a situation where nobody is too big to fail. As Bob says, we want to be in a position where we are not beholden to taxpayers in any way, shape or form. We want to be in a situation where our investors carry the losses and we must be resolvable completely.[38]

Comments by the Bank of England witnesses.

David Mowat: My first question is about the ICB recommendations on the ring fence. Earlier this week we had a session with leaders of the main banks. They seemed to accept the recommendations, or at least were prepared to implement them, or intended to implement them. Is your judgment that the ICB got it about right?

Sir Mervyn King: It is a difficult and complex business. Each person will be tempted to move more or less in that direction. I am broadly comfortable with where they are. It is a very good report. The Government created a commission of outstanding individuals, and it would be unwise to go against their recommendations. They thought it through

David Mowat: Have you given any thought to how you would regulate the ring fence?

Sir Mervyn King: The one point that occurs to all those who might be in the regulatory community, depending upon whether the Bill is passed, is: to what extent should the definition of the ring fence be a role for the regulator, as opposed to a role for Parliament in setting out the legislation? Our strong view is that as far as possible this should be done in legislation and not left to the regulator. I say that because the difficulty that will arise with this approach is that the banks and their lawyers will have enormous amounts of money, time and resources to come up with all kinds of clever ways to try to get round the rules set out in legislation. Unless those rules are pretty clear the regulator will be chasing the banks round in a circle and will come under enormous pressure.

One of the major problems in regulation in the last 10 to 20 years has been that of regulatory capture. By that I do not mean people were bought off but that the sheer weight of resources, time and legal effort put in by banks to try to persuade regulators that what they were doing was compliant with the rules made life extraordinarily difficult for the regulators. I would suggest that, as far as possible, you take the ring-fencing aspect of the Vickers Commission proposals in a separate Bill and make sure those are got right in the process of legislation.

David Mowat: Is there anything else that you would have liked to see in the ICB report?

Sir Mervyn King: They have examined this in great detail. We talked to them about it. This is now the only game in town. The banks have said they are prepared to accept and implement this. I don’t think there is any merit in reopening this, so we should go ahead and implement it.[39]

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38 Ibid Q744

39 Ibid, 3 November 2011 Q762 &766

3 The Parliamentary Commission on Banking Standards

3.1 Birth of the Commission

The birth of the Parliamentary Commission (the Commission) can be traced back to the revelations about Barclay's (and as it would emerge later, plenty of other institutions too) attempted manipulation of the LIBOR interest rate benchmark which became public in June 2012.

In some respects it might be a surprise that the attempted manipulation (which may not have succeeded) of a fairly obscure (to large sections of the public at least) city index, with a virtually incalculable effect though likely to be very small and which would have generated random winners and losers, should cause such a hue and cry. Compared to the real economic losses caused by the financial crash any impact of LIBOR related misdeeds is virtually undetectable in scale. However, in the public eye banks and their employees had suddenly crossed a line. They no longer appeared to be greedy and/or incompetent, now they had been exposed as 'cheats' and 'fixers' in ways that most people could intuitively understand as being wrong. It was this 'tipping point' event that, as the Parliamentary Commission would later put it that "public confidence in bankers and banking [was] shaken to its roots". A strong political response was to be expected.

The Chancellor updated the House with details of the FSA's investigation and the conclusions drawn from it. He promised further action surrounding the destination of FSA fines and the possibility of new or redrawn regulatory or criminal offences to cover such behaviour.[40] On 2 July 2012, the Chancellor announced a series of steps in response to the LIBOR revelations. One was the setting up of the Wheatley Committee to advise on legal reforms which could be incorporated into the *Financial Services Bill* which was then currently proceeding through Parliament.[41]

Both outside the House and within it, there were loud demands to 'do more' about banking. On 5 July 2012 an opposition debate on professional standards in the banking industry calling for an independent enquiry; the Government amendment, which was passed called for a joint committee to examine the issues.[42]

On 16 July 2012 the House approved the following resolution:

> (1) That a Committee of this House be established, to be called the Parliamentary Commission on Banking Standards, to consider and report on—
>
> (a) professional standards and culture of the UK banking sector, taking account of regulatory and competition investigations into the LIBOR rate-setting process;
>
> (b) lessons to be learned about corporate governance, transparency and conflicts of interest, and their implications for regulation and for Government policy;
>
> and to make recommendations for legislative and other action.[43]

40 HC Deb 28 June 2012 c465
41 HC Deb 2 July 2012 c612
42 HC Deb 5 July 2012 c1112
43 HC Deb 16 July 2012 c795

Legislative complexity

Readers should be aware of the complex current state of legislation as at the start of 2013.

Even whilst the *Financial Services Bill 2012* (**the Act**) was still progressing through its parliamentary stages, incorporating changes made by amongst other influences the Wheatley Review and the Chancellor's promises to act over LIBOR, the Treasury published a draft version of its latest legislation – the *Financial Services (Banking Reform) Bill* (**the draft Bill**).[1]

Both the Act and the draft Bill amend the ruling legislation namely the *Financial Services and Markets Act 2000* (**FISMA**). The fact that the draft Bill amends FISMA - which had not yet finished being changed by the Act at the time that the draft Bill was published makes it currently very difficult to establish what FISMA actually is, or will be once the draft Bill becomes law.

A version of FISMA as if amended by the Act's provisions when it was introduced into the Lords is available on the Treasury website here. Significant changes were made to the Act (and hence FISMA) during the Lords proceedings so this updated version is by no means correct and, hence, references in the draft Bill are also subject to change as the Act (FISMA) it amends no longer exists in the form it once did.

3.2 Parliamentary Commission's Report

The Commission published its first report on 21 December 2012.[44] Although the Commission has a wide remit the first report focussed almost entirely on the issue of the structural separation of the activities of banks as proposed by the Vickers Commission. In particular the report looked at the proposals as contained in the draft bill (see above). Since the timetable for the introduction of the Bill is early in 2013, this dictated the timetable of the Commission's publications. The broad conclusion of the Commission is that the history of financial regulation suggests that clever, innovative and inventive employees in the financial services industry always have an incentive to test the limits of any prohibition; in a sense to find their way around any prohibition. The commission's view therefore is that not only should the Government stick to a hard line version of Vickers but that it must introduce disincentives for firms to try and test the separation boundaries. In its words, the Commission wants to 'electrify' the ring fence.

The summary of the Commission's first report is shown below:

> Separation that can stand the tests of time
>
> Investigations into LIBOR have exposed a culture of culpable greed far removed from the interests of bank customers, corroding trust in the whole financial sector. The

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[44] Parliamentary Commission on Banking Standards; First Report; HC 848, HL 98 2012/13

separation of deposit-taking from certain investment banking activities can offer benefits not just for financial stability, but also in helping to address the damage done to standards and culture in banking. The Government has proposed a ring-fence to achieve separation, but any ringfence risks being tested and eroded over time. Pressure will come from many quarters. Any new framework will need to be sufficiently robust and durable to withstand the pressures of a future banking cycle. The precautionary approach of regulators will come under pressure from bank lobbying, possibly supported by politicians. Additional steps are essential to provide adequate incentives for the banks to comply not just with the rules of the ring-fence, but also with their spirit. In the absence of the Commission's legislative proposals to 'electrify' the ring-fence, the risk that the ring-fence will eventually fail will be much higher.

Electrifying the ring-fence

The Commission recommends that the ring-fence should be electrified – that banks be given a disincentive to test the limits of the ring-fence. This should take the form of two measures, set out in statute from the start, which could lead to full separation. First, if the regulator has concluded that the conduct of a banking group is such as to create a significant risk that the objectives of the ring-fence would not be met in respect of a particular bank, it should have the power (subject to a Treasury override) to require a banking group to implement full separation. Second, there should be a periodic, independent review of the effectiveness of the ring-fence across all banks, with the first such review to take place four years after implementation. Each review should be required to determine whether ringfencing is achieving the objectives set out in legislation, and to advise whether a move to full separation across the banking sector as a whole is necessary to meet those objectives.

The approach to legislating

The draft Bill relies too heavily on secondary legislation, the absence of drafts of which has seriously impeded the Commission in assessing the Government's reforms. The jury is still out on the question of how faithfully the Bill will implement the ICB recommendations.

Furthermore, reliance on secondary legislation reinforces the risks to the durability of the ring-fence. It creates uncertainty for the regulators who will be charged with making the new framework operational and for the banks required to operate within it. The draft Bill proposes to leave the Government with too much scope to redefine the location of the ringfence arbitrarily. Not only is the scrutiny provided for this inadequate, it will also provide an incentive for bank lobbying. The powers to re-define the ring-fence through secondary legislation need to be subject to more rigorous scrutiny, with changes to the location of the ring-fence to be considered by a small ad hoc joint committee of both Houses of Parliament before formal measures are brought forward.

Capital and leverage

It is essential that the ring-fence should be supported by tougher capital requirements, including a leverage ratio. Determining the leverage ratio is a complex and technical decision, and one which is best made by the regulator. The Financial Policy Committee (FPC) cannot be expected to work with one hand tied behind its back. The FPC should be given the duty of setting the leverage ratio from Spring 2013. The Commission would expect the leverage ratio to be set substantially higher than the 3 per cent minimum required under Basel III.

1 Other Reports and documents

There have been a number of Treasury Committee Reports into matters that are within the Vickers' remit, two in particular:

Competition and Choice in retail banking; Treasury Committee Ninth Report 2010–12, HC 612, April 2011.

The Report found that the British banking system was not very competitive, a fact worsened by the forced consolidations due to the credit crisis. It saw measures to promote competition, especially, promoting new entrants as being the key to improving the position. It drew attention to the short term versus long term interests of the divestment of national bank shareholdings. In the short term sales of shares into an unreformed market might bring a greater financial yield; however, in the longer term, a more dynamic and competitive market might raise GDP growth rates.

Too Important to Fail - Too Important to Ignore; Treasury Committee Ninth Report 2009–10, HC 261, March 2010

The summary from this Report sets out the issues behind this key policy area:

> This Report looks at the range of reforms currently under consideration, and assesses them against the objectives of an orderly banking system such as protecting the consumer, protecting the taxpayer, setting an appropriate cost of doing business and providing lending to the economy. There are trade-offs between these objectives: the more consumers are protected, the more risks tax payers may have to bear; the more banks have to pay for their capital, the higher the rates they will charge their customers. Policymakers will have to decide where the trade-offs should properly be made and how this should be explained to the public who understandably want to see rapid and sustainable change.
>
> Successful reform would transfer risk away from Government and back into the banking sector. We are clear that radical reform is necessary but it cannot be achieved immediately: if it were done too quickly the cost to banks and to their customers would increase too quickly to be absorbed. But it has to be done. The collapse of Lehman Brothers showed that the failure of an interconnected systemically important international firm has widespread and cataclysmic implications. An indication of improvement will be a system which enables a large international institution to go bankrupt smoothly—and where prices in financial markets do not implicitly or explicitly assume a government guarantee.[45]

The section of the Report on 'Structural Reform' goes to the heart of the issue about whether big, diversified banks are better than narrow, functionally separate banks.

> 90. Mr Corrigan [Managing Director, Goldman Sachs Bank USA] told us that:
>
> it is a little hard for me to envision a world in which we did not have financial institutions of size and financial institutions that have large amounts of capital to commit to the market place. If you look at one of the examples I use in the statement, it is in the aftermath of the crisis we had a situation in which private partners, thank goodness,

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45 *Too Important to Fail - Too Important to Ignore*; Treasury Committee Ninth Report 2009–10, HC 261, March 2010

had been able to raise something in excess of half a trillion dollars in fresh capital for banking institutions. The amount of risk that a small number of institutions had to be willing to 'fess up to accomplish that is very large. It is a little hard for me to see how that would happen if we had a world of just narrow banks.[101]

Mr Varley [Chief Executive, Barclays] was also keen to point out that:

The fundamental point I am making is that investment banking is real economy work. What is it that Barclays Capital does? It offers risk management and financing products to those it serves. Who is on the list of those it serves? The British Government, the French Government, the South African Government, John Lewis, Network Rail and Harvard University. These are real economy players. This is not some activity that takes place in the corner of a room which you might designate as proprietary trading; this is risk management work and it is financing work that lies at the heart of industry and governments to create employment. That is why it is important that these businesses exist within a universal bank.[102]

91. However, not all the witnesses were as sure of the benefits of large banks. Professor Kay provided the following commentary:

a large part of the synergies which we are talking about in these global banks are to do with tax, regulatory arbitrage and the kind of cross-subsidy we were talking about earlier, so from a public policy point of view we should not have very much sympathy with these synergies—the difference between the structure of HSBC and Barclays that you were describing is a lot more noticeable to Barclays than it is to the customers of either of these two banks. Going on from that, if one talks of other industries, people are endlessly talking in these industries about the desire of large corporations to buy from a single global supplier. I have heard that every year in telecoms, for example, since telecom privatisation began. Most of the evidence is that most of their customers do not: they want to pick and choose who are the best suppliers for particular goods. There are some synergies of that kind, but I do not think we should go overboard about that.[103]

The Governor of the Bank of England stated that: "I do think that I would like to see an outcome in which the size and variety of activities contained within these big institutions, if they are going to be financed in the way they are, is a lot less. To have a small number of big institutions dominating world banking is not a healthy position to be in, and I think the implicit subsidy is in part responsible for that".[104] And Mr Haldane has questioned whether large banks are a necessity:

[...] the economics of banking do not suggest that bigger need be better. Indeed, if large-scale processing of loans risks economising on the collection of information, there might even be diseconomies of scale in banking. The present crisis provides a case study. The desire to make loans a tradable commodity led to a loss of information, as transactions replaced relationships and quantity trumped quality. Within the space of a decade, banks went from monogamy to speed-dating. Evidence from a range of countries paints a revealing picture. There is not a scrap of evidence of economies of scale or scope in banking—of bigger or broader being better— beyond a low size threshold. At least during this crisis, big banks have if anything been found to be less stable than their smaller counterparts, requiring on average larger-scale support. It could be argued that big business needs big banks to supply their needs. But this is not an argument that big businesses themselves endorse, at least according to a recent survey by the Association of Corporate Treasurers.[105]

Or, as Mr Corrigan conceded, although "It is a little hard for me to see how that [recapitalisation] would happen if we had a world of just narrow banks. You can turn around and say maybe we would not have had the problem in the first place."[106]