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Client briefing
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The UK Independent Commission on Banking's Interim Report

The Independent Commission on Banking (ICB) was appointed by the UK coalition government shortly after it came to power last year. On Monday 11 April, the ICB published its Interim Report.

The ICB's current view is that all systemically important banks (including wholesale and investment banks) and any other large UK retail banks should have a minimum capital ratio of common equity tier 1 to risk weighted assets of 10%. The ICB provisionally recommends ring-fencing UK retail banks into separate subsidiaries and has confirmed that it will not pursue a number of more severe structural measures.

The ICB's Interim Report also looks at, and suggests means to tackle, the perceived weakening of competition in, and perceived barriers to entry to, the UK retail banking market.

Key Issues

- **UK Independent Commission on Banking has published its Interim Report**
- **Interim recommendation to enhance capital adequacy of systemically important financial institutions**
- **Proposal to ring-fence UK retail banking to separate subsidiaries**
- **Narrow, full reserve, and limited purpose banking and size restrictions dropped but Glass Steagall not ruled out**
- **Proposals addressing perceived barriers to entry into retail market**

Background

The Independent Commission on Banking was appointed by the UK coalition government shortly after it came to power last year. The ICB has been charged with considering the UK banking sector, and looking at structural and non-structural measures to reform the banking system and to promote competition.

In September 2010, the ICB published an Issues Paper, which set out and sought from the industry and public views on, and evidence in respect of, a wide range of proposals. On Monday 11 April, the ICB published its Interim Report, setting out its current provisional views on the possible reforms, and seeking further responses.

The closing date for responses to the Interim Report is 4 July 2011.

Financial Stability Reform

Structure of the Interim Report

The Interim Report is structured as follows. Chapter 2 identifies stability and competition problems in the UK banking sector, assessing the need for reform and setting out an analytical framework for the ICB's proposals. Chapter 3 sets out how the ICB's work is aligned with other UK and international reform initiatives. The substance of the report is in Chapters 4 and 5, which examine reform options aimed at improving financial stability and competition respectively. Chapter 4 focuses on loss-absorbency and structural separation and assesses the likely impact of such reform options on competitiveness, with a full cost benefit analysis at Annex 3. A detailed comparison of different loss-absorbency tools is set out at Annex 6 and an illustration of how a 'retail ring-fence', the ICB's favoured structural reform option, might be designed is at Annex 7.

The immediate reaction of the markets, industry and media alike, on publication of the Interim Report, was to check whether the most aggressive structural reform measures had been dismissed by the ICB. The following structural reform measures have been taken off the table by the ICB: narrow banking, full

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reserve banking, limited purpose banking and restrictions on the size of institutions. Contrary to some headlines, a Glass-Steagall style structural separation of retail banking into different corporate groups from wholesale/institutional banking has not been dismissed outright by the ICB, although the ICB is tending strongly against recommending such approach.

The ICB's currently favoured stability proposals are a self professed "moderate combination" of aggressive, but not as draconian as may have been feared, capital and structural reform measures.

Capital ratios
The ICB's current view is that all systemically important banks (including wholesale and investment banks) and any other large UK retail banks should have a minimum capital ratio of common equity tier 1 to risk weighted assets of 10% (compared with the Basel III ratio of 7%, which includes the capital conservation buffer). However, the Financial Stability Board (FSB) is concurrently looking into the question of importing additional capital charges, above the Basel III ratio, on systemically important financial institutions (SIFIs). The ICB states that its recommended 10% minimum ratio is unlikely to exceed the FSB's ultimate requirements for SFIs. This remains to be seen, but in any event, the scope of UK retail banks caught by the 10% charge could be greater than the scope of SIFIs covered by the FSB's proposals. Moreover, the ICB adds the caveat that its proposed 10% minimum ratio is on the basis that bank debt is effectively loss-absorbing – the ICB therefore leaves itself with enough wriggle room to recommend much more severe capital ratios in its final report.

Ring-fencing of retail banking
On the structure of universal banks, the ICB has come out clearly in favour of the subsidiarisation of UK retail banking businesses. Beyond simply forcing a segregation of capital, this "retail ring-fence" is likely to include limits on the exposures between the retail subsidiary and the rest of the banking group. Although this would involve additional restrictions on the transfer of capital between entities, the ICB acknowledges that it may be possible to structure such a group to allow the transfer of excess capital (above minimum safeguard levels) from the wholesale/investment banking business to support the retail business and vice versa.

Although, from a high level, such proposals seem clear enough and the ICB seems fairly settled on the need to ring-fence the UK retail operations of universal banks, it is far less certain about which activities should fall under the category of 'retail' and the Interim Report's efforts to define what constitutes retail banking are not wholly successful.

Annex 7 of the Interim Report provides an illustrative list of such activities. As an absolute minimum, the activities that would have to be performed within the ring-fence would include only the taking of insured deposits. There are a certain number of activities which may or may not be carried on within the ring-fence and certain activities which, it is suggested, must not be performed within the ring-fence. The latter activities include trading in derivatives, and it is worth noting that even the US Dodd-Frank legislation allows, in certain limited circumstances, such derivative trading to be carried on by banking entities. As an alternative to a classification based on activities, the Interim Report suggests that what falls within the ring-fence could be determined by customer type, so that certain customers can only receive services from certain types of entities, but notes that this model "limits customer choice and may require there to be an arbitrary cut-off point within the corporate client base".

The Interim Report stresses the need for robust definitions as an anti-avoidance measure but goes on to concede that, subject to regulatory oversight, "some flexibility could be allowed – with some activities being permitted both within the ring-fence and outside it". It also suggests that the FSA's authorisation regime could be used as the basis for classifying the specific activities falling within the ring-fence and that regulatory and resolution powers may need to be reviewed in light of any such split.

Clearly for some universal banks the reality of separating an integrated UK retail business will be far easier said than done. The degree of the challenge ahead will depend mainly on the current structure of the particular bank in question but the detail of where the ring-fence will fall, will also be a major factor.

Branches of overseas banks
The proposed treatment of retail branches of non-UK banks is not entirely clear, nor is how such ring-fencing requirements will interact with overseas legislation and regulation.

Whilst the ICB indicates that rules relating to UK ring-fencing rules will apply to UK branches of non EEA banking entities and UK incorporated subsidiary retail banks, it accepts that such rules would not apply with respect to UK branches of EEA banks operating under a passport. Such branches are predominantly subject to the prudential requirements of their respective home state regulators, over which the UK government has no jurisdiction, and the ICB no authority.

Competition Law Reform Options

The Interim Report focuses on competition issues in retail banking and states that it will not investigate competition in wholesale banking further, partly due to the global nature of some of the investment banking markets and the absence of strong representations from customers in this area.

Within retail and SME banking, the Interim Report argues that competition has weakened as a result of the crisis with challenger banks mostly disappearing and Lloyds Banking Group holding large market shares across a number of retail markets. The Interim Report identifies a number of possible measures to improve competition.

The Interim Report suggests that the UK Government seek agreement with Lloyds Banking Group to revisit and substantially enhance the divestment business which it is obliged to sell as part of the European Commission's 2009 State aid decision. The main reason given is the ICB's belief that the divestment business as currently agreed would not have a sufficient impact on competition in the UK retail banking markets.

Switching and other barriers to entry

The Interim Report also suggests tackling a number of perceived difficulties for customers switching accounts, consumer choice and barriers to entry more generally:

- *Switching*: The Interim Report states that the switching process could be improved in the short term by mandating a set time period within which banks would guarantee to switch customers' bank accounts. Another possible solution would be to create a redirection system to transfer debits and credits from the old account automatically to the new account. The ICB has provisionally stopped short of considering bank account portability, although has stated that it will do so if there are no effective solutions to the issues around switching.
- *Barriers to entry*: The Interim Report acknowledges the increased burden of prudential regulation on small banks. It is therefore seeking further evidence on how to mitigate this burden, by finding a less costly way to allow smaller banks to use advanced risk management systems, sharing capabilities between larger and smaller banks or some other form of support for new entrants to meet high capital requirements. The ICB will also investigate further arrangements which may improve smaller banks' ability to provide cash handling services to SME customers, enabling them to serve business customers better.

Role of the FCA

The Interim Report recommends that the Financial Conduct Authority (FCA) (one of the new regulatory bodies proposed in the context of the overhaul of the UK regulatory system) should have a clear primary duty to promote competition. The ICB believes that FCA's range of regulatory tools will enable it to be a "vital spur to competition in banking". In particular, the ICB sets as potential tasks for the future FCA to review price discrimination (including the free if in credit model) and the access to, and governance of, the UK payment systems.

Comments on the competition law proposals

The Interim Report presents few surprises, although there are a number of issues which are worthy of note:

- The biggest surprise in the Interim Report relates to the suggested expansion of the Lloyds divestment arrangements. From a practical perspective, an agreement between the Government and Lloyds to enlarge the divestment business may be difficult to achieve. In addition, as a result of the increased size of the business (and an assumed increase in deposits), although potentially a more viable competitor, it may be less feasible for a small player or new entrant to purchase the business in a situation where the larger players are prevented from doing so by the State aid decision. In addition, under the decision Lloyds is bound to approach potentially interested buyers by no later than 30 November 2011 and complete the disposal by 30 November 2013. The uncertainty and delay caused by the Interim Report seem unlikely to benefit the shareholder in the long term.
- Absent an enlargement of the Lloyds divestment business, the Interim Report suggests that there may be a case for a Competition Commission market investigation into retail and SME markets. Although the Competition Commission has a wide range of powers, including divestment of assets, the process can take up to two years and is likely to create a substantial amount of legal uncertainty.
- The structural remedies are likely to have a knock-on impact on competition in banking. The ring-fencing of retail banking and the increased capital requirements (in particular, those specifically for larger retail banks) are likely to increase costs for consumers and it seems impractical for them to be borne solely by the investment banking divisions of the UK banks.
- The Interim Report does not address free if-in-credit banking, which was raised by many financial services players as one of the main issues related to transparency, switching and therefore a barrier to expansion for smaller banks. Instead, the ICB suggests that the FCA review "price discrimination", although recognising that price discrimination and cross-subsidy can even be pro-competitive in certain circumstances.
- The upholding of free if-in-credit banking also begs the question of how some of the costs of the interim recommendations (such as those related to switching) will be recovered by the retail banks.

Conclusions

The markets reacted relatively favourably to the publication of the Interim Report, on Monday morning. This reflected the fact that the ICB had confirmed that some of the more draconian restructuring proposals were being taken off the table.

What is encouraging is that the ICB has correctly identified that the primary issue is resolution – namely ensuring a regime whereby failing banks can be restructured so that the essential (i.e. retail and infrastructural) parts survive, and other parts are allowed to fail without loss to the taxpayer. The ICB has eschewed extreme crowd-pleasing measures, and facile comments about casino versus utility banking.

The ICB has left itself a fair amount of room for manoeuvre before its final report, expected in September this year. The Interim Report gives us a helpful indication, but the ultimate outcome of the ICB review remains uncertain.