THE FINANCIAL SERVICES PRACTITIONER PANEL

RESPONSE TO THE HM TREASURY CONSULTATION ON
'BANKING REFORM: DELIVERING STABILITY AND SUPPORTING A SUSTAINABLE ECONOMY'
AND
'THE FUTURE OF BUILDING SOCIETIES'
JULY 2012

06 September 2012

Introduction

The Financial Services Practitioner Panel welcomes the consultations on Banking Reform and the Future of Building Societies. We support the Government's objective to create greater stability in the UK retail banking and building society sector, and understand the rationale behind the proposals that have been put forward. Whilst we welcome a number of these, we also have some specific concerns as highlighted below.

Executive Summary

Overall:

1. *The Panel is **supportive** of the intention to improve financial stability, and in general of proposals to increase loss-absorbency and increase competition in the sector*
2. *However, the Panel is **concerned** that there has not been sufficient consideration of other international regulatory reforms in this space*
3. *The Panel **supports** a leverage ratio of 3%, rather than the ICB-proposed 4.06% for large institutions*
4. *However, it has **concerns** around the cost estimates provided in the Report*
5. *The Panel **supports** the introduction of creditor priority*
6. *The Panel **believes** the Government should avoid placing unnecessary restrictions on activities that would be extremely unlikely to give rise to systemic failures*
7. *The Panel **has concerns** about proposals to include all those engaged in financial intermediation as prohibited counterparties*

Sector-specific:

8. *The Panel **supports** amendments to the Building Societies Act*
9. *The Panel believes insurance firms **should not** be on the list of prohibited counterparties for ring-fenced banks*

Detailed paper:

Overall:

1. *The Panel is supportive of the intention to improve financial stability, and in general of proposals to increase loss-absorbency and increase competition in the sector*

The Panel supports global efforts to secure greater financial stability, as well as the Government's objective to enhance competition for its domestic banking sector. We remain strongly supportive of the goal of ensuring that the UK's key financial institutions are sufficiently capitalised and so organisationally structured as to help prevent another financial crisis. The Panel also welcomes efforts to ensure that UK banks and building societies stay competitive and continue to offer valuable services to their customers.

As you will know, the financial services industry remains divided on the benefits of implementing a ring-fence based on lines of business. Although there is recognition amongst many of the potential benefits that could accrue, others have concerns regarding the cost and whether in fact other alternative structures could deliver the same outcome. As such, this response will not comment on the issue of ring-fencing specifically.

2. *However, the Panel is concerned that there has not been sufficient consideration of other international regulatory reforms in this space*

There have already been substantial costs and benefits from a large range of international regulatory reforms that aimed to reduce the probability of another crisis and mitigate its potential impact. The paper mentions that other reforms in this area include Basel III, reforms by the Financial Stability Board and a range of proposals from the G20. In addition, there is extensive work being done at the European level, through a High Level Expert Group led by Erkki Liikanen, on reforming the European banking sector.

Recognition by the Government of ongoing/recent reforms is welcome. However, we are concerned that despite such acknowledgement, the subsequent paper still discusses proposed reforms as though they were taking place in isolation. For proposals discussing how to address specific past policy mistakes or regulatory flaws, it proceeds to propose reforms on the basis that no change has taken place.

We believe that it is key to recognise that there are already significant reforms underway, with quantifiable benefits. As such, we would urge the Government to not only continue to engage on international reforms, but consciously consider imminent proposals in the international arena before implementing UK stability measures.

3. *The Panel supports a leverage ratio of 3%, rather than the ICB-proposed 4.06% for large institutions*

The Panel recognises that the intention of the leverage ratio is to provide a 'backstop' to the risk-weighted capital requirements. However, the ICB proposals to raise the leverage ratio above the internationally agreed ratio of 3% could have the unintended consequence of incentivising those firms who have a predominantly low risk balance sheet to increase their risk taking.

As such, the Panel agrees with the Government that a 3% leverage ratio is appropriate for UK banks and building societies.

4. *However, it has concerns around the cost estimates provided in the Report*

The Panel has concerns that the increased funding costs included in the Commission's assumptions are flawed. The Panel believes that although part of the cost to banks is the incremental spread required by the market to compensate for withdrawal of an implicit 'government guarantee' and the higher loss to creditors should there be a default as identified by the ICB, the actual funding requirements are likely to be higher than the report predicts. This is due to the implied incremental spread requirements being backward-looking as banks are being funded increasingly on a collateralised basis, and the spread requirement on residual unsecured debt is rising beyond the assumptions in the ICB report.

The cost estimates also do not include a number of items with potentially significant impact on affected firms. These include the impact of separating the Pension Scheme and the proposed removal of joint and several liabilities for both Pension and Group VAT arrangements.

The Panel also has concerns regarding the requirement for institutions to meet primary loss-absorbing capacity on a consolidated basis. The analysis provided by ICB assumes that banks already have this in place and that no further cost would be incurred. However, not all large institutions have this in place, and there may be significant cost implications. For banks who are predominantly funded through core deposits, this could force banks to raise additional wholesale funding and significantly increase costs.

We propose the Government consider these additional points further.

5. *The Panel supports the introduction of creditor priority*

The Banking Reform White Paper accepted the ICB's recommendation to introduce FSCS-insured depositor preference upon insolvency. Currently, all bank depositors rank pari passu with unsecured creditors, whilst those in building societies are subordinate.

The Panel welcomes the confirmation that relevant provisions of the 'Butterfill' Act will be implemented simultaneously to the bank reforms, ensuring that both insured and uninsured depositors are in the same position whether they are with a bank or a building society.

6. *The Panel believes the Government should avoid placing unnecessary restrictions on activities that would be extremely unlikely to give rise to systemic failures*

Although supportive of improving financial stability, the Panel is keen for the Government to avoid placing restrictions on low-risk activities for the ring-fenced banks, where those activities would be extremely unlikely to give rise to systemic failures. For instance, the Panel has previously provided its support to work that seeks to ensure there is a range of simplified products appropriately branded and available to consumers. Should the distribution of retail investment products be unable to operate via ring-fenced banks going forward, consumer access to many simple financial products would be significantly restricted.

We further agree that the proposals may give rise to inadvertent frictional costs for customers, and we would therefore urge the Government to continue to consult extensively as it develops its detailed policy framework.

7. *The Panel has concerns about proposals to include all those engaged in financial intermediation as prohibited counterparties*

The paper outlines the Government's view that those institutions who engage in financial intermediation should be included in the list of prohibited counterparties.

The Panel appreciates that the paper states that this would be subject to judgement, but would nonetheless like to raise strong concerns about what this could mean in practice. A broad range of financial institutions engage in some form of financial intermediation, and including a reference to this in the definition of prohibited counterparties could severely restrict the number of entities that would be able to interact with the ring-fenced bank. We are not persuaded that all such entities would pose a high enough risk to warrant such restriction. We would therefore encourage the Government to re-think this requirement.

Sector-specific:

8. *The Panel supports amendments to the Building Societies Act*

The Government proposes not to include building societies in the ring-fencing legislation, but to amend the Building Societies Act to ensure the building societies' sector faces similar restrictions to banks. The Panel is supportive of this measure, and believes this is a sensible approach given the legislative restrictions on building societies' treasury and risk management activities that already exist in the Act.

9. *The Panel believes insurance firms should not be on the list of prohibited counterparties for ring-fenced banks*

The Panel feels there are inconsistencies in the thinking in the Government's paper around the treatment of insurance firms.

Section 2.32 of the paper rightly notes that not all types of financial institutions will have the same capacity to either transmit contagion or offer the same opportunity for arbitrage. The paragraph suggests that the definition of prohibited counterparties for ring-fenced banks should capture institutions that a) engage in financial intermediation and b) may be highly leveraged, have a high degree of maturity or liquidity mismatch, or a high degree of financial interconnectedness. However, the paper subsequently goes on (section 2.33) to explicitly include insurance companies in the list of types of institution that should be restricted in terms of dealings with ring-fenced banks, despite insurers not meeting these criteria.

The Panel believes this approach fails to recognise the fundamental differences between insurers and banks. The Government has previously acknowledged that insurers are important providers of liquidity and that they do not engage in maturity transformation; nor are they systemic/interconnected in the same way as banks – when insurers fail, they do so very slowly.

As such, we would argue that insurance firms should be removed from the 'restricted' list.