News Bulletin

April 29, 2011

ICB Interim Report on UK Banking Reform

Background

The UK's Independent Commission on Banking (the "Commission") published its much anticipated interim report (the "Report") on 11 April 2011. The Commission was established by the UK government in June 2010 under the chairmanship of Sir John Vickers with the task of examining possible structural and related non-structural measures to promote stability and competition in UK banking. In September 2010 the Commission published an Issues Paper[1] which, on top of suggesting possible options for reform, was also a call for evidence. The Report sets out the Commission's provisional views on possible reform options and seeks further feedback and submissions in response to it. The Commission will make its final recommendations in September 2011 to the Cabinet Committee on Banking Reform.

We summarise below the principal features of the Report.

The Report focuses first on the effect of the global financial crisis on the UK's financial sector, which it notes is large, relative to the UK's GDP, and concentrated in a small number of institutions. For instance it estimates that Citigroup's assets constituted 16% of U.S. GDP at the time of its public bail-out, compared to a figure for RBS's assets of 99% of the UK's GDP at the time of its bail-out. In its view, this was a practical illustration of what had been understood for some time—that systemically important banks enjoy an implicit government guarantee because they are considered too big (or interconnected) to be allowed to fail. In the UK, the relative scale of the public bail-outs have served to emphasise, in the Commission's view, that the too-big-to-fail problem needs to be contained by introducing reforms that reduce the likelihood of failure of systemically important institutions and, if they do fail, reduce the impact of their failure. This could be achieved, in its view, by providing for the orderly resolution of failing institutions, as well as reducing levels of risk in the financial system as a whole, but it cautions that these reforms must be tailored so that they do not disproportionately affect the ability of the financial system to provide financial services that are critical for the "real economy".

As a separate topic, the Commission has also proposed initiatives to address its perceived weakening of competition in the UK retail banking industry as a result of the financial crisis. For instance, it estimates that following its acquisition of HBOS plc, the Lloyds Banking Group currently has around 30% of all current accounts in the UK.

The Commission asserts that structural and behavioural changes are necessary to improve conditions for competition in UK retail banking to counter the increased concentration and loss of challengers to the large

[1] ICB Issues Paper: Call for Evidence (September 2010), http://bankingcommission.independent.gov.uk/bankingcommission/wp-content/uploads/2010/07/Issues-Paper-24-September-2010.pdf.

incumbent banks as a result of the crisis. The Report considers three initiatives to help improve competition. The first consists of structural measures, such as imposing on the Lloyds Banking Group an even greater requirement to divest itself of assets and liabilities than it is already subject to pursuant to European Commission conditions for the approval of aid it has received from the UK Treasury. Second is to improve conditions for consumer choice in the banking sector by making it easier for customers to switch bank accounts. The aim of improving consumer choice in this way is to help reduce existing barriers to the entry of new competitors in the retail banking sector. The Commission considers that it should be possible to introduce such a system at a reasonable cost within a short timescale. Third is giving the Financial Conduct Authority a primary duty to promote competition as it will have regulatory tools not available to the general competition and consumer authorities, hence placing it in a strong position to play this role.

The remainder of this note focuses primarily on the financial stability proposals of the Commission.

Bank Stability

The Report states that measures to promote bank stability should be focused on making banks better able to absorb losses, making it easier and less costly to rescue banks that get into trouble and curbing incentives for excessive risk taking. The approach the Commission currently favours is a compromise between full structural separation of retail banking and investment banking and very high capital requirements, so as to balance the benefits of such measures with the associated costs. Its proposed measures include making bank debt more effective at absorbing losses, imposing high (but not excessive) capital requirements, and an internal ring-fencing of UK retail banking services within universal banks.

Increasing Loss-Absorbing Capacity

The Report divides loss-absorbing capacity into two categories, depending on whether it increases the ability of a bank to absorb losses before it fails and goes into resolution ("going concern" capacity), or only when the bank fails and enters resolution ("gone concern" capacity). Pre-resolution loss-absorbing capacity directly reduces the probability of bank failure by reinforcing the ability of a bank to take losses without failing. Post-resolution loss-absorbing capacity reduces the impact of bank failure by allowing losses to be absorbed by the shareholders and creditors of a bank rather than others (including taxpayers) being affected.

The Commission states that both going concern and gone concern loss-absorbing capacity can have an indirect effect on bank stability by exposing banks' owners and creditors to the risk of losing money, hence aligning their incentives with risk management so as to reduce the probability of failure. It therefore believes that increasing loss-absorbing capacity reduces the impact of failure on the rest of the financial system and the economy and therefore reduces taxpayer exposure. It believes that limiting the implicit government guarantee, which is especially relevant to systemically important financial institutions ("SIFIs"), can mitigate both the "too big to fail" problem (which gives rise to moral hazard concerns in encouraging banks with the benefit of an implicit state guarantee to take excessive risks and giving them a competitive advantage over other institutions) and the "too big to save" problem (where public finances are insufficient to bear the costs of bailing out a failing bank).

The Commission notes that the most straightforward and well-understood form of loss-absorbing capacity is equity and states that it has given substantial consideration to the appropriate minimum amount of equity it believes a SIFI should hold. It also observes that debt can be structured to absorb losses and in this regard it considers:

- **contingent capital** – debt instruments that are written down or convert into equity at some point whilst the bank is still viable;

- **bail-inable debt** – liabilities that are written down or convert into equity at the point of non-viability; and
- **depositor preference** – ranking (at least some) depositors above other unsecured creditors in a bank insolvency.

Equity and the SIFI Surcharge

The Commission, in considering the amount of equity that should be held by banks, has had regard to the minimum regulatory capital requirements set out by the Basel Committee for Banking Supervision ("BCBS") in its recent Basel III papers, in particular the amount of common equity tier 1 capital ("CET1") (comprising ordinary shares, share premium and reserves) to be held by banks against their risk-weighted assets ("RWAs"). It notes that although risk weights have in recent history done a poor job of assessing how much capital should be held against assets, they are the "backbone" of the Basel Capital Accord and so should be used in finding a ratio for the amount of equity to be held by banks. The Report notes the minimum requirement under Basel III that banks hold at least a 7% ratio of CET1 to RWA (consisting of a 4.5% minimum common equity requirement and a 2.5% capital conservation buffer). The Commission states that recent studies of appropriate levels of CET1 as a percentage of RWA provide a recommended minimum ranging from between 7% to 20%. The Commission concludes that a 7% ratio is an important step in increasing a bank's loss-absorbing capacity but is clearly insufficient for SIFIs. The Commission states that it believes the minimum credible "SIFI surcharge" over the Basel III 7% minimum is 3%, which should take the form of an increased equity buffer, rather than an increase to the hard minimum requirement, so that a SIFI's minimum ratio of CET1 to RWAs should be 10%. The Commission believes that this will makes SIFIs safer and incentivise them to reduce their systemic importance to avoid or reduce the cost of having to hold extra capital.

The Commission acknowledges the ongoing work in the international community, including by the Financial Stability Board ("FSB") and BCBS, in relation to SIFIs and their minimum capital requirements. It believes that UK banks (including SIFIs) active in international markets should not be required by regulation to hold more equity than that ultimately agreed at an international level, provided that such banks have credible resolution plans, including effective loss-absorbing debt. Regardless of international consensus in relation to the SIFI surcharge, the Commission believes, however, that large retail banking operations in the UK should be backed by an equity ratio of at least 10% (so a minimum SIFI surcharge of 3%).

The Commission also believes there may need to be a distinction between different SIFIs and some may need a CET1 ratio above 10% or be subject to additional requirements, (such as having to issue additional loss-absorbing debt compared with other SIFIs). The Commission also stresses that its conclusion on the appropriate minimum level of equity for SIFIs is based on the assumption that bank debt can also be made loss-absorbing (as set out below). If this cannot be achieved, it believes minimum equity levels would need to be significantly higher.

Contingent Capital

The Report describes contingent capital as debt that is designed to convert into equity or be written-down on the occurrence of some trigger event while a bank is still viable. The aim of contingent capital is therefore to recapitalise a bank under stress to leave it able to continue as a going concern. The Report notes that there are various advantages of contingent capital compared with equity, including that it is cheaper than equity, both because it is senior and (assuming interest payments are tax deductible) is more tax efficient. Another perceived advantage is that contingent capital mitigates the "debt overhang" problem at times of stress (where shareholders have weak incentives to raise additional equity at times of crisis as debt holders reap more of the benefit) as a conversion (or write-down) that effectively recapitalises the bank without requiring the shareholders to provide additional funds. Furthermore, the Commission notes that the prospect of any conversion diluting existing shareholders provides an incentive to those shareholders to raise more equity to ensure a bank remains well-capitalised to steer well clear of the trigger.

The Commission acknowledges that there remain a number of uncertainties in relation to the effectiveness of contingent capital as a loss-absorbing instrument. These uncertainties include the appetite and ability for investors such as insurance companies and pension funds to hold large quantities of contingent capital instruments; and the importance of holders of contingent capital instruments being able to bear the risks associated. If they are not able to bear the potential losses, a conversion or write-down could act as a channel for contagion from the failing bank to another section of the financial system. The Commission also notes the "death spiral" concern associated with contingent capital. This concern is that when the market senses that a bank is nearing the trigger point in relation to its contingent capital, this could have a negative impact on the bank (including encouraging existing shareholders to sell their shares to avoid dilution causing a rapid decline in its share price), speeding up its decline and increasing the chance of conversion or write-down and thus actually weakening financial stability.

Bail-in

The Report describes bail-inable debt as acting in the same way as contingent capital except that the write down or conversion into common equity occurs at the point of non-viability and requires intervention by the regulator. The Commission states that, although such debt may allow some of a bank's operations to continue as a going concern, it may just enable the solvent bank to be resolved in a solvent manner. In identifying which of a bank's liabilities should be bail-inable the Commission notes that although it would be possible to identify certain types of debt that would be subject to bail-in (the recent EU consultation papers suggest all senior debt could be subject to bail-in subject to certain exceptions), this would incentivise banks to avoid issuing such debt. It suggests, as an alternative, that banks could be required to hold a minimum amount of bail-inable debt (which is also suggested as a possibility in the EU consultation papers).[2] The Report states that bail-in may be particularly valuable as a resolution tool for investment banking businesses where there are particular challenges in view of the fundamental differences in the insolvency regimes around the world. A degree of international agreement as to the mechanics of bail-in would therefore be helpful in overcoming this problem and allowing global banking businesses to fail more safely.

Depositor Preference

The Commission proposes that all or some depositors should be ranked above senior unsecured creditors on a bank's insolvency for two principal reasons. Firstly, retail depositors are not as well-placed as other senior unsecured creditors to monitor and discipline banks' risk taking, and therefore the subordination of the senior unsecured creditors would better align the incentive of such creditors to discipline banks with the ability to do so. Secondly, although retail deposits are guaranteed (up to a limit (currently £85,000)) by the Financial Services Compensation Scheme (the "FSCS"), the FSCS guarantee transfers some of the risk relating to a bank's activities away from that bank and its creditors to the banking system as a whole (with an effective back-up from the taxpayer). The depositor preference would create a buffer that would absorb losses prior to depositors (and therefore potentially taxpayers) suffering a loss. The Commission believes this could make failing banks easier to resolve, especially where there is a political motive for avoiding losses for retail depositors. The Commission also states there may be grounds for extending depositor preferences to deposits beyond those that are FSCS-insured, as in the U.S.

Creating a priority for depositors would be a significant move in the UK where there has historically been no priority in insolvency between different classes of unsecured creditor. If such priority is limited to deposits guaranteed by the FSCS, it would be likely to mitigate the effect of any future public bail-out by providing the FSCS with a priority position over other creditors in respect of any amount paid by it. If other depositors also had

[2] The European Commission has recently published a consultation paper on the technical details of a possible EU framework for bank recovery and resolution, which included a consideration of bail-in: http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf.

a priority, this benefit would be reduced and it would also give rise to a greater likelihood of creditors seeking to structure their lending arrangements as deposits.

Structural Reform

The Report proposes isolating the UK retail banking activities within a universal bank (being a large bank conducting a wide range of activities including wholesale and retail banking) and placing the retail banking activities into a separately capitalised subsidiary (or a "retail ring-fence"). Such structural change would be designed to combat the risks associated with universal banks, including that (i) their failure is likely to have a high impact on the banking system and society, (ii) there is more likely to be contagion from their failure, in terms of it causing a failure of other retail banks, (iii) universal banks generally hold less capital compared to assets than if they were segregated, and (iv) to the extent universal banks extend the scope or scale of expected public support, their risk taking is subsidised by the taxpayer.

The Commission proposes that universal banks would be required to maintain minimum capital ratios for their UK retail banking operations (and for their businesses as a whole). It is not envisaged that this would be a strict segregation. Banks could therefore transfer capital in excess of the minimum requirement internally between the retail and wholesale/investment banking operations. The Commission states, however, that if the bank as a whole does not have sufficient capital, the ring-fence would prevent the wholesale/investment banking operations from depleting the resources of the retail banking operations below a minimum safeguard level. The ring-fence would therefore constrain a bank's ability to move capital only to the extent that it would not otherwise meet the minimum capital levels required in its UK retail operations.

The Commission notes that a critical issue will be to determine which activities and assets fall within the retail ring-fence. The Commission provides little in the way of firm proposals although it states that "retail banking" means broadly the provision of deposit-taking payment and lending services to individuals and SMEs. It states that an important question for the design of any ring-fence will be the treatment of deposit taking, payment and lending services to mid-sized and large companies (also referred to as commercial banking). Annex 7 of the Report also sets out an illustration of how a ring-fence could work in practice, divided into three categories:

- activities which must take place in the ring-fence (the only activity the Commission states must be included here at a minimum is the taking of retail deposits explicitly insured by the FSCS);
- activities which may take place in the ring-fence—essentially services typically required by individuals and SMEs, such as current accounts, savings accounts, mortgages, credit cards, business loans, consumer loans, etc.; and
- activities which may not take place within the ring-fence including capital markets services, trading and hedging activities.

The Commission also identifies a key issue as to how the ring-fence would be enforced. It believes that the ring-fence should be strong enough to ensure the retail business can be resolved separately from the rest of the group and not cause contagion in the other parts of the group. However, it believes that it should ideally be possible for the rest of the group to support the retail entity but not to jeopardise it, and vice-versa. For illustrative purposes it believes rules underlying the ring-fence arrangements could include:

- if a subsidiary obtains a licence to conduct retail deposit-taking it can only engage in activities permitted to take place in a retail ring-fence;
- a parent company will not be permitted to transfer capital out of the retail entity if such transfer would result in the entity falling below its minimum regulatory capital ratio;
- a retail subsidiary cannot hold equity in other group companies;

- intragroup exposures by, or guarantees from, the retail subsidiary will be treated as third-party exposures for regulatory purposes;
- the retail subsidiary must have access to operational services which will continue in the event of insolvency of the rest of the group; and
- the retail subsidiary and the rest of the group must enter into separate master netting agreements.

The Commission also states the geographic scope of the ring-fence should be considered. Its initial view is, subject to certain safeguards, there should be no need to impose a functional separation on the non-UK activities of UK-headquartered banking groups. It does, however, believe further consideration needs to be given to the extent to which a UK retail subsidiary should be allowed to conduct retail banking in other parts of the world.

Other Types of Separation Compared

The Commission considers a number of alternatives to their preferred structural segregation proposal set out above including:

- **Full Separation**: The Report considers the option of full separation between the retail banking and investment banking activities so that both legal entities are not in the same corporate group. Although this would guarantee separability in a crisis and thus make resolution easier, the Commission believes that the costs would be higher than is necessary to address the problems associated with systemically important universal banks. It states that full structural separation would remove the intra-bank diversification benefits and so eliminate the possibility that one part of the group could save another part. It would also extinguish economies of scale between retail and investment banking and prevent customers who require both retail and investment banking services sourcing them from the same provider. One concern that the Report highlights in relation to retail and investment banking being in the same group is that in a crisis, managers of a corporate group will typically seek to support all entities within that group even if they are not legally obliged to do so. The Commission states that a way of combating this would be to ensure that the rules relating to transfers of capital within the group are robust enough to prevent managers depleting the level of capital below the minimum safeguard levels.
- **Operational subsidiarisation**: Such a structure would involve the infrastructure that supports the bank (such as the computers, data, intellectual property, staff and buildings) being transferred to a separate subsidiary. The rationale for this is that, coupled with the development of recovery and resolution plans, this would allow the continuation of some of the bank's functions in a crisis. The Report believes that whilst such a structure could be complementary to ring-fencing of UK retail banking activities, such a structure of itself does not address many of the concerns relating to the universal banks highlighted by the Commission, including the systemic consequences of a failure.
- **Volcker Rule equivalent**: The Commission considers a form of separation along the lines enacted under the Dodd-Frank Act in the U.S., referred to as the Volcker rule, which prohibits deposit-taking banks from conducting proprietary trading subject to certain exceptions and limits their investments in hedge funds and private equity funds. The Commission concludes, however, that the impact of a rule along those lines in the UK would not be significant, since the activities of dedicated proprietary trading limits within UK universal banks have typically represented a small proportion of the bank's assets. In addition, the Commission's proposed retail ring-fence would have the effect of separating its retail banking activities from its proprietary trading, as well as other activities.
- **Other forms of subsidiarisation**: The Commission's preferred approach is to target only the UK retail banking activities of those banks which fall under the regulation of the UK banking regulator, whether a UK-headquartered bank or the UK subsidiary of a foreign bank. However, the Commission also considered other forms of separation, such as requiring UK-headquartered banks to separate their retail banking operations globally, either along purely geographic lines or purely functional lines. It rejected

these approaches on the basis that authorities in other jurisdictions should be free to act in their own jurisdictions according to their own views and needs.

- **Narrow banking**: Narrow banking involves retail deposits being held in "narrow banks" and being backed entirely by safe, liquid assets. Although this conceivably would obviate the need for retail deposit guarantees, deposit-taking entities would not be allowed to lend to businesses and households, and such lending would have to be carried out by other entities. The major objection to this is the dual negative effects of lowering interest rates on deposits and increasing borrowing costs for businesses and households, due to the inability of the deposit-taking bank to invest deposits in higher-return assets, and the inability of the lender to fund itself from deposits.
- **Full reserve banking**: Full reserve banking is an even more restrictive model than narrow banking, as it requires banks to retain sufficient funds in cash to cover all deposit liabilities. Even more so than narrow banking, therefore, the Commission considers that this would shrink the amount of credit available to businesses and households.
- **Limited purpose banking**: Under limited purpose banking, would-be "lenders" invest in shares issued by mutual funds, with each mutual fund targeting a different level of risk and return, and different borrowers being matched with different mutual funds accordingly. In this way, all financial intermediation is carried out by mutual funds. However, as with narrow banking, economic value added by traditional bank intermediation would be reduced under such a structure.
- **Size limits**: The Commission also considered an overall limit on the total size of a bank's assets or market share—the main benefit being that smaller banks tend to be easier to resolve when they fail, but having the added advantage in the Commission's view of improving levels of competition. However, it considers that firm size limits are difficult to set and calibrate and risk distorting incentives for banks that are approaching the size limit.
- **Payment systems**: One last structural reform proposal considered was the structural separation of the payments system from other banking activities, in order to increase its resilience. However, the Commission noted that the payments system cannot continue to function in the absence of instructions from the relevant parties involved in the payment in question, and therefore that protecting the operation of payment systems would be best dealt with in the ongoing work on banks' recovery and resolution plans.

Competitiveness

The Report considers the impact of the Commission's contemplated reforms on the competitiveness of the UK financial industry and the wider economy. The Report comes to the conclusion that the reforms would support the competitiveness of the economy and would be likely to have a broadly neutral effect on financial services. This is because firstly they would only impact a relatively small proportion of the international financial services industry based in the UK; and secondly, increased financial stability will help, and not hinder, the competitiveness of the financial and non-financial sectors. The Report states that more resilient banks are therefore central to maintaining London's position as a leading global financial centre, not a threat to it.

Summary and Next Steps

The Commission's proposals in respect of loss absorbency are largely in line with other international initiatives. In suggesting a 3% equity surcharge for SIFIs it has, however, done so in advance of the conclusions of the FSB and the BCBS although it has indicated that, subject to certain safeguards, it does not believe UK banks should be subject to a greater equity requirement than other SIFIs following international agreement. This is subject to the important exception that large retail banking operations in the UK should be backed by an equity ratio of at least 10%. Unless this figure is ultimately included within the Capital Requirements Directive for all European banks, this would not, however, currently be binding on the UK branches of banks which are authorised in another EEA jurisdiction and could therefore give a competitive advantage to foreign banks providing retail banking services in the UK though a branch.

However, one of the primary concerns of the UK banking sector at the outset of the Commission's appointment has so far failed to be realised—the commission has not recommended a more extreme form of structural reform, such as full separation of retail and non-retail banking, that would potentially place UK banks at a competitive disadvantage across their different business divisions generally, nor across all their global operations.

Nevertheless, the direct and indirect costs of implementing and operating the retail ring-fence should not be underestimated. The Commission acknowledges that the costs of a UK retail ring-fence may be material, although it dismisses one estimate of the annual private costs of a UK retail ring-fence as being £12–£15bn, stating that the bottom end of such estimate is significantly higher than the sum of the top of the ranges of more detailed assessments received individually by the Commission from those banks which appear most likely to be affected by the ring-fence.

There is still some way to go before any of the proposals in the Report become enacted in the UK. The Report is expressed to be the Commission's "current and provisional" views, on which they are consulting. Responses on this consultation may be submitted up until 4 July 2011. Even when in final form, the Report will constitute only the recommendations of the Commission to the UK government, and the progress of the reforms thereafter will be subject to any amendments the government wishes to make before presenting the bill to the UK Parliament.

In particular, further work will be required in terms of defining exactly what activities are to be included in any retail ring-fence. There is currently very little in the way of specific provisions in the Report in this regard, and there is likely to be intense debate around which activities currently in the "may be included in the retail ring-fence" category under "Structural Reform" above, should be inside the ring-fence and which should be outside, as this is going to have significant cost and operational implications for UK banks.

The Commission also needs to develop further its thinking as to types and levels of loss-absorbing debt (such as contingent capital and bail-inable debt) that should be held by UK banks, because it has stressed that its recommendations of a minimum CET1 ratio of 10% for SIFIs are dependent upon bank debt being able to be loss-absorbing, and that the CET1 ratio would have to be higher if that were not possible. To the extent that this resulted in UK SIFIs being required to maintain a higher CET1 ratio than foreign banks were required to hold, pursuant to the recommendations of the FSB and the BCBS for SIFIs when these are finalised, the additional capital requirements could place UK SIFIs at a competitive disadvantage to their foreign peers.

Further detail is also needed as to what types of deposit the Commission thinks should be afforded priority over other unsecured bank debt, given the significance of the changes that could ensue to UK banks' funding structures as a result.

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