TREASURY, RISK
AND FINANCE
PROFESSIONALS
ACT

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The Association of Corporate Treasurers

Comments in response to
White Paper - Banking reform: delivering stability and supporting a sustainable economy
From HMT / BIS
June 2012

September 2012

The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the back of these comments and on our website www.treasurers.org.

Contact details are also at the back of these comments.

We canvas the opinion of our members through seminars and conferences, our monthly e-newsletter to members and others, *The Treasurer magazine*, topic-specific working groups and our Policy and Technical Committee.

General

The ACT welcomes the opportunity to comment on this matter. We have previously provided feedback to the Vickers Independent Commission on Banking and accordingly we confine our comments here to the most important proposals.

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We note the Government's intention to reduce the perceived implicit guarantee to support failing banks and to insulate critical banking services from shocks elsewhere in the financial system. We broadly support these objectives and have indicated this support in our previous submissions to the Vickers Commission.

We accept the objectives of the policy for ring-fenced banks to operate as clearly independent, separate entities, and not be established in such a way as to impede their resolution or the resolution of the wider group. It appears that the proposed design of the ring fence generally can achieve the separation required but still retain sufficient flexibility to prevent undue distortions and inefficiencies in the market. This flexibility is to be welcomed.

Response to Specific Questions

Consultation question 1

- *What are your views on the appropriate threshold above which firms should not be required to place their deposits in a ring-fenced bank?*
- *Do you believe that firms below this level should have the opportunity to opt out of this requirement if they meet certain criteria? If so, what should those criteria be?*
- *What are your views on the appropriate threshold above which individuals may opt out of placing deposits in a ring-fenced bank? How should it be measured and at what level should it be set?*
- *What are your views on the Government's proposals for dealing with instances where SMEs or individuals cross those thresholds? Should this be set as an assessment over a sustained period? What should this period be?*

A key role of banking, and valuable social benefit, is to mobilise deposits to provide loans to businesses of all sizes. We therefore welcome the proposal that larger companies will able to choose whether to deposit with the ring-fenced bank or the non ring-fenced side and equally be able to borrow from either side. However by making deposits from individuals and SMEs a mandated (or protected) service, that class of depositor will have to deal only with the ring-fenced bank. We hope that the limits above which a depositor can go outside the ring fenced bank will be set reasonably low or allow for some sort of self certification of awareness of the risks.

The white paper proposes that the thresholds beyond which a depositor is no longer required to deal with the ring fenced bank be set by reference to company size or for individuals by reference to free and investable assets. We are proposing an alternative basis based on size of actual deposits.

Beyond the FSCS £85,000 threshold deposits with the retail bank are likely to be subordinated to the insured depositors. Market trends are for large portions of bank funding to be secured in some way (insured deposits, covered bonds, central bank funding etc) so that unsecured depositors with a bank could find themselves heavily subordinated were the bank to fail. Such depositors may like to choose whether it is preferable to be in effect a subordinated creditor of a ring-fenced bank or unsubordinated creditor of the non ring-fenced side. Rather than set company size limits or net worth threshold those depositors with more than £85,000 should have the ability to decide for themselves which side of that bank they prefer to invest with. The non ring-fenced bank would therefore be free to take deposits from SMEs or individuals that are greater than £85,000 or are smaller than that where they are informed that there is already £85,000 held with the ring-fenced side.

Consultation question 4

- *What are your views on the scope of activities to be prohibited? Should any other activities be included or excluded?*
- *What are your views on the conditions proposed for exempting the provision of certain derivatives to third parties from the general prohibition on trading in derivatives?*

We believe that smaller businesses, perhaps with only one or two bank relationships, use their banks as their access to most financial services including equipment leasing, provision of trade finance, guarantees and letters of credit, provision of derivative instruments (foreign exchange etc.) as well as general finance. Small firms benefit from greater simplicity in their credit based relationships, and indeed can find it difficult to set up lines with other banks who do not win business from the core banking account services.

It is crucial that companies of all sizes can continue to buy derivative products from the ring fenced bank. We welcome the statement in 2.39:
It is the Government's view that a ring-fenced bank may be permitted to provide 'simple' derivatives products to its customers, provided that a number of conditions are met.
And in 2.40:
These proposals will enable ring-fenced banks to provide a full range of services to individuals and SME customers, while ensuring that the vast majority of other investment banking services remain firmly outside the ring-fence.

In 2.41 you indicate that a 'simple' derivative could be one, or a combination of, the following:

- *an instrument whose purpose is to fix or cap client market exposures to interest rate or foreign exchange rate risk related to the business of the ring-fenced bank (for example lending and payments services);*
- *an instrument defined by the Prudential Regulation Authority (PRA) as standardised and for the purpose of hedging only interest rate and/or foreign exchange risk in deep and liquid markets (for example no derivatives classified as Level 2 or 3 under the fair value hierarchy.*[14]

We have a concern that the second strand of this definition could potentially be taken very narrowly and in practice could leave most small companies unable to execute their most basic of derivative needs with their normal bank, namely setting forward foreign exchange rates. Based on your definition in the footer below forward FX contracts would appear to be Level 2 in the fair value hierarchy because their fair value is calculated using valuation techniques and are not based on quoted market prices.

Locking into forward FX rates is not "standardised" since a quoted market does not exist but this is nonetheless a very standard product, meaning a normal and common transaction done by companies to manage business risk from importing or exporting. Every deal is tailored and unique to that customer, albeit based off prices in a highly liquid and deep market, and will include a component related to the credit risk of the party. We counsel you to set the eventual definition so that smaller companies can continue to deal forward FX rates with their retail ring-fenced banks.

[14] Fair value measurements in Levels 2 and 3 of the fair value hierarchy are determined using valuation techniques and not quoted prices directly observable in active markets. In particular, Level 3 assets are those whose fair value cannot be determined using observable measures, such as market prices or models. Level 3 assets are considered illiquid, and fair values can only be calculated using estimates or risk-adjusted value ranges. Banks with a high proportion of Level 3 assets on their balance sheets would likely face severe problems in market valuation in case of distress, thus affecting market confidence.

The Association of Corporate Treasurers

The Association of Corporate Treasurers (ACT) is the leading professional body for international treasury providing the widest scope of benchmark qualifications for those working in treasury, risk and corporate finance. Membership is by examination. We define standards, promote best practice and support continuing professional development. We are the professional voice of corporate treasury, representing our members.

Our 4,200 members work widely in companies of all sizes through industry, commerce and professional service firms.

For further information visit www.treasurers.org

Guidelines about our approach to policy and technical matters are available at http://www.treasurers.org/technical/manifesto.

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