

Submission to HM Treasury consultation on banking reform: draft secondary legislation

The CBI welcomes the opportunity to respond to HM Treasury's consultation on draft secondary legislation for the Financial Services (Banking Reform) Bill. The CBI's contribution to the structural reform debate focuses on the "business user" view of the banking system, helping to align the stability objectives of reform with the need for banks to continue to provide the finance and services businesses need to grow.

This submission focuses on two of the three draft orders currently under consultation: the *Ring-fenced Bodies and Core Activities Order* and the *Excluded Activities and Prohibitions Order*.

This submission makes the following points:

- **Businesses need three fundamental services from the banking system**
- **Businesses should be able to hedge risk directly with a ring-fenced bank**
- **Businesses should be able to access trade finance products directly from a ring-fence bank**
- **The FCA has an important role to play in determining the appropriateness of individual products and policing their market deployment**
- **Added flexibility should be built into the ring-fence rules**
- **The self-certification process strikes a good balance for business but changes could help prevent businesses fluctuating across the threshold**
- **If well specified an agency model has the potential to work for some businesses but further details are needed to fully understand how this would work**

Businesses need three fundamental services from the banking system

The CBI supports the provision of a range of services from within a single banking relationship. Small and medium sized businesses value a single point of contact with their bank through a relationship manager who understands their business model and future strategy.

CBI members use the banking system in three main ways:

- **Lending and providing other forms of finance:** businesses need finance to invest and expand their operations, thereby delivering economic growth and job creation.



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- **Managing risk:** banks help businesses guard against common business risks such as changes in currency exchange rates, interest rates or commodity prices.
- **Providing payment mechanisms and cash management services:** businesses use banks to manage their capital efficiently, ensuring they have enough cash to operate and that any spare cash is well managed.

Businesses should be able to hedge risk directly with a ring-fenced bank

When appropriately marketed and sold the ability to manage normal business risk arising from fluctuations in currency, interest rates and commodity prices is important for businesses seeking to grow.

The CBI acknowledges the requirement that only simple derivatives be sold to customers from inside the ring-fence and we support the Treasury's exemptions for interest rate, foreign exchange and commodity price hedging products which represent the most common business risks.

The CBI supports the inclusion of some simple options contracts inside the ring-fence. There is demand amongst business for a level of optionality and the definition of simple derivatives should allow for this. When sold appropriately these derivatives are legitimate business tools which, with the appropriate level of regulatory oversight, should form part of a 'normal' banking offer.

Based on the current interpretation of the draft rules a number of contracts are set to be excluded that CBI considers appropriate products to be bought from a ring-fence bank: forwards, future and swaps containing break clauses; vanilla options (both call and put) and participating forwards.

CBI welcomes progress made towards creating a concise and durable definition of simple derivatives. The approach to limit products to those where evidence is available to assess fair value in accordance with IFRS 13, where that evidence would be considered to constitute a level 1 or a level 2 input, is understandable. Additional consideration is needed however on how this definition will perform during times of market stress. The rules should be specified in a way that allows a ring-fenced bank to continue to provide the same products under times of market stress as under normal market conditions. Under times of stress products that would constitute a level 1 or level 2 input effectively drop into a level 3 input as markets become illiquid and increasingly volatile thus making relevant observable inputs unavailable.

The Treasury should continue its work on defining simple derivatives to allow a degree of optionality in contracts sold by a ring-fenced bank and to protect the continued provision of these useful products during times of future potential stress.

Businesses should be able to access trade finance products directly from a ring-fenced bank

Trade finance is a crucial business tool and is increasingly important as businesses of all sizes look to increase exports. Many CBI members that will fall below the threshold for depositing outside of the ring-fence regularly use trade finance products and their continued provision within a single banking relationship is appropriate.

CBI supports the Treasury's move to exempt some trade finance products from exclusion from the ring-fenced bank. This exemption should cover a full range of products and should be specified in a way that provides certainty to ring-fenced banks in this regard.

There is concern that the exemption as currently drafted contains a degree of ambiguity. In particular uncertainty remains over the ability of a ring-fenced bank to provide standby letters of credit, revolving letters of credit and third party bonds to clients. These are useful products and should be included in the Treasury's exemption.

The FCA has an important role to play in determining the appropriateness of individual products and policing their market deployment

In evidence previously submitted to the Parliamentary Commission on Banking Standards, the CBI called for a greater focus from the regulator on product governance. We stated that, "the Financial Conduct Authority should focus on product governance throughout the product life cycle, rather than the products themselves. This would include focussing on the process of designing new products including the approval process; financial promotions and marketing; the sales process; and customer satisfaction and complaints monitoring."

It is important the Treasury considers the role to be played by the FCA in regulating the conduct of banks in this context. The FCA's powers under the Conduct of Business regulations should be used to ensure that banks are effectively assessing the suitability of a product for a particular business and should be exercised in relation to the sale of derivative and trade finance products by ring-fenced banks. In designing the ring-fence, policy should not conflate prudential with conduct issues and try to apply prudential solutions to conduct issues, and vice versa. While the CBI is concerned with mis-selling it is clear that this and "undersophistication" are conduct issues, not ones that should primarily drive structural reform. We recognise the issue conduct but argue that the FCA should address this rather than trying to legislate for it in the ring-fence.

Added flexibility should be built into the ring-fence rules

Given the scale and complexity of these reforms CBI encourages the Treasury to create a degree of flexibility in the rules governing the ring-fence. There should be an appreciation within government and within the regulators that it is unlikely that the rules will be exactly right first time, given the diverse nature of the products and services that businesses need and use and the amount of time that will pass by the 2019 implementation date.

Building in flexibility is important to ensure that as business needs develop useful products and services are not excluded inadvertently. This is of course balanced by the need to ensure the ring-fence remains robust over time.

CBI believes a formal review process should be built into the ring-fence rules and should take place before 2022, three years after the ring-fence comes into force on January 2019. This would allow sufficient time for evidence to come to light of how the ring-fence is playing out "on the ground". Two issues that would benefit from review include exclusion of inflation (and any other non-exempt) hedging products and the functioning of the self-certification scheme.

For example, simple derivatives which hedge inflation risk do not pose significantly higher prudential or conduct risk in the context of other products currently exempted from exclusion. If exclusion is based on 'usefulness' sufficient scope should be built into the ring-fence to allow the inclusion of inflation hedging products in the future. The fact that only a small subset of companies use inflation hedging products does not seem to be a compelling reason for their exclusion.

The self-certification process strikes a good balance for business but changes could help prevent businesses fluctuating across the threshold

CBI supports the proposed threshold above which businesses can choose to deposit with a non-ring-fenced bank. The three measures of turnover, balance sheet and headcount are set at appropriate levels to provide flexibility and CBI acknowledges the symmetry with the threshold for small companies to submit abbreviated accounts to Companies House.

The businesses that will be most affected by the threshold and the requirements for the self-certification scheme will be those that wish to deposit outside the ring-fence but who are fluctuating in size around the threshold levels. Flexibility should be built in for firms who fluctuate in this way, to avoid "cliff edge" moments where entire sets of banking contracts and relationships have to be shifted from one side of the ring-fence to another. Clearly, this is most likely to present an issue when a firm goes from just above the threshold (and is certified "out"), to just below (and is no longer able to "bank outside").

One way to achieve this, which also mirrors the rules for statutory accounts, would be to require that the threshold be breached for two consecutive years before the change in certification takes place. This would help prevent those businesses that deposit outside of the ring-fence being forced to switch to a ring-fenced bank by a temporary change in business activity. The self-certification scheme could be further strengthened by requiring that two of the criteria are met before a firm can choose to deposit with a non-ring-fenced bank.

As with the types of product sold from a ring-fenced bank, good conduct regulation is needed to support firms when dealing with a non-ring-fenced bank and potentially more complex products.

If well specified an agency model has the potential to work for some businesses but further details are needed to fully understand how this would work

Businesses' decisions about where to deposit will be influenced by a number of factors. Key amongst these will be where banking groups choose to "locate" different activities, determining where different services will come from within the group.

Whilst an agency model for the provision of some services, on an arm's length basis, has been outlined in the consultation document further detail is needed to fully understand how this will work in practice. At this stage CBI has a number of concerns where further thinking should be developed.

The CBI urges the Treasury to consider the market reaction to the introduction of the ring-fence. It is far from clear whether and to what extent most large banking groups will operate a non-ring-fenced bank in the UK. This limits the potential benefit of an agency model for business. If policy makers rely upon the agency model to mitigate reduced provision of services, this is likely to have a damaging impact on competition in the commercial banking sector as only a small number of banks would be in a position to offer this type of model to businesses.

Another consideration is the impact of existing legal arrangements on the functioning of a potential agency model. Given the current strength of covenants, especially for SMEs, an assessment should be made of how they will shape the ability of businesses to engage in multiple banking relationships, either through an agency arrangement, or directly.

The treatment of collateral in any agency models is also a concern. It remains unclear how collateral will be able to be used in relation to the ring-fence. Businesses expect their main relationship bank to provide as much support as possible to enable them to access the products they need. With exposure between financial institutions to be limited, the likely outcome is that businesses will be required to post additional collateral, most likely in the form of cash, when accessing products from outside their primary relationship bank. This need for duplicate collateral could be a significant constraint for businesses.

Taken together, these points suggest that the degree of “choice” exercised by a company in deciding where and how to bank may be more limited than has been previously considered. Market reactions to the ring-fence, existing legal relationships and the availability of collateral will all have a narrowing effect on the freedom of a small or medium sized business to react to the introduction of the ring-fence.