**To : House of Commons Treasury Committee**

**From: The Association of Corporate Treasurers**

**Submission of written evidence on the ICB Final report**

## Executive Summary

1. The ACT is pleased to see that the ICB has tried to be practical and well balanced in its proposals in the Final Report. We accept that there are benefits for the UK in attempting to avoid, or reduce the risk or impact from, financial crises even when set against the ongoing costs of structural reform that have to be borne.
2. The ICB has set out principles, but precise wording of consequent primary and secondary legislation and subsequent rule-making must be seen before full implications for banks and for their business customers, with their individual contingencies, can be fully evaluated.
3. The requirements for increased capital for banks may however reveal a serious problem over shortage in the supply of equity and need for non financial companies themselves to raise more equity. An extended implementation period could help here.
4. The capital proposals from the ICB, taken together with re-regulation measures in progress driven by the G20 agenda risk reducing the availability of bank funding for business. We are sympathetic to the views of US regulators that the effect on the real economy of the G20 motivated changes cannot be accurately estimated[1]. Large companies can have access alternative markets not available to smaller companies. It is important that any structural changes to the UK banking system be accompanied by significant and practical measures to encourage the flow of finance to both SMEs (small and medium enterprises) and mid-sized companies.

[1] i) The Financial Times of June 8th 2011 reports that Jamie Dimon of JPMorgan Chase asked Ben Bernanke if anyone had “bothered to study the cumulative effect of all these things?” To his great credit Bernanke replied with some candour: “I can’t pretend that anybody really has... We don’t really have the quantitative tools to do that.”
ii) John Walsh, Acting Comptroller of the Currency commented to a dinner in London, June 21, 2011: “I want to urge due caution regarding the cumulative effects of all the contemplated changes.” .... “In considering whether we’re getting all this right, I am reminded of the saying: “In theory, there is no difference between theory and practice. In practice, there is.” We don’t know how all of these new approaches will work in practice, how they may interact with one another, and what their cumulative impact will be.” (http://www.occ.treas.gov/news-issuances/speeches/2011/pub-speech-2011-78.pdf)

5. The proposed design of the ring fence generally can achieve the separation required but retain sufficient flexibility to prevent undue distortions and inefficiencies in the market. The flexibility is to be welcomed.

6. There are, however, some very significant changes proposed, not least in operational terms for the banks affected. It is important to resolve the reforms to be introduced with due speed (allowing time for detailed consultation) so as to remove the destabilising effects of uncertainty. An extended period for implementation is desirable so that all parties, banks and business customers, can adapt. This task should not be underestimated.

**The Association of Corporate Treasurers (ACT)**

7. The ACT is a professional body for those working in corporate treasury, risk and corporate finance, providing the widest scope of benchmark treasury qualifications. Our 4,200 members and 2,400 students work widely in companies of all sizes through industry, commerce and professional service firms. Our members working in non financial services companies are typically responsible for their company's dealings with the banks and financial markets.

**General**

8. The ACT regards the ICB Final Report as pragmatic and, seemingly, balanced. Whilst the changes and challenges for the affected banks are hugely significant we believe that the implications for customers, large and small, and their day to day banking needs, will not be so material. Nonetheless it will be beneficial to resolve any uncertainty quickly by taking clear decisions and progressing the legislation as soon as possible and then allowing for a much longer period for an orderly implementation.

9. At present there are many new elements of financial regulation in train, driven often by the international agenda. The ICB recommendations propose relatively small changes in the context of these other regulatory changes for banks and markets following the financial crisis. Taken together the regulatory changes in prospect are very significant and inevitably complex.

10. We are at an early stage in considering all the implications of the Vickers report and of the international G20 inspired re-regulation generally. It may be that as the details are resolved for particular elements, further particular difficulties and unexpected interactions will become apparent. It will be necessary for legislators and regulators to be prepared to make appropriate amendments and adjustments.

**Capital**

11. The ICB recommends a requirement for up to10% equity capital for large ring-fenced banks which is very similar to the 9.5% level required under Basel III / CRD IV for systemically important banks. There is then a requirement to bring the loss absorbing capital up to a cumulative amount between 17% and 20% of risk weighted assets. Without wishing to specify a precise level we recognise that an additional buffer is required to diminish the likelihood of bank failure if subject to significant shocks. Reducing the occurrence of financial crises carries with it a significant benefit to business and the economy. Theoretically there should be a price and rate of return which is sufficient to generate a demand for this sort of bail-in bond or similar capital, but we remain doubtful about the market's capacity and willingness to provide this capital in sufficient volumes.

12. A quantitative impact study by the Basel Committee on Banking Supervision shows banks worldwide would need additional capital of €175bn to reach a core capital ratio of 4.5% proposed under Basel III and €600bn for the 7% requirement.(euro area bank equity issuance has been $20 to 50b annually since 2005)

13. If there is indeed a shortage of capital, the banks can instead achieve their target ratios by shedding assets, in other words by reducing the extent of their lending.

14. Our members working in business are normally responsible for the funding of their companies. If the banks are in the event unwilling or unable to lend, affected companies will have to adjust their own capital structure and will come to depend more on equity or capital markets.

15. Although corporate gearing in the UK has fallen back somewhat in the past year, it is still very high historically. Anecdotally, our members are indicating that they are beginning to plan to reduce gearing – partly to move to a more robust structure able to withstand uncertainty and partly for fear of lack of bank funding or availability of capital markets in the years ahead. We have concerns over the capacity of the markets to provide this new capital for companies and over the cost particularly at a time when the banks themselves will be raising capital and governments probably being more highly indebted themselves.

16. Share capital cannot be raised easily at the exact point of need, but rather it has to be raised when markets are receptive, in advance of need. This timing effect will tend to reduce corporate leverage and increase the requirement for equity even more. This prefunding and generally cautious approach will result in companies operating at gearing levels that may be sub-optimal from the point of view of stakeholders, including shareholders, and society at large. This puts pressure on weighted cost of capital deployed and thus, at the margin, on business activity across the economy.

17. We do hear arguments that if the banks have to hold additional layers of loss absorbing capital this will come at a cost and that with reduced gearing their returns on equity can only be preserved if their lending rates rise significantly. Treasurers accept that pre 2008 the amounts charged for credit and risk were underpriced and that it may be "correct", in some sense, for prices to have risen. But clearly treasurers and their companies have a very strong interest in keeping the cost of

credit down – it ultimately drives the viability of what they can invest in and thus jobs and economic activity generally.

18. We agree that it would be appropriate for less risky banks with more conservative capital structures to deliver a much reduced return on equity. We have seen the Bank of England paper from David Miles and others[2] and find persuasive their arguments that with much increased capital the cost of bank funding for their customers might only rise by a modest amount.

19. However, we also think that there might be an expectation that annual bank returns on capital in the mid or high teens seen in recent years might fall in future years generally rather than being restored to more normal levels by the periodic effects of financial crises. As regards large corporate banking, the ICB's Interim Report noted "It is clear that there is a lack of price transparency in this market and that for some products and services prices are very high. The remuneration levels of employees involved in providing some of these services do not give confidence that competition is working well for customers."[3] So there may be some cushion available there.

20. The ICB report proposes that the 17% cumulative loss absorbency capacity is required in both the retail bank and the non ring-fenced banks. Given that the ring-fenced bank is supposed to be capable of surviving an insolvency of the non ring-fenced side and is recommended to be capitalised accordingly, presumably this is to protect the external banking system as a whole – the same purpose as the Basel III proposals. We are not best placed to judge if the Commission has justified querying the appropriateness of the Basel III proposals for capital on the non ring-fenced side. If not justified, such a change would weaken the international competitive position of those UK universal banks with retail operations to which the ICB recommendations would apply.

**Ring Fence**

21. We think that the Commission has done a good job in its recommendations for how a ring fence between retail and wholesale banking should be positioned and function, given that UK resolution proposals for distressed banks already require separability - distinct from separation - into different businesses.

22. The ACT is pleased to see the Commission recommends that large corporate loans and deposits are permitted on both sides of the ring fence. It is also encouraging to see that modified 'one-stop' relationships for customers who want both retail and investment banking services would be possible, as would expertise, information and sharing of operational infrastructure across subsidiaries. These were some of the

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[2] Optimal bank capital by David Miles, Jing Yang and Gilberto Marcheggiano http://www.bankofengland.co.uk/publications/externalmpcpapers/extmpcpaper0031.pdf.

[3] Interim Report of the ICB at 2.82.
[The ACT noted the high targets for returns on corporate relationships of banks in the Appendix to its response to the HM Treasury discussion paper on non-bank lending in early 2010. http://www.treasurers.org/hmt/nbl/actresponse, at page 15ff.]

ACT's key concerns when it engaged with the Commission at the consultation stage and they play an important part in the efficient day-to-day functioning of businesses large and small.

23. Allowing wholesale deposits with the ring-fenced bank provides a welcome flexibility for company treasurers. However the preferred status given to the FSCS insured deposits subordinates those deposits and means that once there are any signs of distress at a ring-fenced bank those deposits, kept short-term in anticipation, will probably be promptly withdrawn en masse, destabilising that bank and causing a lack of liquidity and perhaps triggering failure. Alternatively we expect creditors will seek collateral thus diluting the preference and the position of ordinary non-retail depositors. Since the FSCS is funded by the banking and financial services industry we wonder if this depositor preference is really required.

24. The retail bank is prohibited from taking on exposures to non-bank financial organisations. As a point of detail we would like to clarify when definitions are drafted that this should not apply to non-regulated finance or treasury companies within a non financial services group.

**Competition / international competitiveness**

25. With regard to competition in wholesale banking, we note that the Commission does not dwell on this in view of limited responses to its Interim Report. We continue to share the concerns the Commission set out in the Interim Report about this and note that the subject remains for later enquiry. Even for larger companies competition in banking is lacking and this may be reflected in the returns banks have in recent years expected to make on corporate banking

26. There is a risk that competitiveness of the UK wholesale banking sector may be damaged by the Vickers reforms in that the wholesale banking side would no longer benefit from the efficiencies of scale, the synergies, the valuable retail deposit base and some of the cross selling opportunities, thus setting them at a disadvantage to their overseas rivals. Given the market shares in the UK of the affected banks, there is a material risk that much of the cost of this would be passed on to customers rather than reducing bank returns on capital and staff remuneration costs as discussed in paragraph 19, above.

27. The cost and complications arising from the practical implementation of the ring fence should not be underestimated. There will also be material ongoing costs in terms of lost efficiencies and synergies. We would be concerned if during the transition customer service deteriorates for businesses in the UK.

28. We note too that it would not be difficult for a UK retail bank to provide its UK retail services from a European group company and passport its retail operations back into the UK and avoid the new rules. Anti avoidance provisions may address such a relocation but it is hard to see how that would easily comply with European regulations. There may be perceived competitive advantage for new retail banks coming in from abroad that would not be subject to the new rules in course of time.

**Smaller / mid-sized companies**

29. Overall we recognise the argument that there is a cost/ benefit advantage in moving to a more robust UK banking structure, but we note that the benefit comes with some disadvantages for businesses and their ability to finance themselves. For larger companies any problems over financing can be redressed through raising new capital, borrowing from overseas banks or from accessing non bank sources of funding such as the international bond markets when circumstances allow. Many of these mitigating measures are not readily or at all open to SMEs and mid-sized companies.

30. It is important that any structural changes to the UK banking system consequent on the G20 sponsored changes or the report of the ICB be accompanied by significant and practical measures to encourage the flow of finance to those smaller and mid-sized companies.

*The Association of Corporate Treasurers is a company limited by guarantee in England under No. 1445322 at 51 Moorgate, London EC2R 6BH, UK*