Distance but no divorce

PETER WILLIAMS WAS THERE AS THE INDEPENDENT COMMISSION ON BANKING UNVEILED ITS FINAL PROPOSALS ON HOW TO RESHAPE THE UK'S BANKING SECTOR.

The Independent Commission on Banking (ICB) was set up in June 2010 following the global financial crisis to consider structural and related non-structural reforms to the UK banking sector that would promote financial stability and competition. Issues about lending to large corporates are a key element of the banking reforms the ICB proposed in its final report last month.

ICB chairman John Vickers says that the ICB's proposals would build a strong but flexible ring-fence. The ICB has backed the ACT's suggestion that both ring-fenced banks and those outside the ring-fence should be able to lend to corporates in order to prevent trapped deposits and the creation of a credit bubble.

The ICB has rejected the idea that retail banking should be separated from wholesale/investment banking. The objective of the ring-fence is to isolate those banking activities where continuous provision is vital to the economy and to a bank's customers.

A key part of these reform is designed, in Vickers' words, to get the UK taxpayer off the hook of the guarantee which is implicitly in place and favouring the larger banks. The report says that in restoring funding costs to levels that properly reflect risk the proposed reforms may be contrary to the private interests of the wholesale/investment banking operations of some UK banks. The report continues: "But the public interest is another matter. It is best advanced by removing the prospect of government support. The fact that some countries may implicitly subsidise their wholesale/investment banks does not make it sensible for the UK so to do."

However, critics say that the ICB's proposals will increase the cost of credit for large companies. Economic forecaster Ernst & Young Item Club estimates that the extra cost could be as high as 150bp – a figure that the ICB disputes. The ICB estimates an increase in borrowing costs of about 10bp, and argues that it is a price worth paying for greater stability in the banking system.

IN OR OUT The ICB's view is that domestic retail banking services should be inside the ring-fence while global wholesale/investment banking should be outside; the provision of straightforward banking services to large, domestic non-financial companies can be in or out.

The aggregate balance sheet of UK banks currently stands at over £6 trillion – more than four times the UK's annual GDP. The ICB estimates that, given the split it is proposing, between one-sixth and one-third of those assets (amounting to £1–2 trillion) would be within the retail ring-fence.

To insulate UK retail banking from external shocks and financial interconnectedness, the ICB says that a range of services should not be permitted in the ring-fence. Prohibited services would include:

- services to non-European Economic Area customers;

- services resulting in exposure to financial customers (although payment services would be permitted);
- trading book activities;
- services relating to secondary markets activity (including the purchase of loans or securities); and
- derivatives trading (except where necessary for the retail bank to manage its own risk prudently).

Subject to limits imposed on the wholesale funding of retail operations, other banking services – including taking deposits from individual and corporate customers and lending to large companies outside the financial sector – should be permitted, but not required, within the ring-fence.

The ICB report says: "The margin of flexibility in relation to large corporates is desirable. Rigidity would increase the costs of transition from banks' existing business models to the future regime. And it would risk an asset/liability mismatch problem if, for example, retail deposits were prevented from backing lending to large companies. Mismatch could give rise to economic distortion and even to destabilising asset price bubbles."

STRONG GOVERNANCE Ring-fencing will have to be made to work and the ICB is insistent that the proposals it has made are both strong and flexible. To achieve the purpose of ring-fencing, the activities of retail banks should have economic independence. First, the UK retail subsidiary of a wider banking group should meet the regulatory requirements for capital, liquidity, funding and large exposures on a standalone basis. Second, the permitted extent of its relationship with other parts of the group should be no greater than regulators generally allow with third parties, and should be conducted on an arm's length basis.

Effective ring-fencing also requires measures for independent governance to enforce the arm's length relationship. The ICB has expressed the view that the board of a UK retail banking subsidiary should normally have a majority of independent directors, one of whom is the chair. To ensure transparency, the subsidiary should make disclosures and reports as if it were an independently listed company. The ICB admits that corporate culture cannot directly be regulated, but points out: "The structural and governance arrangements proposed here should consolidate the foundations for long-term customer-oriented UK retail banking."

Since the banking crisis broke, some have been calling for complete separation of investment and retail banking. The ICB argues that its ring-fencing solution offers superior benefits compared to the separation model. It says that, subject to the standalone capital and liquidity requirements, shareholders and group-level creditors would retain the benefits from the diversification of earnings. Capital could be injected into the UK retail subsidiary by the rest of the group if it needed support.

Furthermore, agency arrangements within the group would allow one-stop relationships for customers – such as large corporates – that want both retail and investment banking services. The ring-fencing would still allow for expertise and information to be shared across a group's subsidiaries, which would retain economies of scope, and some operational infrastructure and branding could continue to be shared.

Added together, these features mean that ring-fencing should have significantly lower economic costs than full separation. Finally, the ICB says that ring-fencing guards against contagion risk and that there are "legal impediments to requiring full separation".

With the government accepting the recommendations of the Vickers Report, banks will come under pressure to implement the operational changes required as soon as possible. What the splitting of the balance sheet will mean for large corporates whose credit could be on either side of the ring-fence is not immediately clear.

The ICB says that, given the additional capital the measures will require, "an extended implementation period would be appropriate for what amounts in combination to fundamental and far-reaching reforms intended for the longer term". It has called for implementation to be completed at the latest by the Basel III date of the start of 2019. Before that time treasurers should have discovered the degree to which the government intends to adopt the recommendations and they will then be able to discover from their banks how the reforms will impact their ability to borrow.

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The key ICB recommendations

THE ICB RECOMMENDATIONS FOCUSED ON THE FOLLOWING THREE AREAS:

- retail ring-fence (discussed in main article);
- loss absorbency; and
- competition.

On loss absorbency the ICB has two main recommendations.

First, it says that ring-fenced banks with a ratio of risk-weighted assets (RWA) to UK GDP of 3% or more should be required to have an equity-to-RWA ratio of at least 10%; those with RWA-to-UK GDP ratios of 1–3% should have equity-to-RWA of 7–10%.

Second, all UK-headquartered banks and all ring-fenced banks should main a Tier 1 leverage ratio of at least 3%, and all ring-fenced banks with an RWA-to-UK GDP ratio of 1% or more should have their minimum leverage ratio increased on a sliding scale to a maximum of 4.06% at an RWA-to-UK GDP of 3%.

Perhaps the most far-reaching recommendations concern market structure. The ICB wants the divested entity from Lloyds Banking Group to have a funding position at least as strong as its peers, based on its loan-to-deposit ratio at the time of disposal, and a share of the personal current account market of at least 6%.

It also wants action on barriers to entry for would-be new banks and for the process of switching current accounts to be seamless for customers.

Finally, it is looking for greater transparency across all retail banking products.