HOUSE OF COMMONS
LIBRARY

Financial Services (Banking Reform) Bill

Bill No 130 of 2012-13

RESEARCH PAPER 13/15 28 February 2013

This, latest, financial services reform legislation brings together the final proposals for how the banking sector will look going forward.

Already the UK has legislated on the way in which banks in crisis can be rescued; how they can be wound up if they can't be rescued; and the new regulatory reform system within which the whole sector will operate.

The Bill focuses on a crucial issue which was exposed by the financial crisis: banks are not like other companies. Banks are not just commercial companies their traditional lending and deposit taking functions and their custodianship of the payments infrastructure system means that they have a similar social importance as public utilities like water and power. As such, in any advanced economy, many of the functions of a bank must continue even if the bank itself does not. This Bill is part of the answer to how to protect society from losing the utilitarian functions of banks if the bank itself is in financial difficulty.

The Bill builds on the recommendations of the Independent Commission on Banking (the Vickers Commission) and on those made by the Parliamentary Commission on Banking Standards.

The Bill extends to the entire country.

Timothy Edmonds
Lorraine Conway

Recent Research Papers

13/01	Welfare Benefits Up-rating Bill [Bill 116 of 2012-13]	04.01.13
13/02	HGV Road User Levy Bill: Committee Stage Report	07.01.13
13/03	Economic Indicators, January 2013	08.01.13
13/04	Crime and Courts Bill [Bill 115 of 2012-13]	09.01.13
13/05	Groceries Code Adjudicator Bill [HL]: Committee Stage Report	10.01.13
13/06	Unemployment by Constituency, January 2013	23.01.13
13/07	European Union (Approvals) Bill [Bill 121 of 2012-13]	30.01.13
13/08	Marriage (Same Sex Couples) Bill [Bill 126 of 2012-13]	01.02.13
13/09	Economic Indicators, February 2013	05.02.13
13/10	The Local Government Finance Settlement 2013/14 and 2014/15	08.02.13
13/11	Children and Families Bill [Bill 131 of 2012-13]	15.02.13
13/12	Unemployment by Constituency, February 2013	20.02.13
13/13	Justice and Security Bill [HL]: Committee Stage Report	25.02.13

Research Paper 13/15

Contributing Authors: Timothy Edmonds, Business & Transport Section
Lorraine Conway, Insolvency, Home Affairs Section

This information is provided to Members of Parliament in support of their parliamentary duties and is not intended to address the specific circumstances of any particular individual. It should not be relied upon as being up to date; the law or policies may have changed since it was last updated; and it should not be relied upon as legal or professional advice or as a substitute for it. A suitably qualified professional should be consulted if specific advice or information is required.

This information is provided subject to our general terms and conditions which are available online or may be provided on request in hard copy. Authors are available to discuss the content of this briefing with Members and their staff, but not with the general public.

We welcome comments on our papers; these should be e-mailed to papers@parliament.uk.

ISSN 1368-8456

Contents

Summary **1**

1 Introduction **2**

2 Review of bank structure: the Vickers Commission **3**

2.1 The Interim Report 3

2.2 The Final Report 4

2.3 Introduction 4

2.4 The final proposals 4

2.5 The Government response to ‘Vickers’ 15

3 Consideration of the Vickers Commission’s proposals: **17**

The Joint Committee on the Financial Services Bill 17

The Parliamentary Commission on Banking Standards (PCBS) 21

4 The Bill **27**

4.1 Preparation 27

Government amendments to the draft Bill 28

Impact assessment 30

4.2 The Bill 30

Summary

The financial crisis which began in the UK in 2007 with the collapse of the Northern Rock Bank has provoked a sustained legislative response to deal both with the immediate events and to establish a more stable future.

If the Bill passes into law it will be the fifth piece of major legislation to respond to the banking and financial crisis in the UK. The focus of the Bill is the problem of banks that are ‘too big to fail’. Because of their size and their central deposit taking and payment-making functions, banks are as central to the normal functioning of an economy as are other utilities.

The Bill contains provision to separate the banking activities on which households and small and medium-sized enterprises depend (in the Bill "core activities") from wholesale or investment banking activities which may involve a greater degree of risk and expose an entity undertaking them to financial problems arising elsewhere in the global financial system. This separation is referred to in these notes as "ring-fencing". Certain banks carrying on core activities will be required to be ring-fenced: that is, they will have to comply with restrictions on the other activities they can undertake, and with rules made by the regulator intended to ensure that they are capable of carrying on the business of providing the core services related to the acceptance of deposits independently of other members in their group.

They will, for example, be prohibited from carrying on activities (excluded activities) which make them vulnerable to problems arising in the financial system or which may make it more difficult for the banks to be wound down in an orderly fashion (avoiding damage to the wider provision of banking services) if they fail.

The general objective of the Prudential Regulation Authority is amended to require it to discharge its general functions in relation to ring-fencing and ring-fenced bodies to protect the continuity of the provision in the United Kingdom of the core services related to core activities.

The Bill has been informed to a great extent by the consideration of two non-government bodies, namely the Vickers Commission – the Independent Commission on Banking, and the Parliamentary Commission on Banking. It has therefore been subject to much pre-legislative scrutiny and public debate about the central features.

1 Introduction

The financial crisis which began in the UK in 2007 with the collapse of the Northern Rock Bank has provoked a sustained legislative response to deal both with the immediate events and to establish a more stable future.

If the Bill passes into law it will be the fifth piece of major legislation to respond to the banking and financial crisis. It is worth briefly recapping what has gone before;

- First was the *Banking (Special Provisions) Act 2008* which was an emergency and specific response to the collapse of Northern Rock.
- Second, the *Banking Act 2009* built on the previous Act; extended it to the banking sector generally and remedied perceived legal and procedural deficiencies exposed by the experience newly gained in dealing with failed banks.
- Third, the *Financial Services Act 2010* expanded the powers of the financial regulator and established more comprehensive consumer redress schemes. This Act was truncated by the general election in 2010.
- Fourth, the *Financial Services Act 2012* established a completely new financial services regulatory structure.

In addition, there is a huge amount of European-derived legislation, too long to list in a paper like this.

Within this huge mosaic of new laws, rules and requirements, the current Bill addresses the public issue question of banks that are seen to be 'too big to fail'. It proposes restrictions on the future structure of banks in order to insulate and therefore protect, the public service utility functions of banks, namely their ownership and control of the payment systems and their domestic retail functions, from the financially more risky trading and investment activities which, it is alleged, contributed hugely to the financial collapse in 2007/8. Andrew Haldane of the Bank of England outlined the problem in a speech in October 2012 – *On being the right size*. He described the negative aspects of the universal bank model in which one organisation does everything:

> High private return investment banking activities may crowd-out the human and financial resources devoted to high social return commercial banking activities. Investment banking activities might also piggy-back on the cheaper cost of deposit funding. In effect, universal banking allows privately optimal, but socially sub-optimal, cross-subsidisation. This is a normal-times benefit of separation.
>
> Both of these costs were evident ahead of, and during, the recent crisis. Ahead of crisis, resources gravitated to the investment banking side of the fence. Between 2000 and 2007, UK banks' trading books rose six times as fast as their banking books. Human capital made the same journey, helped by investment banking salaries rising four times as fast as commercial bank salaries since 1980.
>
> In the teeth of crisis, risk cross-contamination became a potent factor. Basic banking services in universal banks were often subject to severe disruption from trading book losses, which exceeded by many multiples the capital allocated to them. That is why national deposit insurance schemes were extended and in some cases became

> temporarily unlimited. It is also why repeated attempts have had to be made to resuscitate weak credit growth over the past few years.[1]

The Bill has been informed to a great extent by the consideration of two non-government bodies, namely the Vickers Commission – the Independent Commission on Banking, and the Parliamentary Commission on Banking. It has therefore been subject to much pre-legislative scrutiny and public debate about the central features.

A copy of the text of the *Financial Services (Banking Reform) Bill* 2012/13 can be found here. A copy of the accompanying explanatory notes can be found here.

2 Review of bank structure: the Vickers Commission

2.1 The Interim Report

At his Mansion House Speech in 2010, the new Chancellor, George Osborne, announced a review of the banking industry

> The new Government is establishing an independent commission on the banking industry. It will look at the structure of banking in the UK, the state of competition in the industry and how customers and taxpayers can be sure of the best deal. The Commission will come to a view. And the Government will decide on the right course of action. Sir John Vickers has agreed to chair the Commission.[2]

In September 2010, the Vickers Commission published an issues Paper which outlined its preliminary thinking.[3] The issues it was minded to consider included:

- Financial stability
- Competition
- Interaction of financial stability and competition
- Lending and the pace of economic recovery
- Competitiveness of UK financial services and the wider economy
- Risks to the Government's fiscal position

In April 2011, it published its Interim Report.[4] The response and comment on it focused largely on the proposals surrounding the ring-fencing of British retail banks; i.e. separating deposit and lending functions from investment banking. Sir John Vickers summarised his proposals in the following way:

> Structural reform, in sharp form, would end universal banking and require retail banking and wholesale and investment banking to be carried out by separate banks.
>
> This would aim to isolate retail banking services and taxpayers from the risks of global wholesale and investment banking.
>
> The Commission's focus is on a *combination* of these capital and structural approaches, in moderate form.
>
> First, we estimate that systemically important banks should have an equity ratio of at least 10% provided that they also have genuinely loss-absorbing debt. We believe this should be agreed internationally. But whether or not it is, we believe that it should

---

1 Speech by Andrew Haldane, October 2012

2 Speech by Chancellor of the Exchequer, Royal Mansion House, 16 June 2010

3 Independent Commission on Banking, *Issues Paper call for evidence*, September 2010

4 Independent Commission on Banking, *Interim Report*, April 2010

> apply to UK retail banking. Then international standards would apply to the wholesale and investment banking activities of UK banks, so long as the taxpayer is not on the hook if they fail.
>
> Second, and in structural support of that approach to capital, the Commission sees merit in a UK retail 'ring-fence'. This would require universal banks to maintain the UK retail capital ratio – that is, not to run down the capital supporting UK retail activities below the required level in order to shift it, say, to global wholesale and investment banking. Our current view is that such a limit on banks' freedom to deplete capital would be proportionate and in the public interest, and would preserve benefits of universal banking while reducing risks. Without it, capital requirements higher than 10% across the board might well be called for.[5]

2.2 The Final Report

2.3 Introduction

The Commission produced its Final Report in September 2011.[6] It included a summary of responses to its interim proposals. In general, there was little consensus on many of the issues.

Financial stability: structure
Responses included all possible combinations of views about the effectiveness of 'ring fencing' and higher capital. There was also a range of views about where the 'fence' should sit. Most thought that basic, transactional banking services were within the fence, but there was little agreement on the spectrum of activities that it would include.

Financial stability: loss absorbency
Responses varied from those who thought that the capital proposals for banks were too high to those who thought they were not high enough. There was general acceptance of depositor protection, or preference, as well as support for a mechanism by which bondholders would bear losses in crises.

Competition measures.
Some respondents argued that the Commission's view was wrong and that the Lloyds divestiture went too far. Others argued the precise opposite. There was general support for more micro measures to improve competition, namely easier switching between accounts; more transparent pricing; greater use of comparison websites etc. Views on the competition priority for the new regulator – the Financial Conduct Authority were mixed. Some thought that it should have greater powers whereas others doubted its practical efficacy.

2.4 The final proposals

Before listing the Report's final reforms, it is worth looking at the aims of the Commission as it saw them:

> The recommendations in this report aim to create a more stable and competitive basis for UK banking in the longer term. That means much more than greater resilience against future financial crises and removing risks from banks to the public finances. It also means a banking system that is effective and efficient at providing the basic banking services of safeguarding retail deposits, operating secure payments systems, efficiently channelling savings to productive investments, and managing financial risk. To those ends there should be vigorous competition among banks to deliver the services required by well-informed customers.

[5] Speech by Sir John Vickers 11April 2011

[6] Independent Commission on Banking *Final Report: recommendations*; September 2011

> These goals for UK banking are wholly consistent with maintaining the UK's strength as a pre-eminent centre for banking and finance, and are positive for the competitiveness of the UK economy. They also contribute to financial stability internationally, especially in Europe.[7]

Financial stability: ring fencing

The Commission had to decide two things:

Where should the fence sit (which activities would be within it and which without); and

How high should the fence be – what degree of separation should there be between the activities on different sides of the fence.

Where?

The criteria they chose for what activities should be within the fence are shown below. It should:

- contain all deposits from individuals (except high net worth individuals) and small and medium sized enterprises , along with any overdrafts supplied to them;
- not be allowed to engage in trading or other investment banking activities, provide services to financial companies, or services to customers outside the European Economic Area (EEA);
- within these constraints, be allowed to take deposits from larger companies and provide non-financial larger companies with other intermediation services such as simple loans; and
- where the firm is part of a wider corporate group, have independent governance, be legally separate and operationally separable, and have economic links to the rest of the group no more substantial than those with third parties – but be allowed to pay dividends as long as they maintain adequate capital levels, which will preserve diversification benefits.[8]

The Commission articulated their principles in terms of what they called mandated services, prohibited services and ancillary activities. It admitted that these principles "are not in a format which would be appropriate for legislation or regulatory rules".[9]

Mandated services

These are services which would be provided only by ring-fenced banks – the regulator would remove permission for other banks to provide the service. The services are defined in terms of:

> **Mandated services**. Only ring-fenced banks should be granted permission by the UK regulator to provide mandated services. Mandated services should be those banking services where:

---

[7] Ibid p7

[8] Ibid p29

[9] Ibid p36

a) even a temporary interruption to the provision of service resulting from the failure of a bank has significant economic costs; and

b) customers are not well equipped to plan for such an interruption.

Mandated services currently comprise the taking of deposits from, and the provision of overdrafts to, individuals and small and medium-sized organisations.[10]

Prohibited services

These are the services which the Commission thought that ring-fenced banks must not be permitted to provide.

> **Prohibited services**. Ring-fenced banks should be prohibited from providing certain services. Prohibited services should be those banking services which meet **any** of the following criteria:
>
> a) make it significantly harder and/or more costly to resolve the ring-fenced bank in the event of the bank's failure;
>
> b) directly increase the exposure of the ring-fenced bank to global financial markets;
>
> c) involve the ring-fenced bank taking risk and are not integral to the provision of payments services to customers, or the direct intermediation of funds between savers and borrowers within the non-financial sector; or
>
> d) in any other way threaten the objectives of the ring-fence.
>
> As a result prohibited services should include (though need not be limited to):
>
> a) any service which is not provided to customers within the EEA;
>
> b) any service which results in an exposure to a non-ring-fenced bank or a non-bank financial organisation, except those associated with the provision of payments services where the regulator has deemed this appropriate;
>
> c) any service which would result in a trading book asset;
>
> d) any service which would result in a requirement to hold regulatory capital against market risk;
>
> e) the purchase or origination of derivatives or other contracts which would result in a requirement to hold regulatory capital against counterparty credit risk; and
>
> f) services relating to secondary markets activity including the purchase of loans or securities.[11]

The Commission accepted that separating functions "involves a balance between the costs associated with losing synergies and the benefits of improving financial stability through separation".[12]

It rejected extreme forms of separation – the narrow banking model where banks only lend against deposits – and says that "some risk of failure should be tolerated" provided that

---

[10] Ibid p38
[11] Ibid p51-52
[12] Ibid p41

transmission services can be protected. Neither did it see a US style 'Volcker rule' as a substitute for ring fencing.[13] The Volcker rule bans proprietary trading and investment in hedge and private equity funds. In the UK these would be 'prohibited activities' anyway under the ring-fence rules, but there are other activities which deepen the connectivity between institutions which contributes to the sort of collective failure seen in the banking crisis. The Commission did not see benefit in preventing ring-fenced banks from either lending to or taking deposits from large, non-financial, institutions sited within the EEA.

The Commission described the impact of its proposals below:

> Broadly, this principle would mean that the majority of the retail and commercial banking divisions of current UK banks *could* be placed in ring-fenced banks, but the wholesale/investment banking divisions could not. At present most, but not all, financial companies are served out of the wholesale/investment banking divisions.
>
> Some of the lending to large organisations currently performed in the wholesale/ investment banking divisions would be permitted within ring-fenced banks. As shown in Figure 3.5, based on the balance sheets of UK banks at the end of 2010 this construction of a retail ring-fence could lead to around £1.1tn-£2.3tn of assets being held within UK ring-fenced banks, or around 75%-160% of current UK GDP. This is between a sixth and a third of the total assets of the UK banking sector of over £6tn.[14]

Ancillary activities

The Commission recognised that ring-fenced banks would need to engage in what are normally collectively called treasury functions. This would cover activities such as interest rate hedging, which are often conducted through the derivatives market. It saw no reason why ring-fenced banks should not engage in such activity even if they were at the same time not allowed to provide such a service for customers. This dual model is currently in force for building societies and although some societies failed, this was not directly due to their treasury operations. It also suggested that wholesale funding of institutions should continue albeit within tighter constraints than before. The building societies legislation which limits wholesale funding to 50% might not be appropriate for all ring-fenced banks, but might be used as a baseline for calibrated measures. The third principle therefore is described thus:

> **Ancillary activities**. The only activities which a ring-fenced bank should be permitted to engage in are: the provision of services which are not prohibited; and those ancillary activities necessary for the efficient provision of such services. Ancillary activities should be permitted only to the extent they are required for this provision, and not as standalone lines of business.
>
> Ancillary activities would include, for example, employing staff and owning or procuring the necessary operational infrastructure. In particular, a ring-fenced bank should be permitted to conduct financial activities beyond the provision of non-prohibited services to the extent that these are strictly required for the purposes of its treasury function – i.e. for risk management, liquidity management, or in order to raise funding for the provision of non-prohibited services. In conducting ancillary activities a ring-fenced bank may transact with and become exposed to non-ring-fenced banks and non-bank financial organisations.

[13] Ibid p45-46
[14] Ibid p52

> Backstop limits should be placed on the proportion of a ring-fenced bank's funding which is permitted to be wholesale funding and on its total exposures, secured and unsecured, to non-ring-fenced banks and other non-bank financial companies.[15]

How high?

The next phase of the work on the ring fence was to decide how 'high' it should be; i.e. what degree of separation should there be between banks within the fence and those outside. Should they be completely separate institutions or could they be joint subsidiaries of a parent group for example? As the Commission put it:

- Should a ring-fenced bank be allowed to be in the same corporate group as other companies, including those conducting prohibited activities, at all?
- If so, what legal and operational links should be permitted between a ring-fenced bank and its wider corporate group?
- What economic links should be permitted between a ring-fenced bank and its wider corporate group?[16]

The Commission noted two main arguments in favour of full separation:

Reputational contagion – banks, above all other industries, rely on confidence and reputation is a major component of this. So if part of a banking group collapses it will transmit a fatal reputational loss on the ring-fenced bank even though it may be separate.

Simplicity - policing and regulating connected groups is complex and hard to enforce in the face of strong incentives for the group to get around the barriers. Full separation is just simpler.

Whilst accepting some of these points the Commission pointed out that if retail banking generally is performing badly "more retail banks would fail under full separation than under ring fencing". Alternatively, the risk that general investment banking losses could bring down the ring-fenced bank could be countered by "insisting that the ring-fenced bank is not dependent for its solvency, liquidity or continued operations on the rest of the group".[17] The Commission also emphasised the need for independent management of the ring-fenced bank, to disassociate itself from group incentives or interests.

The Commission noted three arguments against full separation:

- The cost - largely the cost of holding extra capital which could be in the region of £4 Billion annually

- The loss of customer synergies – whilst not outright denying their existence the Commission states that it "has received rather little quantitative evidence on [their] magnitude".[18]

- Illegality – European law places certain obstacles to the full separation model which are not faced by the ring-fenced model.

The Commission rejected full separation and offered the following description of its ring-fence principle:

---

[15] Ibid p62
[16] Ibid p62
[17] Ibid p63
[18] Ibid p65

Legal and operational links. Where a ring-fenced bank is part of a wider corporate group, the authorities should have confidence that they can isolate it from the rest of the group in a matter of days and continue the provision of its services without providing solvency support.

As a result:

a) ring-fenced banks should be separate legal entities – i.e. any UK regulated legal entity which offers mandated services should only also provide services which are not prohibited and conduct ancillary activities;

b) any financial organisation owned or partly owned by a ring-fenced bank should conduct only activities permitted within a ring-fenced bank. This organisation's balance sheet should contain only assets and liabilities arising from these services and activities;

c) the wider corporate group should be required to put in place arrangements to ensure that the ring-fenced bank has continuous access to all of the operations, staff, data and services required to continue its activities, irrespective of the financial health of the rest of the group; and

d) the ring-fenced bank should either be a direct member of all the payments systems that it uses or should use another ring-fenced bank as an agent.[19]

The Commission did not set out how it thought the principle should be effected but described various options (pp 67-68).

The final aspect of ring fencing to be looked at was the question of economic linkages between the ring-fenced institution and the rest of the group.

Economic links

The Commission noted that even opponents of ring fencing thought that if there was one, it had to be "relatively high to secure the benefits". The issue, in terms of responses centred on whether transactions between the bank and the parent should be treated as being closer or more distant than normal third party transactions. The Commission opted for a 'no more favourable than third party' principle. It is shown in full below:

Economic links. Where a ring-fenced bank is part of a wider corporate group, its relationships with entities in that group should be conducted on a third party basis and it should not be dependent for its solvency or liquidity on the continued financial health of the rest of the corporate group. This should be ensured through both regulation and sufficiently independent governance.

Thus, where a ring-fenced bank is part of a wider corporate group:

a) its relationships with any entities within the same group which are not ring-fenced banks should be treated for regulatory purposes no more favourably than third party relationships;

b) all transactions (including secured lending and asset sales) with other parts of the group should be conducted on a commercial and arm's length basis in line with sound and appropriate risk management practices;

---

[19] Ibid p67

c) where third party arm's length relationships are not ensured through the application of existing regulation, additional rules should be considered;

d) assets should only be sold to and from the ring-fenced bank and other entities within the group at market value. The ring-fenced bank should not acquire any assets from other entities within the group unless such assets could have resulted from the provision of non-prohibited services;

e) the ring-fenced bank should meet regulatory requirements, including those for capital, large exposures, liquidity and funding, on a solo basis;

f) dividend payments and other capital transfers should only be made after the board of the ring-fenced bank is satisfied that the ring-fenced bank has sufficient financial resources to do so. In addition, any such payments which would cause the ring-fenced bank to breach any kind of capital requirement, including requirements to hold buffers above minimum requirements, should not be permitted without explicit regulatory approval;

g) the board of the ring-fenced bank should be independent. The precise degree of independence appropriate would depend on the proportion of the banking group's assets outside the ring-fenced bank. Except in cases where the vast majority of the group's assets were within the ring-fenced bank, the majority of directors should be independent non-executives of whom:

i. one is the Chair; and

ii. no more than one sits on the board of the parent or another part of the group;

h) a ring-fenced bank should make, on a solo basis, all disclosures which are required by the regulator of the wider corporate group and/or its other relevant substantial subsidiaries, and those which would be required if the ring-fenced bank were independently listed on the London Stock Exchange; and

i) the boards of the ring-fenced bank and of its parent company should have a duty to maintain the integrity of the ring-fence, and to ensure the ring-fence principles are followed at all times.[20]

If the 'no more favourable than third party' principle is applied then this will mean for example, that the exposures between the bank and its parent (in either direction) could be no more than 25% of its capital resources. The Report includes a description of the exposure controls in operation in the United States for comparison (see p70).

The Commission acknowledged that its proposals would mean an end to the currently unregulated pattern of bank structures which it describes as a "complex web of legal entities and intra-group relationships".[21] It argues however, that bank structures would retain some flexibility where this did not impinge upon the broader objectives of having a ring fence in the first place. For example, their proposals do not prevent non-bank lending to corporations nor would it prevent groups from dealing with customers across a range of services. They dismiss the view that their solution is too complex to be enforced and cite "precedents in other countries and other sectors" in support.[22]

---

[20] Ibid pp71-72
[21] Ibid p76
[22] Ibid p77

Loss absorbency

Capital

As well as looking at the overall structure of the banking industry, the Commission examined proposals for improving the loss absorbency of individual banks.

It started by examining the current system and illustrated that the higher is a bank's leverage (the more it borrows for any given asset base) the more volatile is the bank's return on capital, such that "relatively small declines in the value of their assets threatened insolvency".[23] This risk was tempered by the existence of implicit government support (the problem of 'moral hazard') but encouraged by the more favourable tax treatment of debt over equity (debt interest is deducted from profits – dividends are distributions of it). There are governance issues too. If debt holders only bear losses on the insolvency of a bank and governments cannot, or will not let banks become insolvent, then debt holders have no incentive to monitor what is done with their money. Taken together:

> So banks' shareholders (and some employees) have an incentive to economise on equity in a way that is not aligned with the interests of wider society. It follows from the above that this incentive arises in two ways. First, the social costs of bank insolvency are greater than the private costs. Second, as a consequence of this banks benefit from an implicit guarantee; this makes debt cheaper than it should be, further incentivising leverage.[24]

The Commission therefore identified a lack of quantity of equity capital amongst the banks and a narrowness of the range of assets which could absorb losses as two key areas for reform.

When the global reform of financial regulation settles banks will hold more capital and more in the form of 'hard' equity' in the future than they did in the past. The Basel III capital requirements set the level at 8% of risk weighted assets, with further extensions for systemically important banks and for counter cyclical buffering.[25]

However, the Commission discussed the pros and cons of extending the capital requirements much higher than this 8% minimum. It focused on equity capital (as opposed to variants of convertible debts) since, it said, "equity is the only form of loss absorbing capacity which works both pre and post resolution (insolvency)". It dismissed the view that higher equity will have a serious impact on banks' ability to function: "Higher equity requirements simply require banks to use less debt and more equity funding".[26] Banks would point out that because of the more favourable tax treatment of debt (see above) their profits may be lower and these costs would be passed onto borrowers. However, if banks use more equity and hence pay more tax, that revenue is not lost to the economy as a whole, it could be recycled in some way either through lower taxes elsewhere or higher government spending. The Commission conclude:

> Moreover, any increase in banks' funding costs from higher minimum equity requirements would not be borne solely by borrowers – it would be likely to be shared with shareholders and employees. So it is not clear how much a bank's average cost of funding would increase with more equity funding, nor how much of any such increase would be passed on to borrowers.[27]

---

[23] Ibid p79
[24] Ibid p82
[25] See Report p84 for full Basel rules
[26] Ibid p86
[27] Ibid p88

The Interim Report argued that "all large UK ring-fenced banks be required to have a minimum equity to risk-weighted assets (RWAs) ratio of at least 10% (plus loss-absorbing debt)."[28] Responses to the proposals covered the entire spectrum of too much to too little. In the Final Report, the Commission proposed that:

> large ring fenced banks should be required to have an equity 'ring-fence buffer' of at least 3% of RWAs *above* the Basel III baseline of 7% of RWAs. (A ring-fenced bank is defined to be 'large' if it's RWAs-to-UK GDP ratio is 3% or above.) Smaller ring-fenced banks should have correspondingly smaller ring-fenced buffers.[29]

Arguments against a higher level were:

- The continuing tax distortion between debt and equity meant that a significant redistribution between debt and equity might mean a negative impact on growth
- Any bank in the EEA could simply 'branch' into the UK and would have a competitive advantage over a UK bank
- High equity requirements might encourage the migration of banking activities away from the mainstream and into 'shadow banking' channels.
- Transitional costs. In the current climate, it would take many years to raise sufficient more new capital to achieve the desired ratios. Banks might therefore look to deleverage (stop lending) as a quicker way to meet the ratio targets. This would be undesirable for the economy as a whole

The Commission stressed that these are minimum ratios; they would expect ratios to be higher at periods when the counter-cyclical Basel phase reaches a peak. The system proposed is composed of several strands. A common reserve plus ring fence buffers, systemic buffers and counter cyclical buffers. According to the proposals Barclays, HSBC, Lloyds, Nationwide, RBS and Santander banks would face the 10% requirement. The Co-Op, Verde and Clydesdale banks would have 7% plus any other ring-fence buffers. All other banks would have a 7% requirement.

Debt bail-ins

As well as banks retaining greater amounts of capital, higher levels of equity could be supplemented by 'loss bearing debt'. Under the current system, equity (shareholders) bears all of the losses whereas bond holders (Greece notwithstanding) bear none unless the bank becomes insolvent. There is no mechanism by which debt can be turned into supporting capital before insolvency takes place. There has been considerable discussion about how such a mechanism might be introduced and what debt instruments might be needed for it to happen. The current term for this process is debt bail-in.

The Commission explain the problems with finding an answer to this problem:

> - Imposing losses on secured debt would fundamentally undermine the concept of taking security under English law.
> - Most ordinary deposits are insured by the Financial Services Compensation Scheme (FSCS), so losses imposed on them would largely fall to the FSCS. The FSCS is funded by other banks, but effectively operates with a taxpayer-

28 Ibid
29 Ibid p99

funded backstop – so losses either act as a channel for contagion from a failed bank to other banks, or are picked up by the taxpayer.

- Imposing losses on derivatives counterparties would prompt them to close out their contracts (where this is permitted under the terms of their contracts). This process is likely to exacerbate losses for the shareholders and other creditors of the failing bank. More damaging could be the disruption to financial markets, including as a result of indirect losses to other market participants resulting from a fire sale of collateral and consequential adverse market and confidence effects.

- There may also be systemic risks involved in imposing losses on 'central counterparties', or in other circumstances where market participants rely on the use of collateral and 'close-out netting' to control their mutual exposures.

- Similarly, imposing losses on short-term unsecured debt and uninsured deposits may – depending on the extent to which such liabilities are regarded as loss bearing *ex ante* – cause significant disruption to funding markets, and act as a channel for contagion from a failing bank to other, previously healthy financial institutions.

- Imposing losses on long-term unsecured debt is more straightforward. (Indeed Tier 2 capital mandated by the Basel III rules takes this form – see Box 4.2.)[30]

The responses in the Interim Report from the industry focused upon the possible impact of convertibility on the pricing of bonds. This would affect contingent capital in particular. The Commission accepted this argument but held that bail-in of debt was different. If a bail-in was needed the bank was unlikely to be able to continue and that the real value of bail-in debt would be to increase the chances of an orderly dissolution of the bank, rather than the more ambitious aim of contingent capital which was to allow the bank to carry on. The Commission therefore recommended two new powers for the regulator:

> First, the authorities should have a 'primary bail-in power' to impose losses in resolution on a set of pre-determined liabilities that are the most readily loss absorbing.
>
> This should include the ability to be able to write down liabilities to recapitalise a bank (or part thereof) in resolution.46 As described in Paragraph 4.63, the class of (non-capital) liabilities that bears loss most readily is long-term unsecured debt. The Commission's view is therefore that all unsecured debt with a term of at least 12 months *at the time of issue* – 'bail-in bonds'47 – should be subject to the primary bail-in power. Bail-in bonds should have specific risk disclosure acknowledging this. To the extent possible, the contractual provisions of any foreign law governed bail-in bonds should expressly make such debt subject to the primary bail-in power.
>
> 4.78 It is useful at this stage to introduce the concept of 'primary loss-absorbing capacity', being those liabilities that can be regarded as constituting the best quality loss absorbing capacity. 'Primary loss-absorbing capacity' is made up of (i) equity; (ii) non-equity capital; and (iii) to reflect the fact that short-term liabilities are less reliable as loss-absorbing capacity,48 those bail-in bonds with a *remaining*49 term of at least 12 months.50
>
> 4.79 Second, the authorities should have a 'secondary bail-in power' that would allow them to impose losses on all unsecured51 liabilities beyond primary loss-absorbing

[30] Ibid p100

capacity (again, including the ability to write down liabilities to re-capitalise a bank) in resolution, if such loss-absorbing capacity does not prove sufficient.

4.80 These bail-in powers should add to the other resolution powers that the authorities have at their disposal. Note in particular that any re-capitalisation of a bank through bail-in would most likely be one aspect of the resolution of a failed bank that may also involve the use of other resolution powers, such as property transfers. Bail-in should not simply be regarded as a tool to be used in isolation to re-capitalise a failed bank without further remedial action.[31]

The Commission used previous historical examples of banking crises to determine the amount of loss-absorbing capacity which it thought was needed. According to this, "requiring systemically important banks to hold primary loss-absorbing capacity up to 20% of risk weighted assets (RWA) would come at low social cost...[and] primary loss absorbing capacity of 17% of RWAs would have been sufficient to cover nearly all of the loss making banks [in the current and previous crises]". The Commission expected this to be introduced gradually, to all big banks in the UK, the large ring-fenced banks and, on a sliding scale, to some smaller banks too.

A summary of the recommendations in this section of the Final Report is shown below:[32]

Recommendations

4.132 Equity

• Ring-fenced banks with a ratio of RWAs to UK GDP of 3% or more should be required to have an equity-to-RWAs ratio of at least 10%.

• Ring-fenced banks with a ratio of RWAs to UK GDP in between 1% and 3% should be required to have a minimum equity-to-RWAs ratio set by a sliding scale from7% to 10%.

4.133 Leverage ratio

• All UK-headquartered banks and all ring-fenced banks should maintain a Tier 1 leverage ratio of at least 3%.

• All ring-fenced banks with a RWAs-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 a RWAs-to-UK GDP ratio of 3%).

4.134 Bail-in

• The resolution authorities should have a primary bail-in power allowing them to impose losses on bail-in bonds in resolution before imposing losses on other non-capital, non-subordinated liabilities.

• The resolution authorities should have a secondary bail-in power to enable them to impose losses on all other unsecured liabilities in resolution, if necessary.

4.135 Depositor preference

[31] Ibid p104
[32] Ibid p121

• In insolvency (and so also in resolution), all insured depositors should rank ahead of other creditors to the extent that those creditors are either unsecured or only secured with a floating charge.

4.136 Primary loss-absorbing capacity

• UK G-SIBs with a 2.5% G-SIB surcharge, and ring-fenced banks with a ratio of RWAs to UK GDP of 3% or more, should be required to have primary loss absorbing capacity equal to at least 17% of RWAs.

• UK G-SIBs with a G-SIB surcharge below 2.5%, and ring-fenced banks with a ratio of RWAs to UK GDP of in between 1% and 3% , should be required to have primary loss-absorbing capacity set by a sliding scale from 10.5% to 17% of RWAs.

4.137 Resolution buffer

• The supervisor of any (i) UK G-SIB; or (ii) ring-fenced bank with a ratio of RWAs to UK GDP of 1% or more, should be able to require the bank to have additional primary loss-absorbing capacity of up to 3% of RWAs if, among other things, the supervisor has concerns about its ability to be resolved at minimum risk to the public purse.

• The supervisor should determine how much additional primary loss-absorbing capacity (if any) is required, what form it should take, and which entities in a group the requirement should apply to, and whether on a (sub-)consolidated or solo basis.

Competition issues

The Commission set out to examine the distinction between "'good competition' to serve customers well, and 'bad competition' that exploits customer unawareness or for example, creates a race to the bottom on lending standards".[33] The Report painted a gloomy picture:

- Most of the bad issues highlighted in the 2000 Cruickshank Report remain;
- The competition authorities have had to intervene on several occasions in recent years;
- The industry is more concentrated post crisis than it was before; and
- Consumer satisfaction levels are low and the perceived costs of exercising market choice by switching accounts are 'remarkably' low.

The Commission recommended

- That the current divestment of RBS and Lloyds Banking Group should be enhanced to create a major new 'challenger' in the market;
- The introduction of an account 'redirection' service for personal and small business accounts to 'boost confidence in the ease of [account] switching';
- Improved transparency of the costs of an account, including interest foregone indicators;
- Competition should be central to financial regulation.

2.5 The Government response to 'Vickers'

The Government gave its response to the Report by way of a statement to the House on 19 December 2011.[34] In short the Government accepted all of the recommendations, with one notable exception.

[33] Ibid p153

It accepted:

- The principle of ring fencing. It was undecided over whether there should be a *de-minimis* exemption for small banks;

- Large retail banks will have to hold equity capital of 10% and a loss absorbing capacity of 17% for large banks. There could be adjustments of this figure for banks with a large overseas operation which could be shown to pose no threat to UK stability if it failed.

- The principle of depositor preference

- Improved competition – easier switching of bank accounts, to be done within seven days by September 2013.

The Government did not accept the recommendation that the divestment of Lloyd's branches should go beyond that required under EU rules.

The Chancellor announced that some changes would be made through the then draft *Financial Services Bill* to give the future Financial Conduct Authority a competition objective; and that the Payments Council and payment systems would be more closely regulated.

The Chancellor gave an estimate for the cost of the reforms. For the banks the cost would be between £3.5 Billion and £8 Billion, and the cost to the economy as a whole is estimated at £0.8 Billion to £1.8 Billion. However, these direct costs were, he said, outweighed by the reduced likelihood of a future crisis, valued at £9.5 billion per year.[35]

Regarding the implementation of the Commission's Report, in his statement the Chancellor said "I can confirm that primary and secondary legislation relating to the ring fence will be completed by the end of this Parliament in May 2015, and that banks will be expected to comply as soon as practically possible thereafter. The Government will work with the banks to develop a reasonable transition timetable."

Previously, during an evidence session to the Joint Committee on the draft Financial Services Bill (see below) the Chancellor said that:

> There may be some features of its recommendations which we are able to put into this Bill, particularly, for example, ensuring that the FCA has a proper regard to competition. We have taken the view—and this is a view shared by John Vickers himself— that to try and shoehorn hastily drafted clauses that would implement the ring-fencing part of the Vickers Report into this very important piece of legislation, which is about the crucial issue of how we as a nation supervise financial services, would have been a mistake and would have risked creating poor legislation. We are absolutely committed to putting the Vickers Report into legislation, but we think it is more appropriate to do that with a separate piece of legislation, which we are also committed to introducing.[36]

[34] HC Deb 19 December 2011 cc1069-1092
[35] Ibid c1072
[36] Joint Committee on Draft Financial Services Bill, Evidence Q1005

3 Consideration of the Vickers Commission's proposals:

The Joint Committee on the Financial Services Bill

The committee set up to provide pre-legislative scrutiny of the *Financial Services Bill 2012* took evidence from a number of witnesses about the Commission's proposals. The Committee's Report can be found here.[37] An extract of some of the evidence given is shown below.

Sir John Vickers, justifying ring fencing as opposed to complete separation of banking and investment arms:

> **Q78 Mr Brown:** In defending the ring fence structure in the House of Commons the Chancellor of the Exchequer, in answer to Michael Meacher, said he thought there were strengths in the investment arm of a bank being able at a time of difficulty in its retail arm to transfer money to support that retail arm. Can you explain how that is compatible with a ring fence?
>
> ***John Vickers***: Let me try. This leads to the question of why we did not recommend a full split. One of the arguments for a full split, some would say, is that it deals emphatically with the risk that problems in the non-retail bit would contaminate the retail arm of the bank despite the greater capital cushions and all the rest of it that go with the retail part of the ring-fence design. The argument in the other direction is the one you have alluded to, which is that, depending on the economic and financial shock at issue, there may be some occasions when the retail side is in trouble and globally things are fine. In that circumstance, with a ring fence as distinct from full split, there would be scope for rest of bank to bring in capital to support the troubled retail operations and see them through it. We took evidence on this. We believed that not only would that possibility exist, but there would be very strong reputational incentives for a wider banking group not to let its retail arm in the UK go in those circumstances. Therefore, there are arguments on both sides as far as that is concerned.
>
> It is not just fanciful to suppose that there might be a UK retail problem and not a global one. As we have seen in some other economies, there may be a domestic property market crash, commercial or residential, given the focus of retail lending, whether it is mortgage lending or business lending secured on commercial property, or companies very much involved in commercial property. You can have domestic shocks. Even with fantastically good macro-prudential regulation, you cannot banish that risk. It seems important to retain the possibility of rest of bank supporting the retail operation.
>
> The other set of reasons we went for ring fence rather than full split was that there are, at least arguably, various kinds of synergy between the different banking operations, some would say a diversification benefit, which a full split would lose. The cost-benefit analysis overall led us to the recommendation here.[38]
>
> **Q85 Lord Maples:** Was the decision as between total split and ring-fencing a difficult one for the commission to make? Was it a finely balanced decision when you thought of this and that, or in the end were you unanimously and overwhelmingly in favour of the ring fence?
>
> ***John Vickers***: As chair of the past commission, we were wonderfully united in our thought process throughout. A year ago I was not counting any chickens at all on that front. I would not describe it as finely balanced as between full split and ring-fence design; we firmly came down in favour of the latter. Rather than it being a binary

[37] Draft Financial Services Bill Joint Committee, First Report, HC 1447– I, 2010-12

[38] Draft Financial Services Bill Joint Committee, Evidence Q302

> decision, in our interim report in April we had spoken in general terms about ring-fencing without fleshing it out, so through the summer a lot of our work was on that. At one extreme, ring-fencing by a matter of degree could end up almost as full split. We thought the right way to go was to have a strong fence, ideally with zero porosity, and yet allow co-ownership of different kinds of activity under the same ultimate corporate umbrella. There is some merit in having the benefit of flexibility about where the line is drawn, and it is not so clear how that would fit with a full split. A final point was that there are some EU law issues that would make a full split more difficult to implement, but that was not the decisive consideration. We had come to the collective view before addressing that legal difficulty that a ring-fence design like this was preferable.[39]

Comments by Sir John Gieve – Deputy Governor of the Bank of England during the financial crisis on whether ring fencing will work:

> **Baroness Wheatcroft:** Among all the stable doors that have been crashing, attempts to find a resolution regime had been foremost in people's minds. On top of that, we now have the ICB report and its suggestion about ring fencing. Do you think ring fencing would serve any purpose? Will it work? Do you trust the system proposed by the ICB?
>
> ***Sir John Gieve***: It is a sensible proposal. I do not think it will work in the sense it will make it possible to let Barclays or Barclays Capital go to the wall in a crisis. When there is a real crisis of confidence the main channels of contagion are not the mechanical question of who owes what to whom and uncertainties over that; it operates much more through confidence. We definitely reached the stage in 2008 when we had to save everything—there was really nothing too little to save—in order to prevent a contagious loss of confidence across the system.
>
> If we get into those circumstances again, as we could quite soon, it may well be impossible for the Government or the authorities to step aside, even with these ring fences, and say, "We're saving only this bit and letting this bit go to the wall." It will make it easier to manage the rescue and make creditors pay towards the cost of it than it was in 2008. If it is operated properly it will lead to a greater transparency in the structure of our big banks which are made up of thousands of intertwined companies, mainly for tax and regulatory reasons. If you can create greater correspondence between the businesses and legal structures that will make the handling of a crisis much easier, and would help you to deal with an idiosyncratic failure in a way that put the Bills in the right place.[40]

Comments by the heads of Barclays, HSBC and Royal Bank of Scotland about the impact of ring fencing on their operations and bank costs:

> **David Mowat:** I would like to turn to the ICB report specifically on ring-fencing. Is it your judgment that they have it about right in their proposals?
>
> ***Stuart Gulliver***: It remains to be seen. As has been said at previous Committees, it is obviously a "done deal". The Government wish to introduce this. It would not be our most preferred way of doing it. To my earlier point, there have been several examples in history of narrow ring-fenced institutions also failing. They are happening in Spain at this moment in time. This is what the UK wishes to do; therefore we will implement it.
>
> **David Mowat:** That sounds like a no.

---

[39] Draft Financial Services Bill Joint Committee, Evidence, p1065

[40] Draft Financial Services Bill Joint Committee, Evidence, p717

Stuart Gulliver: No. We don't really know what the end impact of this is at this moment in time. For example, the number that is in the ICB report does not contain the cost of moving a pension fund from within your ring-fenced bank into your non-ring-fenced bank and having to crystallise all of the catch-up required for your defined benefits scheme. Those kinds of technical details are not covered and are often not in that cost-benefit analysis, for example. Also, when the cost-benefit analysis was applied across all assets in the banking system, it of course includes our global balance sheet at £2.7 trillion, of which 70% is outside the UK so it has a bit of a dilutive effect on the basis point cost of the whole thing. It will absolutely help solve the issue that the ICB has been asked to solve. It will absolutely be implemented and absolutely we will all implement it, but all I am saying is that it is not as crystal clear cut, and nor will it be, until we see what implementation takes place.

Bob Diamond: We keep being asked if it was the right decision. [...] It certainly would not have been my first choice. It will add costs to banking and, therefore, it will increase the cost of borrowing, but we can live with it and we are going to implement it. The decision has been made and so I want to be as positive as I can and run the best ring-fenced bank that I can. There are a lot of positives. There is flexibility. As banks, we certainly would have liked to have said there is one model of ring fence that fits all of us, so let's implement that, but there is not. The Independent Commission and the Chancellor have given flexibility. They have given a time frame that is supportive of not overreacting in the UK. There are a lot of positives to this and we are going to make it work, but it would not have been my first choice.[41]

David Mowat: I want to follow up on your answer. My specific question is whether or not it is feasible for a non-ring-fenced bank of the sort of size that your banks are to be allowed to fail—could you imagine a scenario of that happening and the world carrying on?

Bob Diamond: Yes. It is very important to us. We have asked the FSA to put us right at the front of the queue in terms of a test case, if you will—I don't think it is formally that. We are implementing operational subsidiarisation. We have spent £30 million this year, and we will probably spend half of that again next year, in the hope that, by early next year, at the end of the first quarter, we will have everything in place so that, if there were an issue in some area of the bank, the regulators would be able to provide all that is necessary to allow that to be cauterised and the rest of the bank to operate. There are a lot of moves being implemented around resolution and recovery, bail-in bonds and potential contingent capital which, at the end of the day, we hope very much support that banks can be allowed to fail. So I am saying, yes, I can conceive that.

Stuart Gulliver: I would also say yes. The recovery and resolution work that has taken place with the FSA and the international work that has taken place with the Financial Stability Board is all aligned to reach a situation where an institution such as HSBC, if it were to get into difficulty, could fail in a way that inflicted losses on its equity holders and bond holders but not taxpayers. That would absolutely be the aim.

[...]

On the wider point, we would absolutely expect to be in a situation where nobody is too big to fail. As Bob says, we want to be in a position where we are not beholden to taxpayers in any way, shape or form. We want to be in a situation where our investors carry the losses and we must be resolvable completely.[42]

---

[41] Draft Financial Services Bill Joint Committee, Evidence, 1 November 201,1 p277

[42] Draft Financial Services Bill Joint Committee, Evidence, 1 November 201,1 p279

Comments by the Governor of the Bank of England about whether he agrees with the ICB:

> **David Mowat:** My first question is about the ICB recommendations on the ring fence. Earlier this week we had a session with leaders of the main banks. They seemed to accept the recommendations, or at least were prepared to implement them, or intended to implement them. Is your judgment that the ICB got it about right?
>
> ***Sir Mervyn King***: It is a difficult and complex business. Each person will be tempted to move more or less in that direction. I am broadly comfortable with where they are. It is a very good report. The Government created a commission of outstanding individuals, and it would be unwise to go against their recommendations. They thought it through
>
> **David Mowat:** Have you given any thought to how you would regulate the ring fence?
>
> ***Sir Mervyn King***: The one point that occurs to all those who might be in the regulatory community, depending upon whether the Bill is passed, is: to what extent should the definition of the ring fence be a role for the regulator, as opposed to a role for Parliament in setting out the legislation? Our strong view is that as far as possible this should be done in legislation and not left to the regulator. I say that because the difficulty that will arise with this approach is that the banks and their lawyers will have enormous amounts of money, time and resources to come up with all kinds of clever ways to try to get round the rules set out in legislation. Unless those rules are pretty clear the regulator will be chasing the banks round in a circle and will come under enormous pressure.
>
> One of the major problems in regulation in the last 10 to 20 years has been that of regulatory capture. By that I do not mean people were bought off but that the sheer weight of resources, time and legal effort put in by banks to try to persuade regulators that what they were doing was compliant with the rules made life extraordinarily difficult for the regulators. I would suggest that, as far as possible, you take the ring-fencing aspect of the Vickers Commission proposals in a separate Bill and make sure those are got right in the process of legislation.
>
> **David Mowat:** Is there anything else that you would have liked to see in the ICB report?
>
> ***Sir Mervyn King***: They have examined this in great detail. We talked to them about it. This is now the only game in town. The banks have said they are prepared to accept and implement this. I don't think there is any merit in reopening this, so we should go ahead and implement it.[43]

[43] Draft Financial Services Bill Joint Committee, Evidence, 3 November 2011 p205 &206

The Parliamentary Commission on Banking Standards (PCBS)

The Parliamentary Commission on Banking Standards (PCBS) was set up initially in response to the news that Barclay's (and as it would emerge later, other institutions too) had attempted to manipulate the LIBOR interest rate benchmark and other rates.

Compared to the real economic losses caused by the financial crash any impact of LIBOR related misdeeds is virtually undetectable in scale. However, in the public eye, banks and their employees had suddenly crossed a line. They no longer appeared to be just greedy and/or incompetent, now they had been exposed as 'cheats' and 'fixers' in ways that most people could intuitively understand as being wrong. It was this 'tipping point' event that, as the PCBS would later put it, "public confidence in bankers and banking [was] shaken to its roots". A strong political response was to be expected.

On 16 July 2012 the House approved the following resolution:

> (1) That a Committee of this House be established, to be called the Parliamentary Commission on Banking Standards, to consider and report on—
>
> (a) professional standards and culture of the UK banking sector, taking account of regulatory and competition investigations into the LIBOR rate-setting process;
>
> (b) lessons to be learned about corporate governance, transparency and conflicts of interest, and their implications for regulation and for Government policy;
>
> and to make recommendations for legislative and other action.[1]

Parliamentary Commission's Report

The PCBS's first report was published on 21 December 2013.[44] Although it has a wide remit the Report focused almost entirely on the issue of the structural separation of the activities of banks as proposed by the Vickers Commission. In particular, it looked at the proposals as contained in the draft Bill (see above).

The Report's broad conclusion is that the history of financial regulation suggests that clever, innovative and inventive employees in the financial services industry always have an incentive to test the limits of any prohibition; in a sense to find their way around any prohibition. The Commission's view therefore is that not only should the Government stick to a 'hard line' version of Vickers but that it must also introduce disincentives for firms to try and test the separation boundaries. In its words, the Commission wanted to 'electrify' the ring fence.

The summary of the PCBS's Report is shown below:

[44] Parliamentary Commission on Banking Standards; *First Report*; HC 848, HL 98 2012/13

Separation that can stand the tests of time

Investigations into LIBOR have exposed a culture of culpable greed far removed from the interests of bank customers, corroding trust in the whole financial sector. The separation of deposit-taking from certain investment banking activities can offer benefits not just for financial stability, but also in helping to address the damage done to standards and culture in banking. The Government has proposed a ring-fence to achieve separation, but any ring fence risks being tested and eroded over time. Pressure will come from many quarters. Any new framework will need to be sufficiently robust and durable to withstand the pressures of a future banking cycle. The precautionary approach of regulators will come under pressure from bank lobbying, possibly supported by politicians. Additional steps are essential to provide adequate incentives for the banks to comply not just with the rules of the ring-fence, but also with their spirit. In the absence of the Commission's legislative proposals to 'electrify' the ring-fence, the risk that the ring-fence will eventually fail will be much higher.

Electrifying the ring-fence

The Commission recommends that the ring-fence should be electrified – that banks be given a disincentive to test the limits of the ring-fence. This should take the form of two measures, set out in statute from the start, which could lead to full separation. First, if the regulator has concluded that the conduct of a banking group is such as to create a significant risk that the objectives of the ring-fence would not be met in respect of a particular bank, it should have the power (subject to a Treasury override) to require a banking group to implement full separation. Second, there should be a periodic, independent review of the effectiveness of the ring-fence across all banks, with the first such review to take place four years after implementation. Each review should be required to determine whether ringfencing is achieving the objectives set out in legislation, and to advise whether a move to full separation across the banking sector as a whole is necessary to meet those objectives.

The approach to legislating

The draft Bill relies too heavily on secondary legislation, the absence of drafts of which has seriously impeded the Commission in assessing the Government's reforms. The jury is still out on the question of how faithfully the Bill will implement the ICB recommendations.

Furthermore, reliance on secondary legislation reinforces the risks to the durability of the ring-fence. It creates uncertainty for the regulators who will be charged with making the new framework operational and for the banks required to operate within it. The draft Bill proposes to leave the Government with too much scope to redefine the location of the ringfence arbitrarily. Not only is the scrutiny provided for this inadequate, it will also provide an incentive for bank lobbying. The powers to re-define the ring-fence through secondary legislation need to be subject to more rigorous scrutiny, with changes to the location of the ring-fence to be considered by a small ad hoc joint committee of both Houses of Parliament before formal measures are brought forward.

Capital and leverage

It is essential that the ring-fence should be supported by tougher capital requirements, including a leverage ratio. Determining the leverage ratio is a complex and technical decision, and one which is best made by the regulator. The Financial Policy Committee (FPC) cannot be expected to work with one hand tied behind its back. The FPC should be given the duty of setting the leverage ratio from Spring 2013. The Commission would expect the leverage ratio to be set substantially higher than the 3 per cent minimum required under Basel III.

Sir John Vickers gave oral evidence to the PCBS on 16 January 2013. Extracts are shown below:[45] He was asked whether he supported the general proposition of 'electrification'.

> **Q2562 Chair:** [...] May I begin with our report? Do you think that our proposal to, as we put it, electrify the ring fence will increase the likelihood of your ring fence succeeding, and do you support it?
>
> ***Sir John Vickers:*** [...] The short answer to your question is that I welcome anything that reinforces the ring fence and, in particular, I welcome this Commission's proposals to that end. We are now 16 months on from publishing our final report. Nothing has happened in that period that makes me regret it or doubt that ring-fencing is the right structural ingredient, along with others-loss absorbency and so on-for banking reform in the UK, and many things have happened in that period that make me all the more confident that that is the right approach to implement.
>
> As your report and its analysis and the evidence behind it show, there is no cast-iron guarantee of any structural arrangement-ring-fencing, a full split, Volcker or whatever-working effectively indefinitely without the right incentives and the right vigilance. The proposals for electrification-there are really two lead proposals for electrification-would, I believe, further reinforce the chance of ring-fencing working. I believe it will work. I think this will reinforce it, and that is to the good.
>
> **Q2563 Mark Garnier:** Do you think it is inevitable that banks are going to try to test the limits of the ring fence, and is there a commercial advantage to doing so?
>
> ***Sir John Vickers:*** I am not sure. I think the incentive structure could be such that at least for a period of a significant number of years, they would not necessarily test the limits. On the other hand, they might well do so. [...]
>
> I think that will remain to be seen, but I would not see it as inevitable. I think there are some large questions about the business models of banks in the UK. Remember that our design of ring-fencing has its mandated services, the prohibited activities and a wide range in the middle. Banks might, within the scheme, sit at different points in that middle range and not necessarily near the edges. So it is a risk that one would want to guard against very seriously and effectively, but I would not see it as inevitable that there would be attempts to burrow under and the rest of it.

Sir John was asked about the use of a reserve power to force complete separation if the regulator saw fit:

> **Q2564** ***Sir John Vickers:*** As I hope I indicated when I last appeared before the Commission, there are certainly questions about who has the power, what the checks and balances are, what the circumstances are in which it could legitimately be exercised and so on. Indeed, the carrying out of that action would have property right implications. As I mentioned last time, it is not unprecedented for corporate separations to be required, though the private sector ones that I am aware of have been via Competition Commission processes, which raise a different set of issues. We are coming on to competition later, but the question here is not really about that. Those legal, almost constitutional questions would have to be taken very seriously, but I am not aware of a show-stopper in that regard.
>
> You ask whether credibility would only be attained after the power had been used at least once. Again, I think it could well be a pretty credible threat without being brought into being.

[45] Uncorrected Oral Evidence 16 January 2013 HC606 xxiii

> **Q2567 Mark Garnier:** Did you think that this is a potential nuclear threat and is one that will really secure the validity?
>
> ***Sir John Vickers:*** We, the ICB, believe that it would work even without this threat. I think that the reserve power would further increase the chance of it working, and for longer. It is a question of durability and permanence. That is why I welcome it. I have not spent a lot of time thinking about precisely how that contingency would unfold. There are legal and constitutional issues to be solved, but I am not aware of any reason to think that they are insoluble.

Sir John was asked for his views on the lobbying by the banks against electrification:

> **Q2570 Chair:** They have come forward with one view, which is that it will add to uncertainty and uncertainty is bad, the indication being that the uncertainty from the ring fence proposals are quite bad enough.
>
> ***Sir John Vickers:*** I did not find that an attractive argument because the spirit of the recommendation from your Commission was to increase the certainty that ring-fencing will work. The only way that I can see it increasing uncertainty is if banks indeed intend to play around on the boundary, flirting with it. That was my instant reaction in response to that general argument.
>
> **Q2571 John Thurso:** There is no downside to electrification at all, is there?
>
> ***Sir John Vickers:*** One would need to be confident that the power would be sensibly implemented if the need arose. But, as I said at the outset, I welcome it and the spirit in which it was advanced by this Commission, which was to reinforce the fence, its durability and its permanence.

In its written submission to the Commission the Association of British Bankers said:

> We believe that the problems caused through the inter-relationship between retail and investment banking can be overstated since an evidenced-based view of the financial crisis shows that financial losses arose across the entire banking spectrum, from more traditional retail and commercial banks, big and small, through to building societies, universal banks and pure investment banks. This said, the Government's proposals for ring-fencing include provisions for the ring-fenced entity to have its own independent Board charged with establishing a culture appropriate to the retail-orientation of the business. It is incumbent therefore upon banks with significant retail and SME business to review their cultures, values and service provision in light of the financial stability objectives which sit behind the introduction of ring-fencing. This is in addition to the more general reassessment of risk and risk management taking place under the banking reform programme more generally.

Other Reports and comments

There have been a number of Treasury Committee Reports into matters that are within the Vickers' remit. One in particular *Too Important to Fail - Too Important to Ignore*;[46] looked at the issue of the structure of British banks. The summary sets out the issues behind this key policy area:

[46] Treasury Committee Ninth Report 2009–10, HC 261, March 2010

> This Report looks at the range of reforms currently under consideration, and assesses them against the objectives of an orderly banking system such as protecting the consumer, protecting the taxpayer, setting an appropriate cost of doing business and providing lending to the economy. There are trade-offs between these objectives: the more consumers are protected, the more risks tax payers may have to bear; the more banks have to pay for their capital, the higher the rates they will charge their customers. Policymakers will have to decide where the trade-offs should properly be made and how this should be explained to the public who understandably want to see rapid and sustainable change.
>
> Successful reform would transfer risk away from Government and back into the banking sector. We are clear that radical reform is necessary but it cannot be achieved immediately: if it were done too quickly the cost to banks and to their customers would increase too quickly to be absorbed. But it has to be done. The collapse of Lehman Brothers showed that the failure of an interconnected systemically important international firm has widespread and cataclysmic implications. An indication of improvement will be a system which enables a large international institution to go bankrupt smoothly—and where prices in financial markets do not implicitly or explicitly assume a government guarantee.[47]

The section of the Report on 'Structural Reform' goes to the heart of the issue about whether big, diversified banks are better than narrow, functionally separate banks.

> 90. Mr Corrigan [Managing Director, Goldman Sachs Bank USA] told us that:
>
> It is a little hard for me to envision a world in which we did not have financial institutions of size and financial institutions that have large amounts of capital to commit to the market place. If you look at one of the examples I use in the statement, it is in the aftermath of the crisis we had a situation in which private partners, thank goodness, had been able to raise something in excess of half a trillion dollars in fresh capital for banking institutions. The amount of risk that a small number of institutions had to be willing to 'fess up to accomplish that is very large. It is a little hard for me to see how that would happen if we had a world of just narrow banks.[101]
>
> Mr Varley [Chief Executive, Barclays] was also keen to point out that:
>
> The fundamental point I am making is that investment banking is real economy work. What is it that Barclays Capital does? It offers risk management and financing products to those it serves. Who is on the list of those it serves? The British Government, the French Government, the South African Government, John Lewis, Network Rail and Harvard University. These are real economy players. This is not some activity that takes place in the corner of a room which you might designate as proprietary trading; this is risk management work and it is financing work that lies at the heart of industry and governments to create employment. That is why it is important that these businesses exist within a universal bank.[102]
>
> 91. However, not all the witnesses were as sure of the benefits of large banks. Professor Kay provided the following commentary:
>
> a large part of the synergies which we are talking about in these global banks are to do with tax, regulatory arbitrage and the kind of cross-subsidy we were talking about earlier, so from a public policy point of view we should not have very much sympathy

[47] *Too Important to Fail - Too Important to Ignore*; Treasury Committee Ninth Report 2009–10, HC 261, March 2010

with these synergies—the difference between the structure of HSBC and Barclays that you were describing is a lot more noticeable to Barclays than it is to the customers of either of these two banks. Going on from that, if one talks of other industries, people are endlessly talking in these industries about the desire of large corporations to buy from a single global supplier. I have heard that every year in telecoms, for example, since telecom privatisation began. Most of the evidence is that most of their customers do not: they want to pick and choose who are the best suppliers for particular goods. There are some synergies of that kind, but I do not think we should go overboard about that.[103]

The Governor of the Bank of England stated that: "I do think that I would like to see an outcome in which the size and variety of activities contained within these big institutions, if they are going to be financed in the way they are, is a lot less. To have a small number of big institutions dominating world banking is not a healthy position to be in, and I think the implicit subsidy is in part responsible for that".[104] And Mr Haldane has questioned whether large banks are a necessity:

[...] the economics of banking do not suggest that bigger need be better. Indeed, if large-scale processing of loans risks economising on the collection of information, there might even be diseconomies of scale in banking. The present crisis provides a case study. The desire to make loans a tradable commodity led to a loss of information, as transactions replaced relationships and quantity trumped quality. Within the space of a decade, banks went from monogamy to speed-dating. Evidence from a range of countries paints a revealing picture. There is not a scrap of evidence of economies of scale or scope in banking—of bigger or broader being better— beyond a low size threshold. At least during this crisis, big banks have if anything been found to be less stable than their smaller counterparts, requiring on average larger-scale support. It could be argued that big business needs big banks to supply their needs. But this is not an argument that big businesses themselves endorse, at least according to a recent survey by the Association of Corporate Treasurers.[105]

Or, as Mr Corrigan conceded, although "It is a little hard for me to see how that [recapitalisation] would happen if we had a world of just narrow banks. You can turn around and say maybe we would not have had the problem in the first place."[106]

Andrew Haldane of the Bank of England appeared to give implicit support for the idea of electric ring-fencing before the phrase became current in his October 2012 speech cited above, when he noted that

So how far will existing structural proposals take us in harnessing these benefits? Volcker, Vickers and Liikanen seek legal, financial and operational separation of activities. So in principle each ought to prevent cross-contamination at crisis time. Whether they do so in practice depends on loopholes in, or omissions from, the ring-fence. And each of the existing proposals has open questions on this front.

For example, the Volcker rule separates only a fairly limited range of potentially risky investment bank activities, in the form of proprietary trading. The Vickers proposals mandate only a limited range of basic banking activities to lie within the ring-fence, namely deposit-taking and overdrafts. And the Liikanen plans allow a wide range of derivative activity to lie outside of the investment banking ring-fence.

> It could be argued that these loopholes are modest. But as the history of the Glass-Steagall Act demonstrates, today's loophole can become tomorrow's bolthole, today's ring-fence tomorrow's string vest.[48]

4 The Bill

4.1 Preparation

The Government produced a number of documents prior to the publication of the Bill. In date order they are:

> Banking reform: delivering stability & supporting a sustainable economy.[49]
>
> Sound banking: delivering reform.[50]
>
> Banking reform: a new structure for stability and growth.[51]

The first of these, *Banking reform: delivering stability & supporting a sustainable economy,* set out the broad platform for the Coalition government's plans to implement the Vickers Commission recommendations under three main headings, ring fencing, loss absorbency and competition. The Consultation paper noted that not all of the reforms would require primary legislation although the ring fencing parts would.

Government proposals on ring fencing can be found in part 2 of the paper. The main questions upon which responses were asked for were:

- the distinctions between 'mandated' (services provided only by ring-fenced banks) and 'protected services' all the other banking activities;
- definitions of small firms and high net worth individuals;
- how ring-fenced banks should be insulated in terms of financial exposure from institutions outside the ring, both in terms of their absolute financial exposure and their connectivity through financial products; and
- intra-group links, because the proposal was not for complete separation, issues such as the degree of independence/control, the nature of ownership, the legal form and the governance of the group have to be decided upon.

The second document, *Sound banking: delivering reform*, was both a response to the Consultation paper above and a further consultation in its own right as it included a draft Bill. Developments between the first Consultation and the draft Bill included:

- Provision of a continuity objective for UK financial regulators to "protect the uninterrupted provision of banking services (known as core services);[52]
- The Vickers Commission terminology of 'mandated services' are called instead 'core services;'[53]
- Legislation will be forthcoming to apply the rules to building societies;[54]

---

[48] Speech by Andrew Haldane October 2012
[49] June 2012, Cm 8356
[50] October 2012, Cm 8453
[51] February 2013, Cm 8545
[52] Sound banking: delivering reform, Cm 8453 p7
[53] Ibid p8
[54] Ibid p9

- *De-minimis* exemptions will exist, applying to deposit takers and, by implication to high net worth individuals and large companies. The actual limits will be set by regulations;[55]
- The draft Bill provided for a general power to prohibit activities taking place within the ring fence. Most of these will be set out in secondary legislation. The draft Bill did specify 'dealing in investments as a principal' as an excluded activity. It notes that "this would exclude most of the derivatives and trading activities currently undertaken by wholesale and investment banks"; and[56]
- The drafting of the rules on the 'height' of the ring fence is delegated to the Prudential Regulatory Authority (PRA). The scope of the rules were set out in the draft Bill and closely reflected the Vickers commission's recommendations.[57]

The third document – *Banking reform: a new structure for stability and growth* - included the Government's response to the first report of the PCBS and consequent changes to the draft Bill.

Though the Government response included comments on subjects other than ring fencing this formed the bulk of the Report. Areas where the Bill has been amended since it was in draft are outlined in the section below.

Government amendments to the draft Bill

The Report starts by noting the PCBS's finding for the "widespread, but not universal, support for structural separation in some form" and the majority "view that the partial structural separation... would probably bring significant benefits".[58] It set out the "overall objective of banking reform should be to curtail any perceived implicit guarantees enjoyed by banks seen as too big to fail".[59]

Strength of the 'fence'

The document acknowledged the PCBS's concern that however robust the 'fence' is it will, over time, be either eroded (through regulatory capture) or breached (by innovative firms). In response the Government has given the PRA objective of continuity of core services and has amended the Bill to include this objective within the PRA's general objective so that it "is a central pillar of the PRA's general objective , and not an additional obligation".[60]

The PCBS's proposal to 'electrify' the fence is reprinted in considerable detail in the Report. The actual electricity switch suggested by the PCBS is a power for the regulator to order a firm to separate itself completely from a parent group. The PCBS's comments are shown below:

> Additional powers are essential to provide adequate incentives for the banks to comply not just with the rules of the ring-fence, but also with their spirit. In the absence of the Commission's legislative proposals to electrify the ring-fence, the risk that the ring-fence will eventually fail will be much higher. (Paragraph 163)
>
> The regulator already has powers under section 45 of FSMA to require banks to cease certain activities in specified circumstances. The Commission believes that it is

55 Ibid p9
56 Ibid p10
57 Ibid p11
58 Banking reform: a new structure for stability and growth, p6
59 Ibid
60 Ibid p10

> necessary to go further. The Commission recommends that the forthcoming legislation add reserve powers to implement full separation. (Paragraph 164)
>
> The first reserve power would be a power exercisable in respect of individual companies. A second reserve power would relate to the sector as a whole and would be exercisable in consequences of the review to which we refer in paragraph 171. With regard to the first reserve power, the Bill should include powers for the regulator to take steps that could lead to a specific banking group affected by the ring-fence being required to divest itself fully of either its ring-fenced or its non-ring-fenced bank. The powers would be exercisable only if the regulator had concluded that the conduct of that banking group was such as to create a significant risk that the objectives of the ring-fence would not be met in respect of that bank. In these circumstances the regulator should consider the group's adherence to the principles and spirit of the ring-fence as well as its compliance with the letter of the law. The Commission recommends that the objectives for this purpose should be aligned with those for the relevant work of the regulator set out on the face of the Bill, as amended from the draft Bill in accordance with our recommendation in paragraph 130. (Paragraph 165)
>
> The Commission recommendation is of sufficient significance to require a number of limitations and safeguards. First, in order to allow time for the ring-fence to demonstrate its effectiveness, the Commission recommends that the Bill provides that the powers should not be exercisable by the regulator until after the completion of the first independent review of the effectiveness of the ring-fence that we propose in paragraph 171 and that we envisage should be completed less than four years after the ring-fence comes into force. The opportunity of this delay in commencement should also be taken by the Government to secure amendments to European legislation to ensure that the provisions relating to full structural separation are compatible with European law.[61]

The Government agreed with this analysis and has amended the Bill to:

- Give the regulator a reserve power of separation subject to meeting certain statutory tests;
- The PRA will be required to conduct annual reviews of the operation of the ring fence; and
- The Bill requires that all directors of ring fenced banks must be an approved (by the regulator) person.

Parliamentary scrutiny

The required level of Parliamentary scrutiny of the secondary legislation that will contain much of the fine detail of the separation requirements has been enhanced. The draft affirmative procedure will apply to:

Section 142 regulations regarding:

- exemptions of ring-fenced bodies;
- when accepting deposits is not a core activity, and new core activities;
- exceptions to the excluded activity of dealing in investments as principal;
- new excluded activities;
- prohibitions;
- regulations in relation to pensions;

[61] Ibid p14-15

- requirements on the regulator to make ring-fencing rules in additional areas to achieve the ring-fencing objectives; and
- power in relation to loss absorbency requirements.

Clause 8 regulations: power to make provision about ring fencing in relation to mutuals such as the building societies; and

Section 410A: fees to meet certain expenses of the Treasury, apart from an order made under section 410A(2).[62]

Other amendments made or promised for the Bill

- Requirements on banks to produce 'granular' lending data if voluntary industry schemes do not work; and[63]
- The operation of the *de minimis* rule (smaller institutions need not have split functions) will be assessed with regard to its effect on competition

Impact assessment

The Report also includes the latest impact assessment of the Bill. This is summarised best in the explanatory notes to the Bill (see below). It says:

> Ring-fencing and depositor preference are expected to impose transitional and on-going costs on UK banks: the Government estimates the on-going costs in the range £2bn to £5bn per annum, with one-off transitional cost in the range £1.5bn to £2.5bn. Additional private costs for UK banks are likely to create a cost to GDP: the Government estimates this will lead to a reduction in the long-run level of GDP of between 0.04 and 0.1 per cent, equivalent to an average annual cost to GDP of £0.4bn to £1.1bn. There is also likely to be a consequent cost to the Exchequer in reduced tax receipts, estimated at between £150m and £400m per annum, and in a reduction in the value of the Government's shareholdings in Royal Bank of Scotland and Lloyds Banking Group, estimated in the range £2bn to £5bn relative to a 'do nothing' baseline. There is also expected be a cost to the regulator (PRA) of enforcing the new regulations, estimated at around £2m per annum. The benefits of the preferred option will accrue from increased financial stability. These cannot be quantified precisely (only illustrative estimates are included in the impact assessment) but are expected significantly to exceed the costs of the preferred option.[64]

As it says in the last sentence, the benefits are subject to a wide degree of uncertainty. However, the illustrative figure for benefits used in the assessment is £6.9 billion:

> Illustrative calculation shows that reducing probability of future crises by 10% and severity of future crises by 15% would produce an annual benefit equivalent to 0.47% of GDP (£6.9bn in 2010-11 terms).[65]

4.2 The Bill

A copy of the text of the *Financial Services (Banking Reform) Bill* 2012/13 can be found here. A copy of the accompanying explanatory notes can be found here.

The Bill extends to the entire country.

---

62 Ibid p13
63 Ibid p19
64 Explanatory notes paragraph 102
65 Impact Assessment January 2013

The Bill has 19 clauses and one Schedule. Technically, it follows the pattern of the previous financial services legislation in that it amends the original governing law namely the *Financial Services and Markets Act 2000*.[66] The first eight clauses establish the ring fencing regime as described in the previous sections of this Paper. One clause deals with depositor preference in the event of bank insolvency; and four clauses with aspects of the Financial Services Compensation Scheme. Other clauses deal with fees for Treasury expenditures, the accounts of the Bank of England and the enhanced Parliamentary scrutiny of statutory instruments made under the Act (again discussed above).

As the Impact Assessment explains:

> The Bill will largely be enabling in nature: it will give powers and/or duties to HM Treasury and the regulatory authorities to impose requirements on UK banks. The precise nature of those requirements will be determined by a combination of secondary legislation and rules made by the regulators. These will define the details of, for example, what activities may not be conducted within the ring-fence, and the financial relationships between ring-fenced and non-ring-fenced banks.[67]

Clauses 1 and 2 confer the new 'continuity objective' on both the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) as part of their general objectives. The PRA and FCA are new regulatory bodies established by the *Financial Services Act 2012.* Put simply, it will be the job of the PRA to regulate the larger firms, hence, initially at least, all ring-fenced firms will be regulated by the PRA. The extension of the new objective on the FCA too, is one of a number of examples in the Bill of attempts to 'future-proof' the legislation.

The focus of the clauses as noted in the explanatory notes is that "the PRA is not required to ensure that a particular ring-fenced body does not fail, provided that its failure can be so managed that the continued provision of core services elsewhere in the UK is not adversely affected."[68]

Much of the content of the *Financial Services Act 2012* was about the relationships between the different regulatory bodies and the occasions when one might give directions to act of another. **Clause 3** amends the power of the PRA to direct the FCA in case where the continuity of core services are threatened.

Clause 4 is the heart of the Bill. Just as the 2012 Act inserted large new sections into the original 2000 FSMA, so this clause inserts 15 new sections into FSMA (S142A to S142O).[69]

S142A defines what a ring-fenced body is; **S142B** what a 'core activity' is. The only core activity defined in the Bill is accepting deposits and this is subject to exemptions which the Treasury may provide for. Similar Treasury flexibility surrounds the determination of ring-fenced institutions. Such that the Treasury may introduce the *de-minimis* (small bank) exemption discussed in the Consultations and can exclude banking services for high net worth individuals or large companies from the definition of core activity.

---

[66] The 2000 Act was only recently substantially amended by the Financial Services Act 2012. It is therefore difficult to gain a sense of what the 2000 Act now looks like– because no fully amended version has been yet published. Clause 4 of the Bill for example introduces 15 new clauses after Section 142 of the 2000 Act.

[67] Impact Assessment January 2013

[68] Explanatory notes paragraph 23

[69] This Paper will refer to these by their new section number rather than their clause part

Other core services will be determined by subsequent Order. The explanatory notes say that:

> The definition of core services is intended to be comprehensive, and those services which do not fall within the categories of services listed in *subsection (2)*, and are not specified as core services in an order made by the Treasury under *subsection (3)* or *(4)* will not be core services, however closely they are associated with a particular core activity.[70]

Just as the Bill only defines one core activity – accepting deposits – and allows for others to be included by Order, so it only specifically *excludes* (**S142D**) one activity (an excluded activity) from the 'core' namely 'dealing in investments as principal' (or the firm trading on its own account). However, it gives the Treasury power to provide exceptions so that in some circumstances a ring-fenced firm could undertake its own trades.

New sections **142E** and **142F** give the Treasury directly and the regulators indirectly powers to prohibit actions or activities by ring-fenced firms and thus insulate them from exposure to other financial firms. This power mirrors to a degree the new powers in the *Financial Services Act 2012* where the regulators have general powers to force regulated firms to stop offering products or services irrespective of their strict compliance with the rules.

New section **142G** includes the penalties for contravention. The explanatory notes reflect the balance to be drawn between penalties and possible contractual difficulties where they have taken place. Where a contravention has taken place:

> New section 142 G provides for the consequences where a ring-fenced body carries on any excluded activity, or contravenes any prohibition imposed under new section 142E. Under subsection (1) a ring-fenced body which has done this is treated as having contravened a requirement imposed on that body by the regulator under FSMA. It will in consequence be liable to the disciplinary measures and penalties which the regulators may impose under Part 14 of FSMA. However, under subsection (2), the ring-fenced body will not have committed a criminal offence solely by reason of the contravention, and transactions entered into contrary to a prohibition remain valid. Further, no-one will be able to rely on the contravention to bring an action for breach of statutory duty against the ring-fenced body, unless the Treasury make express provision for this in the exercise of the power given in subsection (3).[71]

New section **142H** imposes the duty on the regulators (in the first instance the PRA) to draw up ring fencing rules. As well as the primary requirement that the firm can undertake its core activity, the rules will cover various aspects of the economic and operational independence of the firm from other firms in the group. New section **141I** gives the Treasury power to extend or alter these rules and to require new rules for 'other areas'.

New section **142K** addresses the issue of the pension liabilities of the ring-fenced firm. The Bill intends that the ring-fenced firm will not be liable for the liabilities of a non ring-fenced firm within the same group. Many of the specific requirements will be set out in later regulations. Firms have until 2025 to ensure they fully meet these requirements.

New section **142M** addresses a different concern of the ICB, namely the loss absorbency of ring-fenced firms. The explanatory notes explain:

[70] Explanatory notes; paragraph 33
[71] Ibid; paragraph 39

> The ICB recommended that certain banks should be required to hold minimum levels of debt (or extra capital in its place if a bank chooses to do this). This is intended to facilitate the exercise of the new powers proposed in the Recovery and Resolution Directive currently being negotiated in the Council of the European Union. If, for example, a bank suffers a significant drop in the value of its assets, the powers proposed in the Directive may be exercised to impose a reduction in the value of the obligations due under the bank's debt before the bank actually becomes insolvent, so reducing the chance that the bank will need to be liquidated, undermining the stability of the financial system.[72]

All the requirements regarding the powers to be given to the regulators over the type and nature of debt instrument will be subject to a future Treasury Order.

The ring fencing principles introduced by the Bill do not meet *all* of the recommendations of the PCBS. Specifically the PCBS suggested that a regulator should be able to enforce separation of the entire banking sector if it concluded that the existing controls (and the threat of enforced separation of one firm) was not working. The Chancellor explained why the Government had not taken this extra step in evidence given to the PCBS on 26 February 2013. The exchange is shown below:

> **Q4309 Mr McFadden:** Chancellor, in our report published just before Christmas, with regard to structural separation, we made recommendations for two reserve powers to go into the Banking Bill. The first was a reserve power with respect to individual banks: they could be broken up if they were trying to game the ring fence or get round the rules. The second, on the basis of an independent review, was a reserve power that could apply to the sector as a whole. In your JP Morgan speech a few weeks ago you accepted the first reserve power but not the second. Could you tell us why you rejected the second reserve power applying to the sector as a whole?
>
> ***Mr Osborne:*** The first thing I can say is that I thought about this quite deeply. I did not lightly turn down one of your recommendations. Of course, it is in the context of having accepted the bank-specific power we are giving the regulator to break that bank up if they are flouting the rules and not ring-fencing themselves in the way that has been intended by the law. That is a pretty powerful new tool that the regulator has-the most powerful tool it probably has. That, I think, meets your demand that the ring fence be electrified.
>
> On that second issue of whether you have a sector-wide power in this legislation, the short answer is I think it would be rather undemocratic. There is an irony here. When I came before you previously you asked me all about the secondary legislation and why more of the content was not on the face of the Bill. I would say that to hand to a Government, even to a Parliament, a simple power to break up the entire banking system, without having to go through the hard work of primary legislation, is a mistake. If a future Government wants to do that, if it feels that the Vickers reforms have completely failed, then it should go to Parliament with primary legislation so it can be properly debated, in the way that the Vickers reforms have been and are being, in order to bring about that complete separation of the industry.
>
> That was my primary motivation. There is a second motivation, which is the one that Mervyn King, who has been quite a strong advocate of structural reform of the banks, gave to this Committee. He said that it would be like a sword of Damocles hanging over the industry.[73]

---

[72] Ibid; paragraph 49

[73] Oral evidence to PCBS, uncorrected evidence, 25 February 2013

Clause 5 inserts the requirement that all directors of ring-fenced firms shall be approved (by the regulator) persons. **Clause 6** requires the PRA to produce an annual report on the "way in which ring-fenced bodies comply with the ring-fencing provisions".[74]

Clause 7 gives effect to Schedule 1. This includes the mechanism by which the core parts of banks or other financial firms are transferred to the ring-fenced institution under what is called a 'ring fencing transfer scheme'.

Clause 8 allows for the legislation to be applied by the Treasury to building societies.

Clauses 9 to 12 relate in one way and another to the situation of the insolvency of a bank and the ability of the Financial Services Compensation Scheme (FSCS) to meet its obligations.

Clause 9 of the Bill amends Schedule 6 of the *Insolvency Act 1986* (IA 1986) and Schedule 3 of the *Bankruptcy (Scotland) Act 1985 (*BSA 1985) to add to the existing categories of preferential debts. Preferential debts are unsecured debts which, by statute, are to be paid in priority to all other debts apart from secured debts (and subject to the expenses of realisation).[75] Preferential debtors rank equally amongst themselves and are required to be paid in full, unless the assets are insufficient to meet them, in which case they share the assets between themselves in proportion to their debts.

Clause 9 provides that deposits which are eligible for protection under the FSCS (so called 'insured deposits') are to be preferential debts in the event of bank insolvency. This means that, such deposits will rank ahead of the claims of other unsecured creditors.[76]

Specifically, clause 9(1) defines the new category of preferential debts. It stipulates the following:

- Where a deposit is within the scope of the FSCS, it will be a preferential debt.
- Where a deposit is not eligible for protection under the FSCS, it will not be a preferential debt.
- If a single depositor has a very large deposit, part of which is not eligible for protection under the FSCS, only the part of that deposit which is covered by the FSCS will be a preferential debt. The remainder of the deposit will not be a preferential debt: it will rank equally to other non-preferred unsecured debts.

Paragraph 15C defines the terms 'eligible deposit' and 'deposit' for the purposes of the new category of preferential debts. Deposits include ex-dormant accounts which have been transferred to authorised reclaim funds under the *Dormant Bank and Building Society Accounts Act 2008.*

In considering the effect of the Bill on Scottish legislation, it is important to note that the IA 1986 covers corporate insolvency in both England and Wales and Scotland, but deals with

---

[74] Explanatory notes; paragraph 56

[75] 'Secured debts' (also referred to as 'fixed charges') are debts which are secured against a particular asset of the company, for example, a mortgage lender who has security against a property. Where there is a fixed charge over an asset, the secured creditor will be paid out of the proceeds of sale of those specific assets, after the costs of realisation have been deducted. In other words, any fixed charged assets are not available for distribution to the 'general' body of creditors).

[76] 'Unsecured creditors' are all other non-secured and non-preferential creditors and are the last external creditors to be paid. These are often unpaid trade creditors (i.e. trade suppliers) and other unsecured loans. This category of unsecured creditors also includes any 'Crown' debts (such as VAT and PAYE). All unsecured debts rank equally with each other.

bankruptcy only in England and Wales. Bankruptcy (or sequestration) in Scotland is dealt with under the BSA 1985. Clause 9(3) of the Bill amends Part 1 of Schedule 3 to the 1985 Act to insert new paragraph 6B. This paragraph makes provision in relation to bankruptcy and sequestration proceedings in Scotland equivalent to the provision made in new paragraphs 15B of Schedule 6 to the IA 1986 which will apply to England and Wales and corporate insolvency proceedings in Scotland. Section 9(4) amends Part 2 of Schedule 3 to the BSA 1985 to insert new paragraph 9A. This paragraph contains equivalent definitions of 'eligible deposit' and 'deposit' to those set out in new paragraph 15C of Schedule 6 to the IA 1986. It should be noted that a balance transferred to an authorised reclaim fund is not mentioned as the insolvency of a reclaim fund in Scotland is subject to the IA 1986, not the BSA 1985

The ICB recommended that deposits protected under the FSCS should be made preferential debts in the event of insolvency. Since the FSCS will take on the claims of insured depositors, the effect of clause 9 will be to increase the amount which the FSCS is able to recover in the event of bank failure, this in turn would reduce the amount required from surviving banks and, arguably, limit the threat of contagion.[77] However, adding a new category of preferential debtors to insolvency legislation may also have the effect of exposing the remaining unsecured creditors to greater risks.

Clauses 10, 11 and 12 also relate to the operation of the FSCS. The scale of the financial crisis exposed the FSCS as being underfunded. In order to meet its liabilities the scheme had to make use of central government funds. In 'normal' times, the scheme had been financed by an industry levy. The new situation whereby public money has been used to finance the scheme has prompted the need for legislation governing responsibility for and accountability for, that money

Clause 10 places a responsibility on the FSCS (the scheme manager) to 'have regard 'to ensure efficiency and effectiveness' in the operation of the FSCS. Clause 11 gives the Treasury the power to require information from the scheme.

Clause 13 enables the Treasury to recoup expenses related to its membership of various organisations connected to 'work in relation to financial stability or financial services'. The actual fees will be set by the appropriate regulator.

[77] *'Banking reform: A new structure for stability and growth'*, article by Jonathan Herbs, Simon Lovegrove, Hannah Meakin, Peter Snowdon, 11 February 2013, [online] Accessed 25 February 2013)